

The Economic Outlook of Taiwan

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I. Introduction

Because of the rather weak recovery in global economy observed at the beginning of this year, the International Monetary Fund (IMF) had revised forecast of global economic growth for 2015 downwards in April. The main reason was unusually weak global trade volume. In July the IMF revised its forecast of global trade volume up to 4.1% because the pace of recovery in advanced economies including the United States and the Eurozone was viewed as solid, supported by strong consumption spending. However, growth of oil exporters, as well as emerging markets and developing countries is suffering because of low oil prices and financial instability, which is dragging the global economy down. Taiwan's economic performance is far weaker than expectation because of the subdued global trade volume as well as the hard landing of China. These factors have dampened the export sector and business investment; Taiwan's GDP in the second quarter of this year was up only 0.52%, following a 3.84% growth in the first quarter. The latest figure shows a slump in exports which implies the economy in Taiwan is losing momentum in the second half of this year. In the following, we briefly discuss recent economic performance and forecasts for each GDP component.

II. Recent Economic Performance

A. Consumption

After considerably weak growth until early 2013, real private consumption has displayed a relatively steady growth pattern recently. Although the food scandal destroyed the food and beverage services industry in the late 2014 the effects were temporary. A sharp decline in oil price has also resulted in a slight deflation and is stimulating consumption intentions in the backdrop of rising real wages (until July). As a result, growth rates of real private consumption were 3.53% and 2.85% in the first and second quarter, respectively, of 2015; this was the fourth consecutive quarter to register a growth of over 2%, reflecting a respectable growth.

On the contrary, real government consumption didn't maintain the 3.69% growth it registered in 2014. The real government consumption experienced a negative growth of -2.66% in the first quarter and a slight increase (0.05%) in the second quarter of this year.

B. Investment

After a strong growth in 2013 gross fixed capital formation decelerated in 2014 mainly because of financial difficulties faced by the government; there was a negative growth in government investment. Though private investment was robust because of attempts to maintain competitiveness in the electronics industry, gross fixed capital formation

declined -0.20% in the first quarter and registered a nominal growth of 1.33% in the second quarter. Besides a decline in government and public utilities investments private investment too was disappointing.

Private investment continues to be weak because of slack demand for electronics, which is also reflected by a marked fall in imports of machineries and electrical equipment for eight consecutive months. Consequently, private investment rose in the first and second quarters this year by 0.76% and 1.38%, respectively, much below the 3.46% in 2014.

Government investment continually declined this year also but at a pace slower than 2014: -1.92% and -1.53% in the first and second quarter, respectively. Meanwhile, the government stopped building the Lungmen Nuclear Power Station and investment by government-owned enterprises declined 30.40% (annualized) in the first quarter, though it bounced back with a 22.80% increase in the second quarter.

C. Exports and Imports

Sluggish growth in China dragged Taiwan's exports down sharply in the first half of this year even though the latest estimate of annual growth of world trade volume this year is higher than in 2013 (3.3%) and 2014 (3.2%). According to the Directorate General of Budget, Accounting and Statistics (DGBAS), the total volume of goods exports in Jan.-Aug. was 189.9 billion U.S. dollars, representing a negative growth of 8.8% year-on-year. Imports also declined 15.5% in the same period. The cumulative trade surplus was 33.3 billion U.S. dollar, up 45.4% on annualized basis.

Share of China (including Hong Kong) in the total volume of exports declined from 39.7% to 38.9% in the first eight months as exports to China were down 10.4% year-on-year. The main reason is that China's imports have been decreasing for the last ten months, since last November, because of weak demand and lower prices. The second and third largest export destinations were ASEAN countries and the U.S., whose shares in the total volume of exports were 18.0% and 12.1%, respectively, in January to August of 2015. While exports to ASEAN declined 12.7% exports to the U.S. grew 1.0%, suggesting weak emerging markets and developing countries and a recovery of the U.S. economy. Though economic recovery was more robust in the Eurozone, exports to Europe registered negative growth. Exports to Japan are also down.

China has replaced Japan as the largest supplier to Taiwan since 2013. Its share rose from 16.1% in 2013 to 19.4% in the first eight months of 2015 while Japan's share has dropped from 17.6% to 16.6% during the same period. The main reason for the

depressed growth in imports from Japan was the loss of competitiveness of machineries and electrical and transport equipment.

Exports of industrial products have declined because of lower export prices but this sector continues to be the major component of Taiwan's exports, accounting for almost 99% over the past few years. Imports of agricultural and industrial materials have declined for twelve consecutive months, leading to a sharp decrease in their share in total imports from 77.8 in Aug. of 2014 to 70.1 this year (first eight months). Share of capital equipment on the other hand has increased from 11.5% to 16.8% in the same period. However, the increasing share of capital equipment is mainly attributed to the weak demand for agricultural and industrial materials rather than domestic investment.

D. Money, Prices and Exchange rates

Due to the weakness in the economy in the first half of the year, loans advanced by financial institutions also decelerated, leading to modest growth in both narrow money supply M1B and broad money supply M2. Moreover, expansion of M1B has been below M2 in the first eight months for the first time since 2011. The latest numbers are 5.86% and 6.01% for M1B and M2, respectively (Aug. 2015).

Because of the continuous fall in crude oil price, consumer price index (CPI) and the core price index in the first nine months were up only -0.52% and 0.80% (year-on-year), respectively. However, due to typhoons, CPI was up 0.68% (0.28% annualized) in Sep., the highest rate in this year.

The wholesale price index (WPI) has been falling along with the downward trend in international commodities prices. As a result, in the first nine months of 2015, the annualized growth rate of WPI was -9.12%. Due to the recent strong performance of the US dollar and the sudden depreciation of RMB in the middle of Aug., the exchange rate for NT dollars has fallen and was ranged from 31.1 to 33.292 in the third quarter.

III. Future Prospects: 2015-2017

A. Consumption

Even though most major institutions believe the global economy will be stronger in the coming months, the weak trade and investment are expected to continually dampen Taiwan's GDP in the rest of 2015. According to the macroeconomic model of Academia Sinica, real GDP is forecast to grow only 1.05% in 2015 reflecting the dismal conditions. Nevertheless, real private consumption, a major component of GDP, still shows a steady growth. For example, sales of food and beverage services and imports of consumer goods grew 2.3% and 11.1% respectively in August. Moreover, with lower prices and

rising wages, the Taiwan consumer confidence index (CCI) has reached a historical high in the first nine months (on average), underpinning a more robust forecast of growth of 3.01% in 2015. However, we expect private consumption to decelerate and grow only 2.27% in 2015 because of the rise in prices, though it is expected to revert to its normal growth pattern (about 3.38%) in 2017 in real terms. Government consumption is projected to decline by 1.35% in 2015 and rise 1.77% in 2016.

B. Investment

A sudden drop in gross fixed capital formation in the first half of this year reflects the concern for the weak external background. Although imports of capital equipment have rebounded since June, there was a decline of 6.0% in September (year-on year). The more detailed data show that the rebound was mainly because of imports of transport equipment. Growth rate of total floor area constructed under new building projects was also negative. In addition, the PMI (Purchasing Managers' Index) has fallen into the contraction territory since July; it was 46.1 in September. All these data suggest investment is losing momentum and therefore we expect real private investment to grow only 0.10% and 2.55% in the third and fourth quarters of 2015, respectively, which translates into a growth of 1.15% on an annualized basis in real terms. However, despite the stimulus plan for the semi-conductor industry, the slowdown in China's growth will still pull business confidence down in the next year and therefore real private investment is expected to register a lower growth of 1.05% in 2016.

Government investment has declined for five consecutive years since 2010 mainly due to budget constraints. According to the 2016 central government budget plan, the budget for public construction and infrastructure would be up 2.33%, a positive change for the first time since 2010. This probably reflects that the government wants to use the increase of government investment to spur private investment as well as the economy. Additionally, after a negative growth of investment by government-owned enterprises in 2015, a positive growth of 4.76% is projected for 2016. Overall, we expect that the average annual growth of gross fixed capital formation will remain weak in 2016 with 1.32% change year-on year and accelerate in 2017 to 6.0%.

C. Exports and Imports

Despite the expectation of recovery in world trade, the performance of the trade sector in Taiwan still suffer from the slowdown of China's imports severely (for more details, please see Section IV) as well as the weakness in ASEAN countries. We believe that the downward trend of China is unavoidable and therefore the long-term growth trend of trade performance in Taiwan should be pessimistic, while the risk of financial

instability that may be caused either by a stronger U.S. dollar or depreciation of RMB is uncertain (for more details, please see Section IV) and needs more attention.

After taking impacts of inflation into account, trade activity is likely to remain weak in the coming year. Therefore, based on our model, real goods and services exports are predicted to grow by -0.07 and 3.02% in 2015 and 2016, respectively. We also expect imports of real goods and services to rise 0.74% and 2.08% in 2015 and 2016, respectively.

D. Money, Prices and Exchange rates

In Sep., the turnaround of inflation rate was mainly due to a 5.85% rise in food prices, caused by typhoons. However, continually dropping oil prices are leading to a possible deflation in Taiwan; especially the core CPI has risen less than 1% for seven consecutive months (Mar. to Sep.). Even though the central bank of Taiwan cut the policy rate to 1.75% on 24 Sep., inflation is unlikely to accelerate in the coming months. Hence, CPI is being projected at -0.62% and 0.25% for 2015 and 2016, respectively. WPI is expected to fall sharply in 2015 (-8.30) due to falling prices of raw materials but will gradually accelerate in 2016 (0.91%). Money supply is expected expand modestly, with M1B and M2 growing 6.67% and 6.86%, respectively, in 2015.

IV. Policy Issues and Uncertainty

A. Hard landing of China

The slow economic growth in China has been an important issue, especially across the region of East Asia, recently. Over the last decade, GDP grew 11.4% on average in 2005-2009 and then decelerated in 2010-2014 to an average growth rate of 8.6%. The IMF expects growth of 6.8% and 6.3% in 2015 and 2016, respectively, and this downward trend will continue, which makes the long term growth rate in 2015-2019 probably less than 6.0%. The economic downturn is mainly attributed to weak investment. More specifically, growth of total fixed investment fell to 5.00% in the third quarter of this year from the average 7.41% for the whole year in 2014. The latest Caixin PMI has been below 50 since March and reached the lowest number after the financial crisis in Sep. The reason for sluggish investment is not only China's attempts to restructure its economy during the 12th (2011-2015) and the 13th (2016-2020) five-year plan periods but also because of a weak global demand for electronics products.

Taiwan is heavily dependent upon exports to China, which implies that the domestic demand in China also affects the Taiwanese economy. Despite the unusual growth of exports to China in 2008-2010 after the financial crisis, the growth rate was strong and

ranged from 12.2% to 14.8% in 2005-2007 but was only ranged from -4.4% to 8.1% in 2011-2014. Although the weak recovery of global economy might explain the subdued numbers, it cannot explain the reason why the share of China in Taiwan's total exports is decreasing; in the latest period it was only 37.8% though it had reached a historical high of 41.8% in 2011. This probably reflects the adjustment from an investment oriented economy to a consumption oriented economy and the rise of "red supply chain" in China.

While the economy in China is supposed to be supported by stable consumer expenditure in the coming years, the degree of change in investment is still volatile. Under the situation that Taiwan's economy has declined more than our expectation, the uncertainty of China's investment will continue to dampen our exports. Therefore, the government should have a clear plan for the future including the reform of the industry.

B. Uncertainty by financial instability

While the world economy is expected to be steadier in the second half of this year, the federal funds rate was not raised in the last FOMC meeting. The main reason was uncertainty in the outlook of the world economy. Especially the lower oil price is still eroding revenues of oil exporters and the strengthening dollar can raise debt burden for countries with weaker currencies.

However, the strengthening dollar is actually the reason why there is a divergent behavior in currencies of emerging markets and developing countries. The RMB was suddenly depreciated by about 3% in the middle of Aug. because export performance of China was viewed as worse than expectation. Consequently, countries who are heavily dependent upon exports to China, including Australia, Taiwan, South Korea, Brazil and Malaysia, etc. choose to depreciate their respective currencies, in order to maintain competitiveness. The details for these dynamic behaviors of currencies can be found in Figure 1.

Moreover, the pressure from the strong U.S. dollar is expected to continue when the Fed raises the rate, which implies that the uncertainty not only in the exchange rate market but also in the equities market will lead to more volatile capital flows and probably drag the economies in emerging markets and developing countries down again.

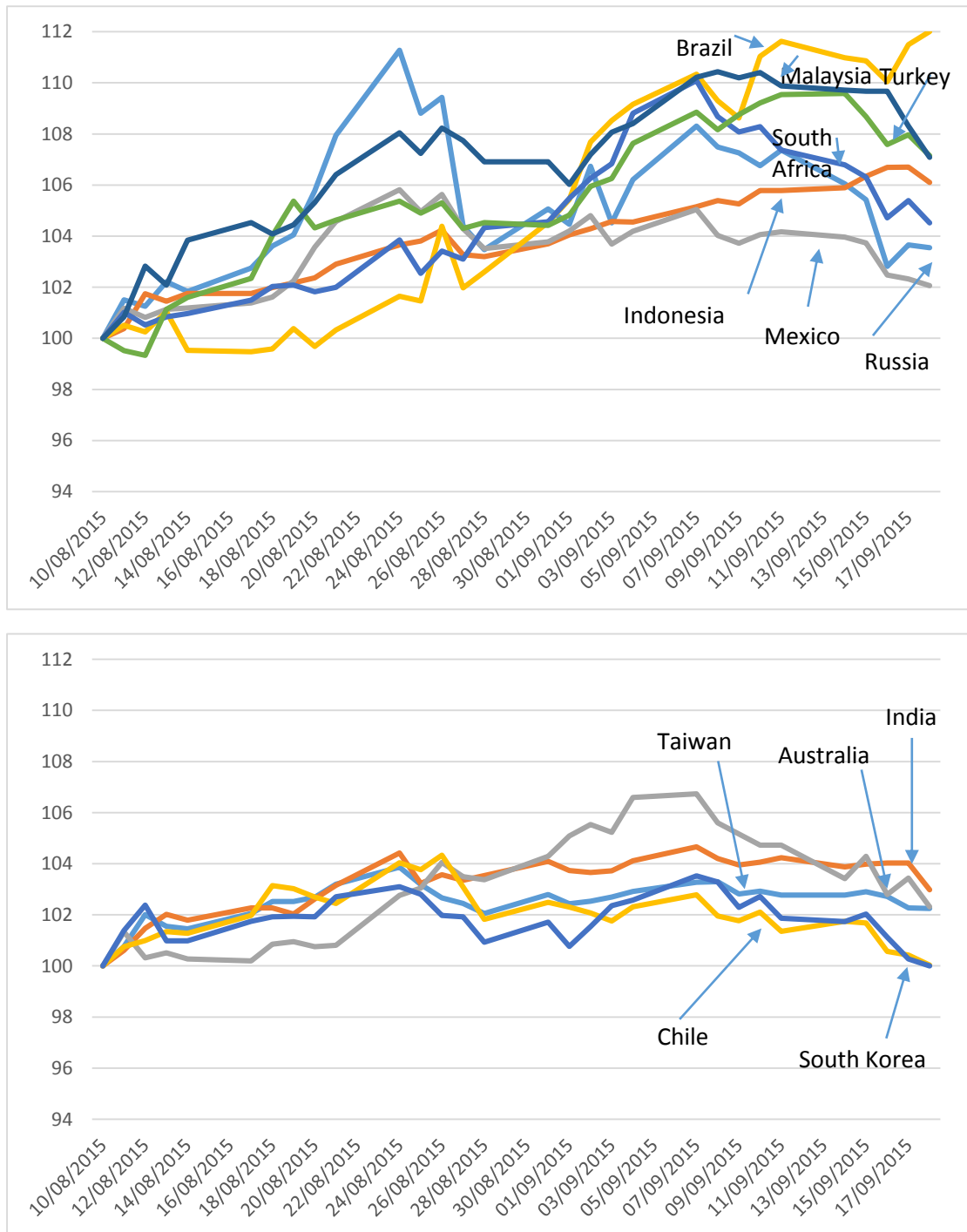


Figure 1. The dynamics of currencies vs.US dollar for some developing countries (Since 2015/08/10)

V. Conclusion

Taiwan's GDP growth in the second quarter of 2015 presented a very weak trend, representing the worst performance since the second quarter of 2012. Looking ahead, probably robust growth in advanced economies in the future will help the Taiwanese economy recover but the most worrisome factor is weak investment in China.

Therefore, the answers to the following questions are still crucial to Taiwan's economic performance in the near future: Will the emerging economies, led by China, keep losing growth momentum? How to respond to the structural change of the "red chain supply"? In sum, the long-term growth in Taiwan is still weak, less than 3% in 2015 and 2016 but might recover in 2017 to 3.66%, in view of the not strong recovery of global economy, world trade, and a weak growth in China.

Taiwan

	2010	%chg	2011	%chg	2012	%chg	2013	%chg	2014	%chg
Aggregate Demand (Billions of NT\$, Current Prices)										
Exports gds+serv	10014	27.93	10420	4.06	10345	-0.71	10580	2.27	11272	6.54
Imports gds+serv	9015	35.02	9457	4.90	9252	-2.17	9194	-0.62	9599	4.40
Gross dom prod	14119	8.93	14312	1.37	14687	2.62	15221	3.64	16084	5.67
Aggregate Demand (Billions of NT\$, 2011 Prices)										
Priv consumption	7563	3.76	7799	3.12	7941	1.82	8128	2.35	8368	2.95
Pub consumption	2126	1.05	2168	1.95	2214	2.16	2189	-1.15	2270	3.69
Fixed invest	3386	19.31	3347	-1.15	3259	-2.61	3422	4.98	3485	1.84
Increase stocks	196	--	36	--	19	--	-34	--	57	--
Exports gds+serv	10000	25.67	10420	4.20	10462	0.41	10830	3.51	11468	5.90
Imports gds+serv	9501	28.03	9457	-0.46	9288	-1.78	9599	3.34	10150	5.75
Gross dom prod	13788	10.63	14312	3.80	14608	2.06	14934	2.23	15497	3.77
Balance of Payments (Billions of U. S. Dollars, Current Prices)										
Exports gds+serv	269.73	34.88	301.84	11.90	296.62	-1.73	301.29	1.58	309.29	2.65
Imports gds+serv	242.41	43.38	272.38	12.36	262.60	-3.59	261.69	-0.35	264.13	0.93
Fob trade bal.	27.32	-11.62	29.45	7.82	34.01	15.48	39.60	16.43	45.16	14.04
Exch rate(loc/\$)	31.65	-4.26	29.47	-6.90	29.62	0.50	29.77	0.52	30.37	2.02
Key Economic Indicators(Index and Billions of NT\$)										
CPI	98.60	0.96	100.00	1.42	101.93	1.93	102.74	0.79	103.97	1.19
Whole sale pr.	95.86	5.46	100.00	4.32	98.84	-1.16	96.44	-2.43	95.89	-0.56
Exports deflator	100.14	1.80	100.00	-0.14	98.88	-1.12	97.70	-1.19	98.28	0.59
Import deflator	94.89	5.46	100.00	5.39	99.61	-0.39	95.79	-3.83	94.57	-1.27
GDP deflator	102.40	-1.54	100.00	-2.34	100.54	0.54	101.93	1.38	103.79	1.82
Money Supply,M2	29966	4.53	31714	5.83	33038	4.17	34617	4.78	36577	5.66

Taiwan

	2015	%chg	2016	%chg	2017	%chg
Aggregate Demand (Billions of NT\$, Current Prices)						
Exports gds+serv	10869	-3.57	11209	3.12	12069	7.67
Imports gds+serv	8706	-9.30	9007	3.45	10010	11.15
Gross dom prod	16698	3.82	17109	2.47	18056	5.53
Aggregate Demand (Billions of NT\$, 2011 Prices)						
Priv consumption	8620	3.01	8815	2.27	9113	3.38
Pub consumption	2237	-1.42	2264	1.19	2325	2.69
Fixed invest	3499	0.41	3545	1.32	3758	6.00
Increase stocks	--	--	--	--	--	--
Exports gds+serv	11460	-0.07	11806	3.02	12532	6.15
Imports gds+serv	10225	0.74	10438	2.08	11123	6.56
Gross dom prod	15660	1.05	16034	2.39	16621	3.66
Balance of Payments (Billions of U. S. Dollars, Current Prices)						
Exports gds	283.51	-8.97	281.90	-0.57	306.84	8.85
Imports gds	225.40	-16.50	235.20	4.35	266.11	13.14
Fob trade bal.	58.12	28.69	46.70	-19.64	40.73	-12.80
Exch rate(loc/\$)	32.35	6.52	32.79	0.73	32.79	0.00
Key Economic Indicators(Index and Billions of NT\$)						
CPI	103.32	-0.62	103.58	0.25	105.44	1.79
Whole sale pr.	87.93	-8.30	88.73	0.91	90.60	2.10
Exports deflator	94.84	-3.50	94.94	0.10	96.30	1.44
Import deflator	85.14	-9.97	86.28	1.34	90.00	4.30
GDP deflator	106.63	2.73	106.71	0.08	108.63	1.80
Money Supply,M2	39086	6.86	41434	6.01	44029	6.26