2.2 Domestic economic and financial conditions

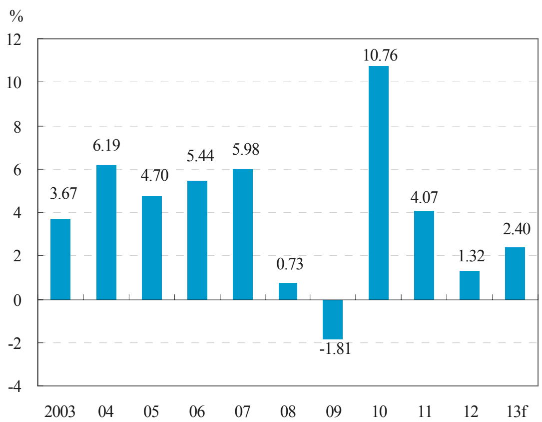
Taiwan's economy grew at a decelerated pace in 2012 compared to the previous year due to weaker foreign demand. Meanwhile, the rise in the price level remained moderate. Short-term external debt servicing ability remained strong on the back of a continued surplus in the current account and ample foreign exchange reserves. Although the scale of external debt continued to expand, overall external debt servicing ability stayed robust. Moreover, the government's fiscal deficit shrank, whereas total government debt continuously mounted.

Domestic economic expansion decelerated

In the first half of 2012, owing to the weakening global economy, exports declined continuously and private investment trended downward. Benefiting from increasing sales of the catering and retail industries, private consumption acted as a key factor underpinning overall growth. However, factors including a dull stock market and shrinking financial wealth somewhat counteracted the growth momentum. The economic growth rate registered merely 0.59% in Q1 and further declined to -0.12% in Q2. As for the second half of the year, in addition to a recovering global economy and a lower base, private consumption and export growth both performed better than expected. All of these favorable conditions led the economic growth rates for Q3 and Q4 to rebound to 0.73% and 3.97%, respectively. Nevertheless, DGBAS statistics stated that the annual economic growth rate dropped to 1.32%[21] in 2012, exhibiting a significant fall from 4.07% a year earlier (Chart 2.17).

In order to cope with global economic turmoil and domestic issues such as an imbalanced industrial structure and maladjustment between labor supply and demand, the Executive Yuan proposed several policies, such as the Economic Power-Up Plan[22] in September 2012, to promote economic growth momentum and to strengthen the country's ability to weather external impacts (Box 2). Taking a glance into 2013, the global economic recovery softened as growth faltered, and Taiwan's export expansion

Chart 2.17 Economic growth rates in Taiwan



Note: Figure for 2013 is forecast by DGBAS.
Source: DGBAS.

[21] See Note 6.
[22] See Executive Yuan press release on 11 September 2012.

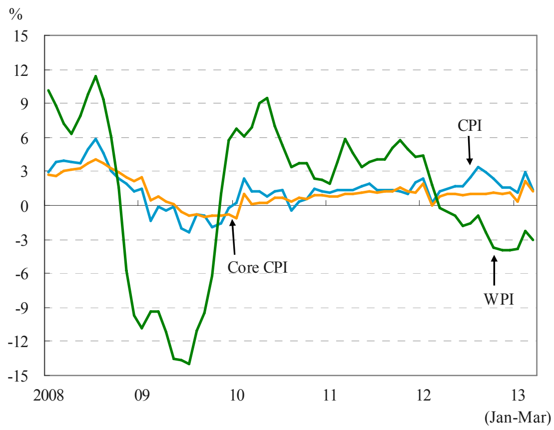
suffered waning momentum due to lackluster international markets and pressure from increasing competition. In addition, as a consequence of falling real wages and a dull stock market, private consumption performed worse than expected. Reflecting this, the DGBAS revised the forecast of Taiwan's economic growth rate down to 2.40%[23] in 2013 (Chart 2.17). Moreover, the U.S. fiscal cliff and the European sovereign debt crisis both raise uncertainties concerning global economic recovery. Therefore, the ongoing impact on Taiwan's economy is worth close attention.

Domestic prices rose mildly

Despite ascending prices of international agricultural products and domestic electricity, prices of crude oil, base metals and plastic raw materials trended downwards. As a result, the average wholesale price index (WPI) inflation rate showed a decreasing trend and registered only 0.46% during the first half of 2012. Afterward, cooling international raw materials markets and relatively low prices of oil, machinery and equipment together brought the WPI inflation rate significantly down to -3.95% in December, hitting a record low since November 2009 (Chart 2.18). The annual WPI inflation rate registered -1.16% in 2012, materially lower than the 4.32% recorded a year earlier, according to the DGBAS.

As for the consumer price level, at the beginning of 2012, the CPI inflation rate rose moderately due to declining raw material prices. However, after April, the electricity and gasoline price hikes pushed inflation expectations upwards. In addition, domestic prices of vegetables and fruits, and international prices of crude oil and crops all moved up, and as a consequence the CPI inflation rate soared to a yearly high of 3.43% in August. Subsequently, a slowdown in vegetables and fruits prices, and relatively low prices of telecom service charges and consumer electronics products collectively offset some of the price increases of fuels, lubricants and household electricity, leading to a descending CPI inflation rate. Overall, the average CPI inflation rate of 2012 was 1.93%, higher than the 1.42% of the previous year, and the core CPI[24] inflation

Chart 2.18 Consumer and wholesale price inflation rates



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

23 See Note 6.
24 The term "core CPI" in this report refers to the consumer price index excluding perishable fresh fruits and vegetables, fish and shellfish, and energy.

rate of 2012 was 1.0%, slightly lower than the 1.13% registered a year earlier.

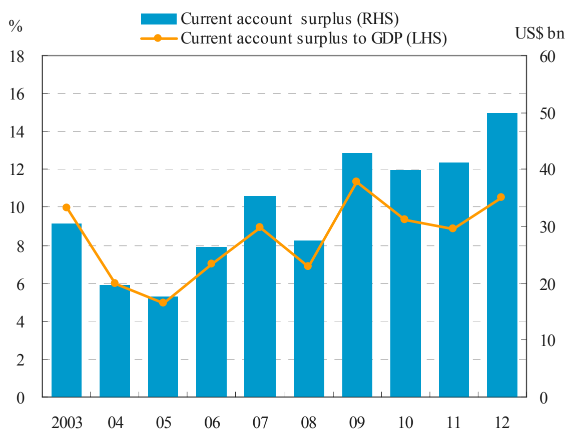
With regard to 2013 Q1, the average WPI inflation rate was -3.08%, and the average CPI and core CPI inflation rates were 1.81% and 1.23%,[25] respectively (Chart 2.18). As the sluggish global economy lowered the demand for crude oil and raw materials production faced a situation of excess capacity, the DGBAS projected the annual WPI inflation rate in 2013 to continuously decline to -1.22%. As for the CPI, because prices of international commodities moved to a lower level, and prices of Japanese imported products gradually reflected the depreciation effects of the Japanese yen against the NT Dollar, the CPI inflation rate was predicted by the DGBAS to drop back to 1.23%.[26]

Current account surpluses persisted and foreign exchange reserves stayed abundant

In 2012, although influenced by tepid growth in Western economies, the decrease in exports was smaller than that in imports, making Taiwan's goods trade surplus trend up. Combined with a larger trade surplus of both services and income, and a narrower current transfers deficit, the annual current account surplus reached US$49.8 billion, or 10.51% of annual GDP,[27] increasing by US$8.6 billion or 20.93% compared to 2011 (Chart 2.19).

As for the financial account, in 2012, direct investments and portfolio investments both saw net outflows, due to the considerable expansion of business activities in Mainland China by Taiwanese companies, insurance companies' greater investments in foreign debt securities and residents' greater investments in foreign funds combined. However, the net inflows from other investments[28] during the same period somewhat offset the effects of the above-mentioned capital outflows. As a result, the annual balance of outflows in the financial account still registered US$31.4 billion,

Chart 2.19 Current account surplus

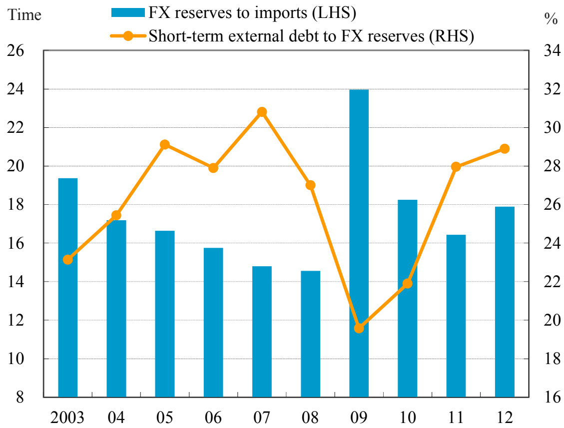


Note: Current account surplus and GDP are annual figures.
Sources: CBC and DGBAS.

[25] See Note 5.
[26] See Note 6.
[27] 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.
[28] Two parts mainly contributed to the net inflows from other investment in 2012. In the banking sector, it included the redemption of foreign short-term loans and inbound remittance of funds from banks' foreign branches. In the private sector, it resulted from the withdrawal of foreign deposits and increases in foreign borrowings.

slightly lower than US$32.0 billion the previous year. With the current account surplus and marginal decline in outflows on the financial account, the balance of payments surplus recorded US$15.5 billion in 2012, a significant growth of 148.18% from a year earlier.

Chart 2.20 Short-term external debt servicing capacity



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

In 2012, the steady balance of payments surplus together with continuously accumulated earnings on investments made with foreign exchange reserves contributed to ascending foreign exchange reserves, which reached US$403.2 billion in December, a 4.57% increase from the previous year. Furthermore, at the end of April 2013, the number had continuously climbed to US$405.1 billion, reflecting ample foreign exchange reserves. At the end of 2012, the ratio of foreign exchange reserves to imports increased to 17.89 months,[29] led by growth in foreign reserves and shrinkage of imports, whereas the ratio of short-term external debt to foreign exchange reserves elevated to 28.90%[30] due to a rise in external debt. These two ratios were both below internationally recognized warning levels, implying that Taiwan's foreign exchange reserves have a robust capacity to meet payment obligations for imports and to service short-term external debt (Chart 2.20).

Scale of external debt was moderate and debt-servicing capacity remained strong

There was a slight decrease in Taiwan's external debt[31] in the first half of 2012, resulting from the reduction in debt owned by foreign institutional investors. However, external debt mounted from 2012 Q3 as a result of the increase of domestic banks' borrowing from overseas. Overall, outstanding external debt rebounded to US$130.8 billion, or 27.58% of annual GDP, at the end of 2012, implying a moderate level of external debt.[32] Moreover,

[29] A country with a ratio of foreign exchange reserves to imports of more than three months is considered to be at relatively low risk.
[30] The general international consensus is that a ratio of short-term external debt to foreign exchange reserves less than 50% indicates relatively low risk.
[31] The CBC defines external debt 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 is not guaranteed by the public sector.
[32] The general international consensus is that a country with a ratio of external debt to GDP lower than 50% is deemed to be at relatively low risk.

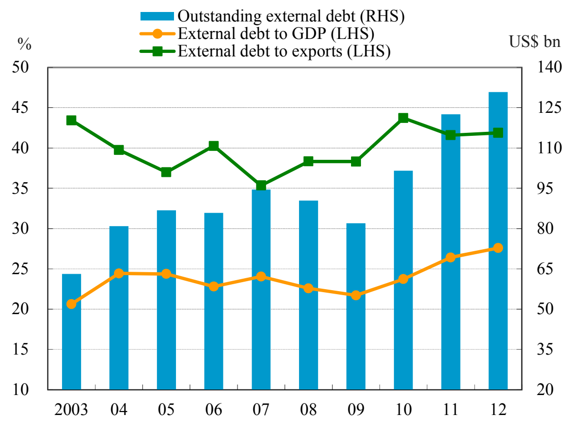
owing to the shrinkage of exports, the ratio of external debt to annual exports jumped to 43.43% as of the end of 2012. Nevertheless, export revenues were still sufficient to cover external debt[33] (Chart 2.21), and there were no signs of servicing pressure on external debt.

Fiscal deficits slightly rebounded while government debt kept accumulating

Since the times of peak spending on public infrastructure construction and domestic demand expansion plans ended, fiscal deficits at all levels of government have contracted from 2009 onwards. In 2012, the amount of the fiscal deficit, compared to the previous year, marginally rebounded to NT$325.5 billion, and the ratio of fiscal deficits to annual GDP increased to 2.32% over the same period, but it is expected to drop to 1.95% in 2013[34] (Chart 2.22).

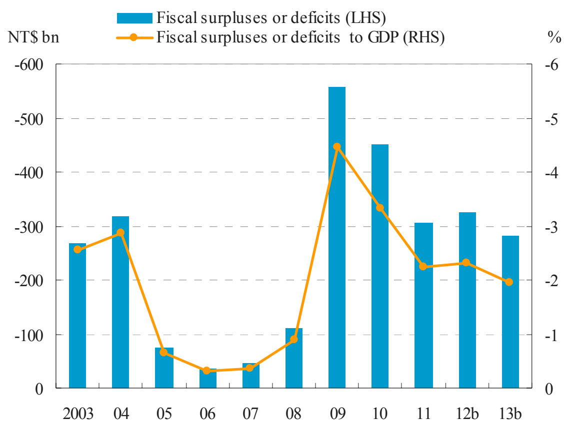
As fiscal deficits stayed high and both central government and local governments relied on debt issuance to finance debt servicing expenditures, outstanding public debt at all levels of government[35] in 2012 continuously expanded to NT$5.75 trillion,[36] or 40.92% of annual GDP,[37] well above the NT$5.49 trillion recorded in 2011 (Chart 2.23).

Chart 2.21 External debt servicing capacity



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

Chart 2.22 Fiscal position



Notes: 1. Fiscal position data include those of central and local governments.
2. Data of fiscal surpluses (deficits) are annual figures. Figures for 2012 and 2013 are budgets.
Sources: MOF and DGBAS.

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

34 See Note 7.

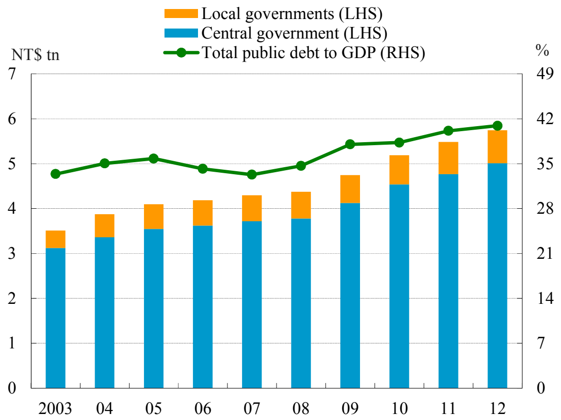
35 The term "outstanding debt at all levels of government" as used in this report refers to outstanding non-self-liquidating debt with a maturity of one year or longer. The budgeted figures for outstanding one-year-or-longer non-self-liquidating public debt (NT$5.63 trillion) issued by all levels of government during the 2012 fiscal year is equivalent to 41.24% of the average gross national product (GNP) for the preceding three fiscal years (NT$13.65 trillion). This figure is below the ceiling of 48% set out in the Public Debt Act.

36 The figure is based on final accounts (or preliminary final accounts) of outstanding non-self-liquidating debt at all levels of government with a maturity of one year or longer at the end of 2012. If adding in debt with a maturity of less than one year and self-liquidating debt, outstanding public debt at the end of 2012 stood at NT$6.70 trillion.

37 As a comparison, outstanding debt in EU member nations is not allowed to exceed 60% of GDP, according to the Maastricht Treaty and the subsequent Stability and Growth Pact.

To promote fiscal health, Taiwan's government will put into practice five medium and long-term strategies that aim to enhance a sound fiscal system, including: (1) diversifying sources of government funds; (2) managing government finance with the entrepreneurial mindset; (3) promoting fair taxation; (4) optimizing local finance; and (5) minimizing public debt. Besides these, the government will also implement measures, including: (1) strictly monitoring debt limits; (2) lowering debt leverage; and (3) increasing mandatory debt principal repayment, to effectively manage outstanding public debt.[38]

Chart 2.23 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. Figures for 2012 are final accounts and preliminary final accounts for the central government and local governments, respectively.
Sources: MOF and DGBAS.

[38] See Ministry of Finance press release on 6 September 2012.

Box 2
Taiwanese government's policy responses to the global economic slowdown

In order to ease the impacts of persisting global uncertainties arising from the euro area sovereign debt crisis and slowdown in Western economies since the second half of 2011, the Taiwanese government unveiled the Economic Climate Response Program in December 2011, putting forward seven strategies and ten focuses to stimulate economic growth. The program, which adopted countercyclical measures such as the augmentation of private participation in public construction and expansion of exports, displayed considerable efficacy. It placed emphasis on shorter-term response measures, even though it was designed to mitigate challenges that typically cannot be solved in a short time. For instance, external challenges include the prolonged Eurozone debt crisis which has caused global economic turmoil, weaker-than-expected growth in industrial countries, decelerating growth momentum in Mainland China and other emerging economies, and the emergence of regional economic integration which has significantly affected Taiwan's exports. On top of that, internal challenges hindering the domestic economy, such as an imbalance in industrial structure and mismatch between labor supply and demand, highlight the need for redress. Thus, the Executive Yuan again issued the Economic Power-up Plan on 11 September 2012 with the aim of improving industrial health, propelling economic impetus, and raising the capability to respond to economic challenges.

The Economic Power-up Plan focuses on the adjustment of Taiwan's economic structure and the relaxation of regulations as its two key pivots, thereby incorporating dimensions of both short-run growth and medium- to long-term development. Through joint deliberation and periodical reviews by concerned Cabinet agencies, this plan has been mapped out into five dimensions – industry, exports, human resources, investment, and government efficacy – according to the required elements of economic growth. The government set forth five policy directions and 25 concrete focal undertakings and responding action plans. Each of the policy actions has been set a time line for completion, with an overall time frame spanning from 2012 to 2030. The total expenditure is estimated to be about NT$389.4 billion. Summarized in Table B2.1 below are the plan's initiatives and targets.

Table B2.1 The Economic Power-up Plan : Initiatives and targets

Initiatives	Targets
Promote innovative and diverse industries	1. Implement the Three Industries, Four Reforms Program, namely: a service-oriented manufacturing industry, an internationalized and high-tech services industry, and a specialty-oriented traditional industry. 2. Turn small and medium enterprises (SMEs) into backbone enterprises. 3. Accelerate the application of R&D results. 4. Lift the quality and quantity of tourism. 5. Spark sustainable growth in the financial sector. 6. Develop top-quality, eco-friendly and sustainable energy. 7. Create a "golden agricultural corridor" featuring modern agriculture practices with the special characteristic of Lifestyles of Health and Sustainability (LOHAS).
Develop new export markets	1. Increase value-added exports and explore emerging markets. 2. Raise the competitiveness of service exports. 3. Strive to participate in regional economic integration. 4. Strengthen intellectual property rights strategies.
Cultivate industry talents	1. Improve technical and vocational education to meet industry needs. 2. Develop industries with value-added human resources to enhance industry-academia training convergence. 3. Promote strategic distribution of human resources and nurture talents specialized in emerging markets. 4. Adjust labor laws and regulations according to industrial and social trends.
Spur investment and public construction	1. Attract private-sector investment. 2. Finance public works with innovative financial strategies. 3. Facilitate more medium and long-term investment for public works. 4. Adjust investment regulations in time with industrial trends. 5. Design free economic pilot zones.
Enhance government efficacy	1. Improve government procurement mechanisms. 2. Implement government budget review mechanisms. 3. Strengthen regulatory reviews and revise laws to meet changing needs. 4. Effectively utilize public land and assets. 5. Push state-owned enterprises to launch major investment projects.

Source: Executive Yuan.

The Executive Yuan has urged concerned ministries/agencies to earnestly implement the plan so as to lift Taiwan's competitiveness in the medium and long term. Among the initiatives, attracting overseas Taiwanese businessmen to invest back in Taiwan and enlivening sustainable growth in the financial sector have achieved the desired effects rather well. Moreover, the free economic pilot zones currently under programming should be able to effectively raise national competitiveness. Illustrated below are these three major undertakings.

Strengthen efforts to encourage overseas Taiwanese firms to invest back in Taiwan

Owing to the fact that the phenomenon of "order-taking in Taiwan followed by offshore production" has been increasing over the years making domestic employment opportunities decline gradually, the Executive Yuan ratified the “Program of Promoting the Investment of Overseas Taiwanese Businessmen Back to Taiwan” on 26 October 2012 in order to attract inbound investment from overseas Taiwanese firms, increase job opportunities, and power up the engine for economic growth. Based on the program, the government will actively help businessmen solve attendant problems concerning their investment with regard to issues such as access to land and labor, optimizing the investment environment to boost domestic investment and employment, and embarking on upgrading industrial structure. Within four months after the program was initiated in the beginning of November 2012, the Ministry of Economic Affairs, jointly with other concerned agencies, approved 22 cases of applications for inbound investment by overseas Taiwanese businessmen, with total amounts estimated to be about NT$168.4 billion and jobs to be generated for twenty-three thousand workers. Therefore, the performance of this program was notable.

Ignite sustainable development in the financial sector

In order to develop financial services with cross-strait characteristics, three major policy measures have been initiated. First, the CBC and the People’s Bank of China jointly signed the Memorandum on Cross-Strait Currency Clearing Cooperation and designated NTD and renminbi (RMB) clearing banks, respectively. A bilateral mechanism for the clearing and settlement of cross-strait currencies was officially inaugurated. Thereafter, the CBC opened up RMB deposits, loans and remittances to be conducted by authorized banks. Second, the FSC repealed the restriction that foreign corporations with more than 30% of their capital held by mainland investors should not list on Taiwan’s stock exchange and over-the-counter (OTC) market. Listing on the stock exchange and the OTC market was also opened up as an option for well-performing overseas Taiwanese corporations. Third, the FSC, through the platform of cross-strait supervisory cooperation, loosened the criteria for banks in Taiwan to enter the mainland market and lifted the ceiling of shareholding of domestic banks and financial holding companies by a single bank registered in the mainland.

In order to promote a Taiwan-centric wealth management platform, the FSC and the CBC revised the Directions for Banks Conducting Financial Derivatives Businesses and the Regulations Governing Foreign Exchange Business of Banking Enterprises, respectively, opening up derivatives that are allowed to link to RMB-denominated indicators, such as exchange rates, interest rates and stock prices, and relaxed the rules on foreign currency-denominated securities investment trust funds to use NT dollars as a payment vehicle.

Move forward free economic pilot zones

The detailed programming of the free economic pilot zones is expected to be completed by the end of June 2013. Its design mainly lies in the core philosophy of liberalization, internationalization, and being forward-looking in nature. The program will greatly loosen the restrictions on the flows of merchandise, people, funds, information, and knowledge, and earnestly put into effect the policy of opening markets. The promotion strategies will be focused on breaking through regulatory limitations and innovating administration mechanisms, with a view to holistically building a superior liberalized and internationalized business environment. For example, policy measures include, among others, easing restrictions on foreign white-collar professionals to work in Taiwan, allowing free import and export of agricultural and industrial raw materials and merchandise without taxes, opening markets and loosening investment constraints, facilitating access to land and granting of preferential rents, as well as setting up a highly efficient single window providing government services. These measures will be able to effectively raise the national competitiveness of Taiwan, achieving the expected effectiveness of attracting investment and increasing output value.