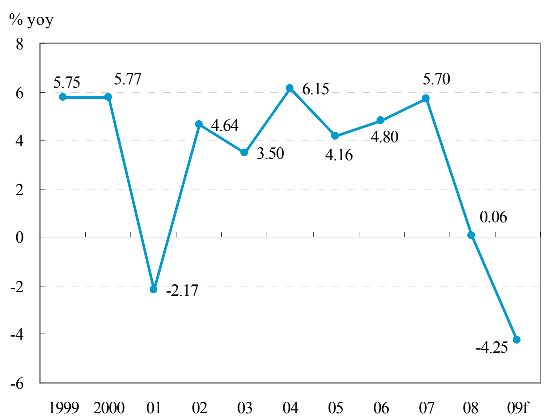
III. Domestic economic and financial conditions

Taiwan's economic growth turned negative in the second half of 2008 and inflationary pressures receded. Nevertheless, short-term external debt servicing ability remained strong as a result of abundant foreign exchange reserves, a current account surplus and a contraction in the scale of external debt. However, the outstanding balance of the government's debts increased due to rising fiscal deficits.

Domestic economy entered a downturn

In the second half of 2008, worsening international financial conditions and a declining world economy severely affected Taiwan's export momentum and the production of its manufacturing sector. Domestic enterprises responded with large-scale layoffs or requiring employees to take unpaid leave. As a result, the domestic unemployment rate increased dramatically, which in turn had a negative impact on private consumption. Private investment also shrank rapidly against the backdrop of a precipitous drop in corporate profitability and an uncertain economic outlook. Statistics from the DGBAS indicated that Taiwan's economic growth registered -1.05% in 2008 Q3, and further deteriorated to -8.61% in 2008 Q4, causing annual economic growth to decline materially to 0.06% in 2008 from the previous year's 5.70% (Chart 3.1). Looking ahead, the sharp global economic downturn may continue to affect Taiwan's exports and private investment despite the government's persistent efforts to mitigate its adverse impacts by taking measures to expand public investment and domestic demand. The DGBAS forecasted that Taiwan's economy would post a negative growth rate of -4.25% in 2009. Its preliminary statistics revealed that the economic growth rate fell to a trough of -10.24% in 2009 Q1 owing to a marked contraction in exports. However, it was expected to gradually improve from Q2

Chart 3.1 Economic growth in Taiwan



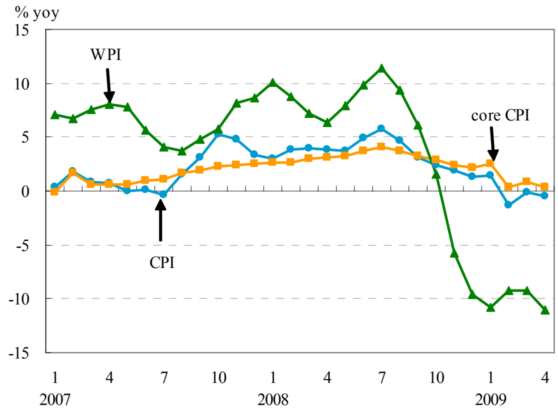
Note: Figure for 2009 is DGBAS forecast.
Source: DGBAS.

onwards and become positive in Q4.

Inflationary pressures receded

The average CPI and core CPI[10] inflation rates increased to 3.53% and 3.08% in 2008, respectively. Both were 1.73 percentage points higher than the previous year. The average WPI inflation rate fell to 5.15% in 2008 from 6.47% a year earlier. After reaching their peaks in July 2008, the deteriorating world economy and sharp declines in the prices of crude oil, raw materials and commodities contributed to the falls in the WPI, CPI and core CPI. The fall was especially significant for the WPI inflation rate which dropped into negative territory from November 2008 onwards (Chart 3.2).

Chart 3.2 Consumer and wholesale price inflation rates



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

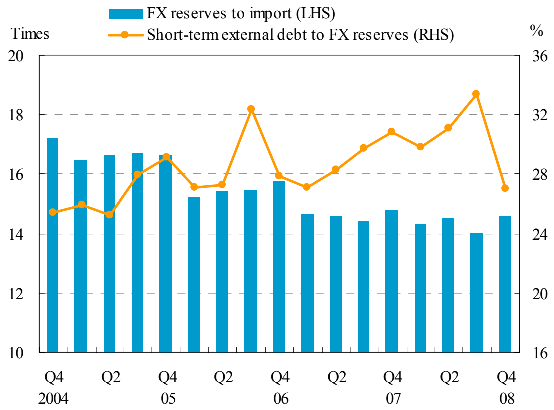
The average WPI inflation rate from January through April of 2009 decelerated to -10.09%, year on year, while that of the CPI and core CPI stood at -0.12% and 1.02%,[11] respectively. It was expected that manufacturers' production costs would decrease and domestic energy and services prices would remain stable on the back of the global economic slowdown, shrinking demand, and the substantial drop in the prices of crude oil and agricultural and industrial raw materials. The DGBAS projected the annual WPI and CPI inflation rates in 2009 to fall to 7.75% and 0.84%, respectively.[12]

[10] The term "core CPI" in this report refers to a consumer price index excluding perishable fresh fruits and vegetables, fish and shellfish, and energy.
[11] The figures are based on a DGBAS press release on 5 May 2009.
[12] The figures are based on a DGBAS press release on 21 May 2009.

Current account surpluses persisted and foreign exchange reserves remained sufficient

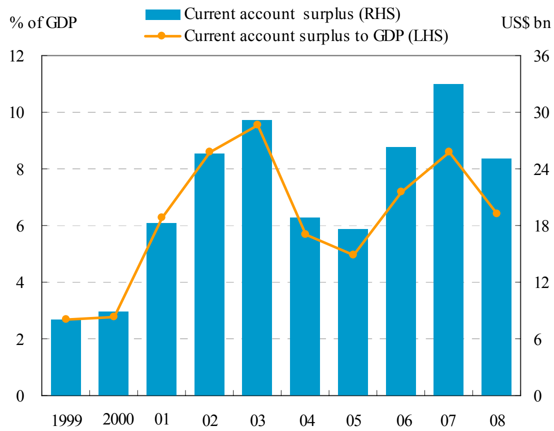
Taiwan's foreign exchange reserves continued to accumulate and reached US$291.7 billion at the end of 2008 despite a temporary fall in Q3 caused by net foreign capital outflows. The outstanding amount further grew to US$304.7 billion in April 2009, reflecting sufficient foreign exchange reserves. As of the end of 2008, foreign exchange reserves were enough to cover 14.56 months of imports,[13] while the ratio of short-term external debt to foreign exchange reserves declined notably to 27%[14] due to a sharp contraction in short-term external debt. These data indicate that Taiwan's foreign exchange reserves have a strong capacity to meet payment obligations for imports and to service short-term external debt (Chart 3.3). In addition, the current account recorded a surplus of US$25 billion in 2008. Nevertheless, the value was 24.12% less than the previous year, mainly due to a sharp contraction in trade surpluses. As a result, the ratio of the current account surplus to GDP dropped to 6.4% in 2008 from 8.57%[15] a year earlier (Chart 3.4).

Chart 3.3 Short-term external debt servicing capacity



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

Chart 3.4 Current account surplus



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

[13] See "Damocles: Testing Times Ahead," Lehman Brothers, 22 July 2004. For import cover of foreign exchange reserves, the cutoff point for risk is three months. A country with an import cover of less than three months is considered to be at relatively high risk.

[14] See Wu Yih-Jiuan, " Taiwan's financial crisis early warning system [in Chinese]" (April 2003), quoting the country risk scoring system of JP Morgan and similar scoring system benchmarks from American Express Bank. The general international consensus is that a reading of less than 50% indicates relatively low risk.

[15] See Note 13. 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.

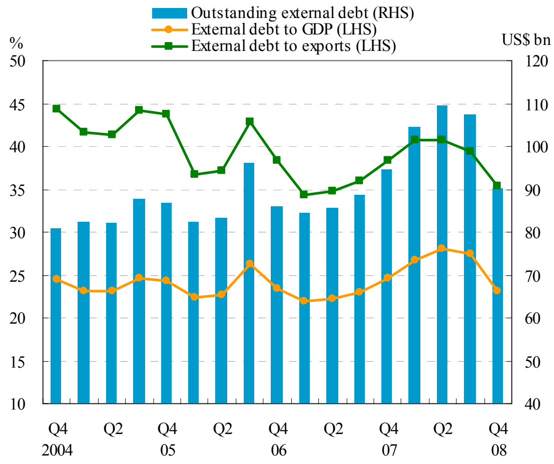
External debt trended downward and servicing capacity remained strong

Taiwan's external debt[16] grew substantially in the first half of 2008, fueled by a rise in net capital inflows. However, external debt shrank substantially in 2008 Q4 due to a reversal of foreign capital flows. As of the end of 2008, outstanding external debt declined to US$90.3 billion or 23.07% of annual GDP, far lower than the internationally recognized warning level of 50%.[17] Meanwhile, the ratio of external debt to annual exports decreased to 35.51%, indicating that export revenues were sufficient to cover external debt (Chart 3.5), and there were no signs of servicing pressure on external debt.[18]

Rising fiscal deficits likely to increase government debts

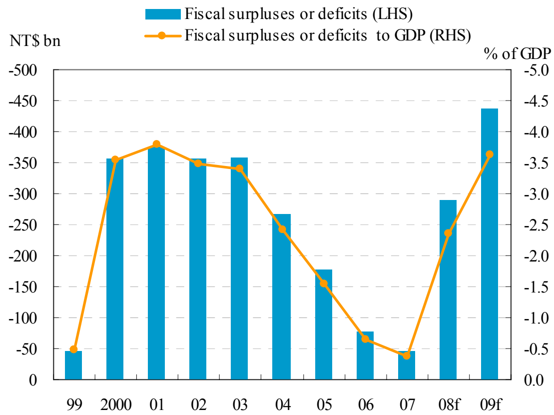
Fiscal deficits fell to a low of NT$46.8 billion at the end of 2007. In 2008, however, the fiscal budget deficit expanded to NT$290.5 billion, or 2.35% of annual GDP, driven by increasing infrastructure spending aimed at spurring domestic demand (Chart 3.6). The ratio, nevertheless, is still below the internationally recognized warning level.[19]

Chart 3.5 External debt servicing capacity



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

Chart 3.6 Fiscal positions



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 2008 and 2009 are budgeted ones.
Sources: MOF and DGBAS.

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16 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 debts with a maturity of greater than one year and short-term debts with a maturity of one year or less. The term "public external debt" refers to debts 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 debts arising from repo transactions between the CBC and international financial institutions). The term "private external debt" refers to private-sector foreign debts that are not guaranteed by the public sector.

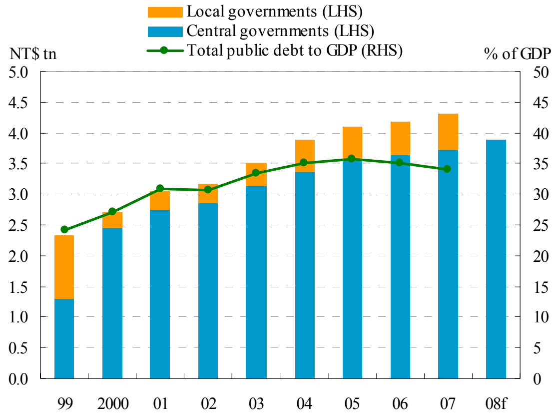
17 See Note 13. For the ratio of external debt to GDP, the cutoff point for risk is 50%. A country with a ratio higher than 50% is deemed to be at relatively high risk.

18 See Note 14. A ratio of external debt to exports of less than 100% indicates relatively low risk.

19 See Note 14. Under the 1992 European Union Maastricht Treaty and the subsequent Stability and Growth Pacts, fiscal deficits in EU member nations are not allowed to exceed 3% of GDP.

As fiscal deficits rose and central and local governments relied on debt issuance to finance debt servicing expenditures, outstanding public debts at all levels of government[20] increased steadily from the late 1990s and stood at NT$4.3 trillion, or 34.07% of annual GDP, at the end of 2007,[21] well below the internationally recognized warning level.[22] In 2008, the central government's outstanding public debt increased steadily to NT$3.9 trillion because of the influence of rising infrastructure construction expenditures. Looking ahead, public debts are likely to grow further in 2009 on the back of ongoing implementation of economic stimulus measures (Chart 3.7).

Chart 3.7 Public debts



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 2008 is budgeted figure, while the 2008 data for local government is not available.

Sources: MOF and DGBAS.

[20] The term "outstanding debts at all levels of government" as used in this report refers to outstanding non-self-liquidating debts with a maturity of one year or longer. Final audited figures for outstanding one-year-or-longer non-self-liquidating public debt (NT$4.3 trillion) issued by all levels of government during the 2007 fiscal year within their general budgets and extraordinary budgets is equivalent to 36.47% of the average GNP for the preceding three fiscal years (NT$11.8 trillion). This figure is below the ceiling of 48% set out in the Public Debt Act.

[21] This figure indicates the amount of non-self-liquidating debts with a maturity of one year or more issued by all levels of government. If adding in debt with a maturity of less than one year and self-liquidating debt, outstanding government debt as of 31 December 2007 stood at NT$4.7 trillion.

[22] See Note 14. 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.