example, the Korean won) and could potentially compromise the stability of their financial markets and commodity prices (Chart 2.11). Moreover, in those countries with less flexible exchange rate regimes, large capital inflows could complicate the implementation of monetary and exchange rate policies, increasing difficulties to safeguard financial stability. The IMF encourages policymakers in these emerging economies to use macroeconomic policies and macroprudential policies in response to the capital inflow surges. Alternatively, introduction of capital controls could be considered given that these policy measures appear to be insufficient and the capital inflows are likely to be temporary.

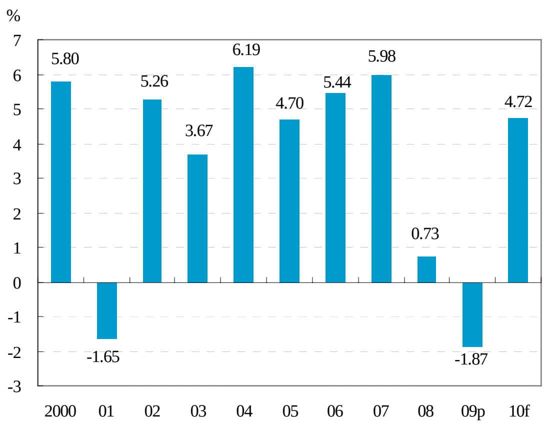
2.2 Domestic economic and financial conditions

In line with the ongoing revival of the global economy, Taiwan's economy recovered steadily and turned to positive growth in 2009 Q4. Domestic prices remained stable. Fueled by the current account surplus and ample foreign exchange reserves, short-term external debt servicing ability remained strong. Overall external debt servicing ability was robust due to a contraction in the scale of external debt. Nevertheless, the government's fiscal deficits widened along with rising government debt.

Domestic economy resumed growth

Driven by shrinking exports, slack private consumption and a sharp contraction in private investment, the economy dropped to negative growth of -9.06% and -6.85% in 2009 Q1 and Q2, respectively. In the latter half of 2009, benefiting from the global economic recovery, the momentum in exports strengthened. As the global economic outlook improved dramatically, along with rising private consumption and investment, and an expansion in public expenditure, the domestic economy showed signs of recovery. As a result of the fledgling economic recovery and the influence of a low base, the downward movement in domestic output improved significantly and posted negative growth of merely -0.98% in Q3. Moreover, the growth rate turned to positive 9.22% in Q4, the highest growth rate recorded since 2004 Q3. Based on DGBAS statistics (Chart 2.12), annual economic growth registered -1.87% for 2009, 2.60

Chart 2.12 Economic growth in Taiwan



Note: Figure for 2009 is preliminary, while figure for 2010 is forecast by DGBAS.
Source: DGBAS.

percentage points lower than the previous year.

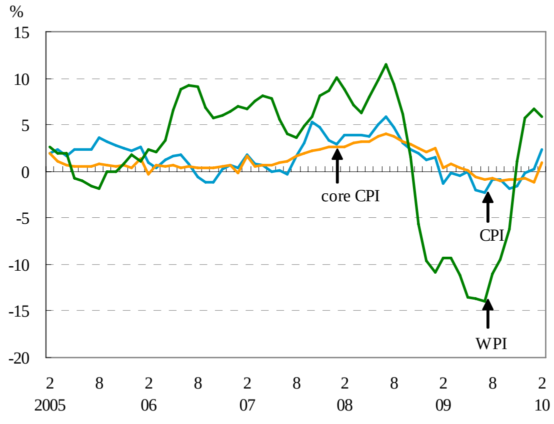
Looking ahead, the brighter global economic situation may continue to boost Taiwan's exports and private investment, and the mild growth in private consumption is likely to sustain. The DGBAS predicts annual economic growth will increase to 4.72%[14] in 2010 (Chart 2.12).

Domestic prices remained stable

The international prices of crude oil and agricultural and industrial raw materials rebounded from the beginning of 2009 as a result of the global economic recovery but exhibited a large decrease compared to the same period of the previous year. The wholesale price index (WPI) inflation rate continued to drop but gradually rebounded after reaching a trough of -13.99% in July 2009. The annual WPI inflation rate dropped to -8.74% in 2009, far below the 5.15% a year earlier. Affected by declines in oil prices, coupled with slackness in effective demand owing to higher unemployment rates and shrinking wages, the CPI inflation rate in 2009 was negative for eleven consecutive months, except for the Chinese Lunar New Year effect in January. Similarly, the core CPI[15] inflation rate was negative for seven consecutive months from June 2009 (Chart 2.13). The annual CPI and core CPI inflation rates in 2009 were -0.87% and -0.14%, respectively, lower than the 3.53% and 3.08% a year earlier.

The average WPI inflation rate from January to February 2010 accelerated to 6.31%, while the average CPI and core CPI inflation rates registered 1.30% and -0.06%,[16] respectively, over the same period (Chart 2.13). As the prices of crude oil and agricultural and industrial raw materials keep ascending in line with the upturn in global demand and abundant liquidity in the banking system, the DGBAS projects the annual WPI and CPI inflation rates in 2010 to rise to 4.78% and 1.27%,[17] respectively.

Chart 2.13 Consumer and wholesale price inflation rates



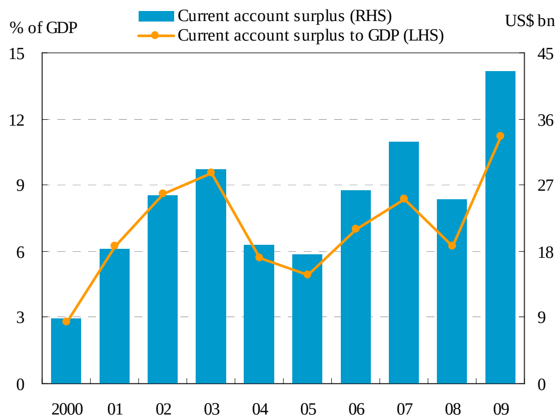
Note: Figures are measured on a year-on-year change basis.
Source: DGBAS.

[14] The figures are based on a DGBAS press release on 22 February 2010.
[15] The term "core CPI" in this report refers to a consumer price index excluding perishable fresh fruits and vegetables, fish and shellfish, and energy.
[16] The figures are based on a DGBAS press release on 5 March 2010.
[17] The figures are based on a DGBAS press release on 22 February 2010.

Persisting current account surpluses and abundant foreign exchange reserves

Taiwan's imports and exports both experienced declines in the first three quarters of 2009. Nevertheless, the decrease in imports was larger than that of exports, and hence the current account surplus persisted. Meanwhile, there was an ongoing accumulation of the trade surplus caused by import and export surges in Q4. As a result, the annual current account surplus was US$42.57 billion in 2009, increasing notably by 69.46% compared to that in 2008. The ratio of the current account surplus in relation to annual GDP registered 11.22%[18] through the whole of 2009 (Chart 2.14).

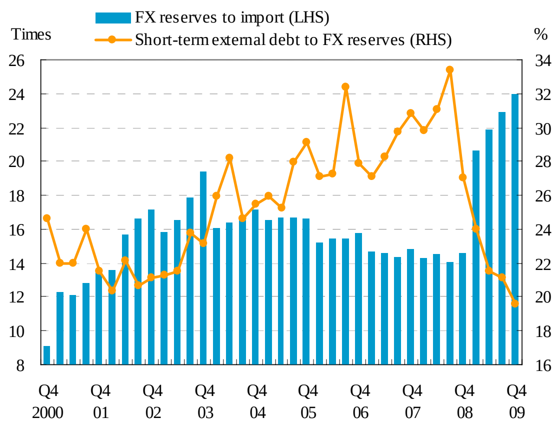
Chart 2.14 Current account surplus



Note: Current account surplus and GDP are annual figures.
Sources: CBC and DGBAS.

The balance of payments recorded a surplus of US$54.13 billion in 2009 owing to the continued current account surplus and sustained net inflows in the financial account from non-resident securities investments and other investments. This, coupled with the fact that major currencies (such as the euro and pound) held as part of the foreign exchange reserves appreciated against the US dollar over the same period, caused Taiwan's foreign exchange reserves to continue accumulating and reach a high of US$348.2 billion at the end of 2009, and further up to US$355 billion at the end of March 2010. Therefore, it reflects that foreign exchange reserves are sufficient. Moreover, foreign exchange reserves at the end of 2009[19] were enough to cover 23.96 months of imports, while the ratio of short-term external debt to foreign exchange reserves dropped sharply to 19.60% over the same period.[20] This was affected by the increase in foreign exchange reserves, as well as the decline in imports and short-term

Chart 2.15 Short-term external debt servicing capacity



Notes: 1. FX reserves and external debt are end-of-period figures.
2. Imports are average monthly figures.
Sources: CBC, DGBAS and MOF.

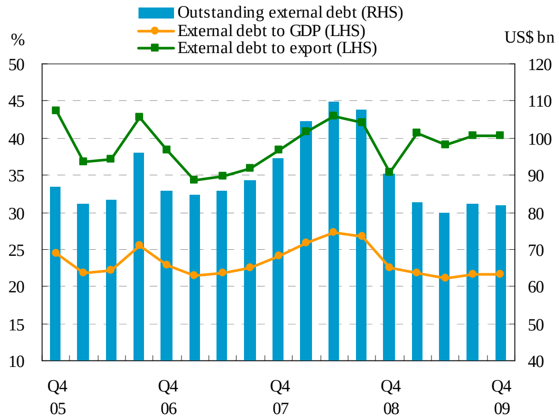
[18] For the ratio of current account deficit to GDP, the cutoff point for risk is 3%. A country in which the reading is greater than 3% and has risen by at least 5 percentage points from the previous year is considered to be at relatively high risk.
[19] A country with an import cover of foreign exchange reserves more than three months is considered to be at relatively low risk.
[20] The general international consensus is that a reading of less than 50% indicates relatively low risk.

external debt. These data imply that Taiwan's foreign exchange reserves have a strong capacity to meet payment obligations for imports and to service short-term external debt (Chart 2.15).

External debt contracted and debt servicing capacity remained strong

There was a substantial reduction in Taiwan's external debt[21] in the first half of 2009 caused by a fall in private external debt. However, external debt increased in 2009 Q3, triggered by increasing foreign capital inflows to local bond investments. Outstanding external debt rose to US$82 billion, or 21.62% of annual GDP, at the end of 2009.[22] Moreover, the ratio of external debt to annual exports stood at 40.27% as of the end of 2009, higher than a year earlier. Nevertheless, export revenues were still sufficient to cover external debt (Chart 2.16), and there were no signs of servicing pressure on external debt.[23]

Chart 2.16 External debt servicing capacity

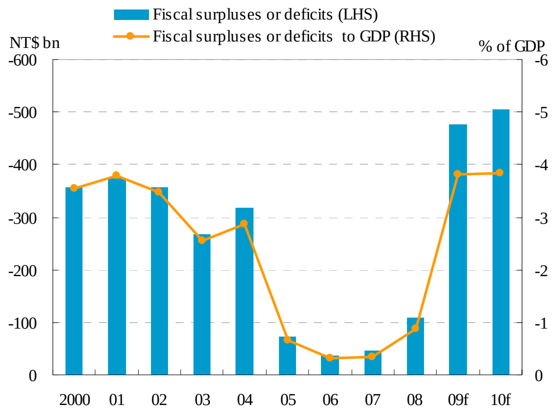


Notes: 1. External debt are end-of-period figures.
2. GDP and exports are annual figures.
Sources: CBC and DGBAS.

Rising fiscal deficits increased government debt

Driven by the implementation of measures aimed at revitalizing the economy and promoting consumption from September 2008 onwards, fiscal deficits trended upwards. The fiscal budget deficit in 2009 expanded to NT$476.4 billion, or 3.80% of annual GDP,

Chart 2.17 Fiscal position



Notes: 1. Fiscal position data includes those of central and local governments.
2. Data of fiscal surpluses (deficits) are end-of-period figures. Figures for 2009 and 2010 are budgeted ones.
Sources: MOF and DGBAS.

[21] External debt is defined by the CBC as the combined amount owed to foreign parties by Taiwan's public and private sectors, including long-term debt with a maturity of greater than one year and short-term debt with a maturity of one year or less. The term "public external debt" refers to debt that the public sector is either obligated to repay directly or has guaranteed (starting from December 2004, figures for public external debt include outstanding foreign debt arising from repo transactions between the CBC and international financial institutions). The term "private external debt" refers to private-sector foreign debt that are not guaranteed by the public sector.

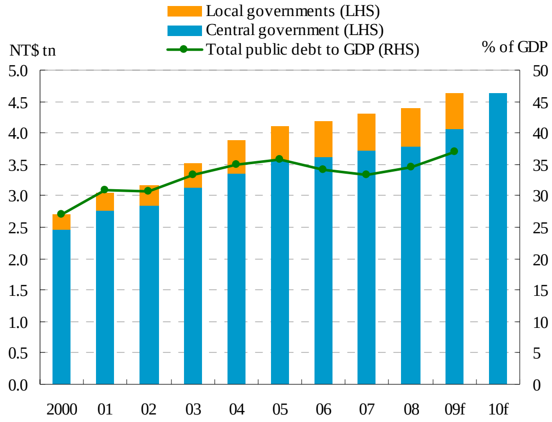
[22] The general international consensus is that a country with the ratio of external debt to GDP lower than 50% is deemed to be at relatively low risk.

[23] The general international consensus is that a ratio of external debt to exports of less than 100% indicates relatively low risk.

and the ratio may further increase to 3.85%[24] in 2010 (Chart 2.17).

In 2009, outstanding public debt at all levels of government[25] expanded to NT$4.64 trillion, or 37.03%[26] of annual GDP, well above the NT$4.38 trillion[27] in 2008, as fiscal deficits increased and central and local governments relied on debt issuance to finance debt servicing expenditures. It is expected that public debt is likely to grow further in 2010 on the back of increasing public debt for supporting the expansion of infrastructure construction expenditures (Chart 2.18).

Chart 2.18 Public debt



Notes: 1. Outstanding public debt refers to non-self-liquidating debt with a maturity of one year or longer, excluding external debt.
2. Outstanding public debt for 2009 and 2010 are budgeted figures; data of 2010 for local governments is not available.

Sources: MOF and DGBAS.

[24] Under the 1992 European Union Maastricht Treaty and the subsequent Stability and Growth Pact, fiscal deficits in EU member nations are not allowed to exceed 3% of GDP.

[25] The term “outstanding debt at all levels of government” as used in this report refers to outstanding non-self-liquidating debt with a maturity of one year or longer. Final audited figures for outstanding one-year-or-longer non-self-liquidating public debt (NT$4.4 trillion) issued by all levels of government during the 2008 fiscal year is equivalent to 35.01% of the average GNP for the preceding three fiscal years (NT$12.5 trillion). This figure is below the ceiling of 48% (i.e. 40% for central government and 8% for local governments) set out in the Public Debt Act.

[26] Under the Maastricht Treaty and the subsequent Stability and Growth Pact, outstanding debt in EU member nations is not allowed to exceed 60% of GDP.

[27] If adding in debt with a maturity of less than one year and self-liquidating debt, outstanding public debt at the end of 2008 stood at NT$5.33 trillion.