2.2 Domestic economic and financial conditions

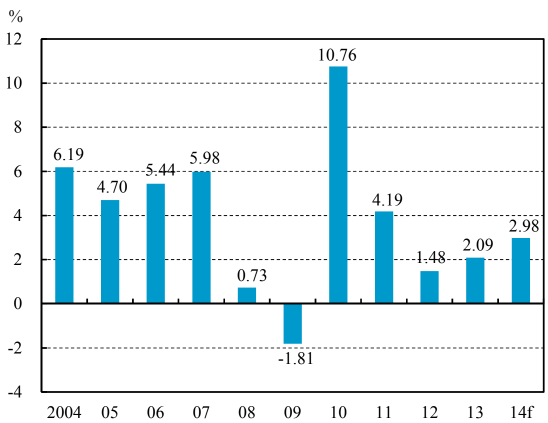
Taiwan's economic growth was moderate in the first three quarters of 2013 due to weaker foreign demand. Nevertheless, thanks to the sustained expansion of the global economy, the real growth rate regained its upward momentum in Q4. Meanwhile, the rise in the general price level remained moderate. Short-term 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.

2.2.1 Domestic economy expanded slightly

At the beginning of 2013, affected by the sluggish global economy, as well as a tepid domestic stock market and falling real wages, export demand and domestic private consumption posted worse figures than expected, resulting in the economic growth rate registering merely 1.44% in Q1. However, it rose to 2.69% in Q2 owing to temporarily recovering private consumption and growing exports, but then fell to 1.31% in Q3 on account of export shrinkage as well as lackluster consumption and investment. After that, under the green shoots of a global recovery began to emerge, exports and domestic demand performed better than expected in Q4, leading the quarterly growth rate to rebound to 2.88%. As a result, the annual economic growth rate rose to 2.09%[23] for 2013, higher than the 1.48% of the previous year (Chart 2.16).

Taking a glance into 2014, the pickup of economic growth in advanced countries is expected to boost exports, while raising salaries by domestic companies and steadily rising stock prices could help to improve private consumption. Moreover, accelerating 4G network construction and increasing aircraft purchases by the airline industry also could enhance private investment. In line with these improvements in the economic environment, the DGBAS forecasts Taiwan's

Chart 2.16 Economic growth rates in Taiwan



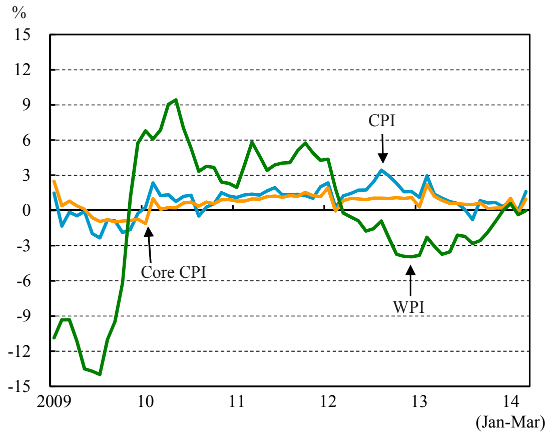
Note: Figure for 2014 is forecast by DGBAS.
Source: DGBAS.

[23] See Note 5.

economic growth rate to improve to 2.98%[24] in 2014 (Chart 2.16).

2.2.2 Domestic prices rose mildly

Chart 2.17 Consumer and wholesale price inflation rates



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

In 2013, owing to the descending prices of crude oil and raw materials, the wholesale price index (WPI) inflation rates in the first three quarters showed a significant fall compared to the same periods of the previous year. However, the WPI inflation rate turned to decline at a diminished pace in Q4, registering -0.01% in December as a result of depreciation of the NT dollar (Chart 2.17). The annual WPI inflation rate stood at -2.43% in 2013, lower than the -1.16% recorded a year earlier, according to the DGBAS.

At the beginning of 2013, the average CPI inflation rate registered 2.04% during January and February due to rising prices of gasoline, fruits, and travel fares. However, after March, the CPI inflation rate fell successively and hit a yearly low of -0.78% in August, primarily because of a higher 2012 base. Subsequently, domestic prices of vegetables and fruits surged significantly owing to typhoons, and, combined with an electricity price hike, pushed consumer prices upwards and led to the rebound of the CPI inflation rate. Overall, domestic prices rose mildly in 2013 as the average CPI inflation rate was 0.79%, lower than the 1.93% of the previous year, whereas the core CPI[25] inflation rate was 0.66%, lower than the 1.00% recorded a year earlier.

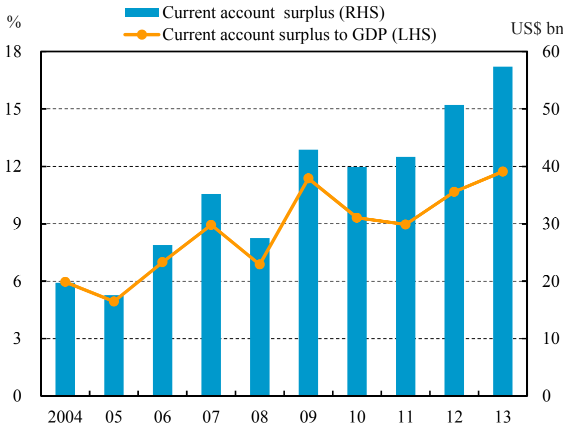
In 2014, while the prices of international agricultural products and raw materials went up due to abnormal climate events, the DGBAS projects the annual WPI inflation rate to rebound to 0.93%. Regarding the CPI, as the rising prices of raw materials exert upward pressure on food prices, the CPI inflation rate is predicted by the DGBAS to rise to 1.53%[26] in the same year.

[24] See Note 5.
[25] The term “core CPI” in this report refers to the consumer price index excluding fruits, vegetables and energy.
[26] See Note 5.

2.2.3 Current account surplus persisted and foreign exchange reserves stayed abundant

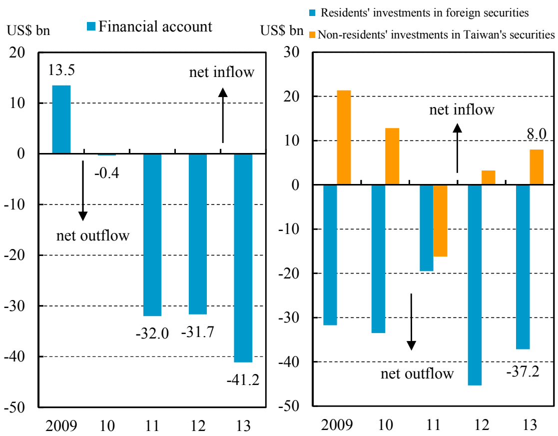
On account of slightly increasing exports supported by gradual global economic recovery and contracting imports, the goods surplus trended up in 2013. This, combined with a larger services surplus, caused the annual current account surplus to reach US$57.4 billion, or 11.73% of annual GDP, [27] increasing by US$6.7 billion or 13.24% compared to 2012 (Chart 2.18).

Chart 2.18 Current account surplus



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

Chart 2.19 Financial account and net inflow of investments in securities



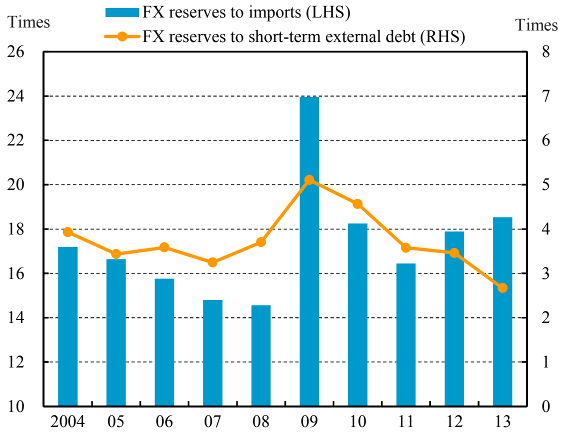
Source: CBC.

As for the financial account, in 2013, the annual balance of outflows registered a record high of US$41.2 billion, primarily because net outflows of residents' direct investment and debt securities investments, as well as due from foreign banks in the banking sector, registered record highs. Analyzing the components of financial account, the net outflows of residents' investment in foreign securities in 2013 recorded US$37.2 billion, mainly due to more investments in foreign debt securities by insurance companies seeking higher revenues. During the same period, the net inflows of non-residents' investment in Taiwan's securities registered US$8 billion because of greater investments by foreign institutional investors in the domestic stock market (Chart 2.19). In addition, the outflows of other investments saw an expansion led by domestic banks increasing re-deposits at foreign banks due to a sharp growth in RMB deposit balances. Although the funds of foreign institutional investors primarily flowed into the stock market and, in turn, helped to promote stock market momentum, this may have a negative impact on the domestic stock market if capital flows reverse.

[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.

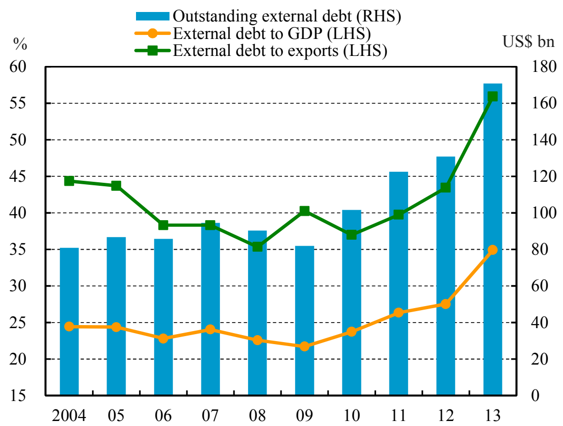
With a rising current account surplus but a greater increase in outflows on the financial account, the balance of payments surplus declined to US$11.3 billion in 2013, contracting by 26.91% from a year earlier. Over the same period, the steady balance of payments surplus together with continuously ascending investment earnings of reserve assets contributed to accumulating foreign exchange reserves, which reached US$416.8 billion at the end of December, a 3.38% increase from the previous year. Furthermore, at the end of March 2014, this total amount had continuously climbed to US$419.2 billion, reflecting ample foreign exchange reserves. At the end of 2013, the ratio of foreign exchange reserves to imports increased to 18.53 months,[28] led by growth in foreign reserves and shrinkage of import values, whereas the ratio of foreign exchange reserves to short-term external debt decreased to 2.67 times[29] due to a greater rise in external debt. These two ratios were both higher than internationally recognized minimum 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).

Chart 2.20 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.

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.

[28] A country with a ratio of foreign exchange reserves to imports of more than three months is considered to be at relatively low risk.
[29] The general international consensus is that a ratio of foreign exchange reserves to short-term external debt higher than 100% indicates relatively low risk.

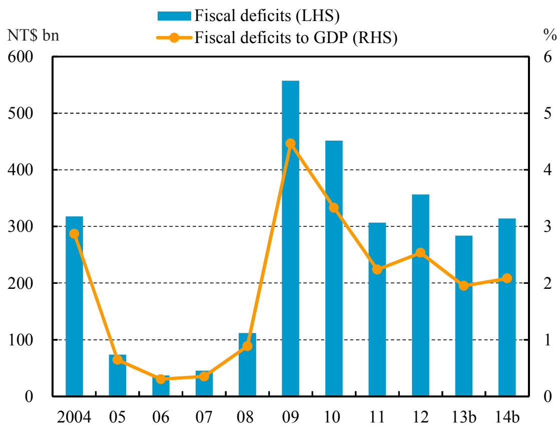
2.2.4 Scale of external debt expanded and debt servicing capacity remained strong

Taiwan's external debt[30] increased continuously in 2013 and registered US$170.8 billion, or 34.92% of annual GDP, at the end of the year, indicating that the capacity to service external debt remained robust.[31] In recent years, the scale of external debt expanded constantly owing to the increases of foreign institutional investors' NTD deposit balances and domestic banks' due from foreign banks. Owing to the greater rise of external debt than that of exports in 2013, the ratio of external debt to annual exports rose to 55.91% as of the year end (Chart 2.21). Nevertheless, export revenues were still sufficient to cover external debt,[32] and there were no signs of servicing pressure on external debt.

2.2.5 Fiscal deficits slightly contracted while government debt kept accumulating

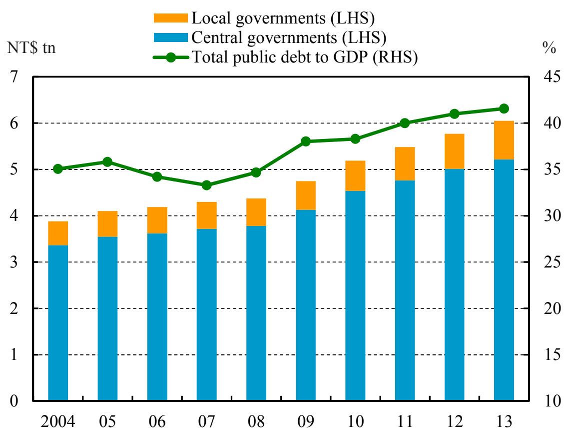
Since the times of peak spending on public infrastructure construction and domestic demand expansion plans ended, fiscal deficits at all levels of government have notably contracted from 2009 onwards. In 2013, the amount of the fiscal deficits declined to NT$284.1 billion, or 1.95 % of annual GDP, following a marginal rebound in 2012. It is

Chart 2.22 Fiscal deficits position



Notes: 1. Fiscal position data include those of central and local governments.
2. Data of fiscal deficits are annual figures. Figures for 2013 and 2014 are budgets.
Sources: MOF and DGBAS.

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 2013 are preliminary final accounts and budgets for the central government and local governments, respectively.
Sources: MOF and DGBAS.

30 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.

31 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.

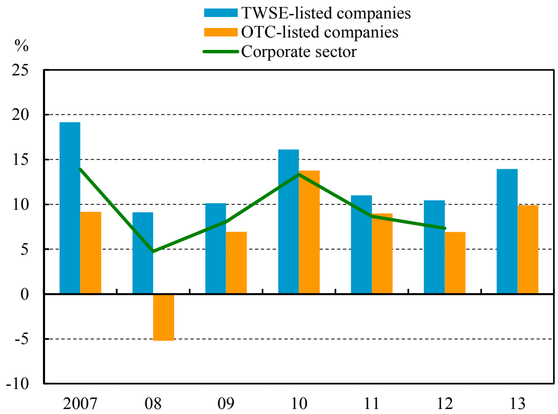
32 The general international consensus is that a ratio of external debt to exports less than 100% indicates relatively low risk.

expected that fiscal deficits will increase to NT$313.9 billion alongside a slight rise in the ratio of fiscal deficits to annual GDP to 2.08%[33] in 2014 (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[34] in 2013 expanded steadily to NT$6.05 trillion,[35] or 41.55% of annual GDP,[36] well above the NT$5.77 trillion recorded in 2012 (Chart 2.23).

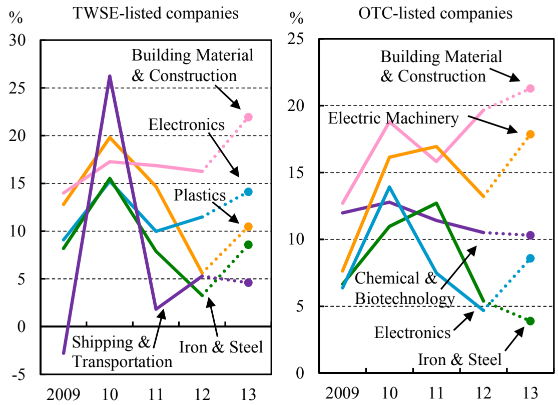
To promote fiscal health, the Ministry of Finance proposed the "Fiscal Health Plan" that seeks to enhance a sound fiscal system through urging related government agencies to take action. The key aspects of the policy direction include: controlling the scale of debt; adjusting the structure of expenditure; coordinating all the resources; diversifying sources of finance; and timely modifying taxation.[37]

Chart 2.24 Return on equity in corporate sector



Note: Return on equity = net income before interest and tax / average equity.
Sources: JCIC and TEJ.

Chart 2.25 Return on equity of TWSE-listed and OTC-listed companies by major industries



Note: Return on equity = net income before interest and tax / average equity.
Source: TEJ.

[33] As a comparison, fiscal deficits in EU member nations are not allowed to exceed 3% of GDP, according to the *Maastricht Treaty* and the subsequent *Stability and Growth Pact*.

[34] 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. As of February 2014, the outstanding one-year-or-longer non-self-liquidating public debts are NT$5.30 trillion, NT$0.54 trillion, NT$0.16 trillion, and NT$1.2 billion for central government, municipalities, counties, and townships, respectively. The figures account for 37.52%, 3.86%, 1.16%, and 0.009% of the average GDP for the preceding three fiscal years, which are below the ceilings of 40.6%, 7.65%, 1.63%, and 0.12% for central government, municipalities, counties, and townships, separately, set out in the *Public Debt Act*.

[35] The figure is based on preliminary final accounts and budgets for central government and local governments, respectively. Outstanding non-self-liquidating debt at all levels of government with a maturity of one year or longer stood at NT$6.01 trillion as of the end of February 2014. If debt with a maturity of less than one year and self-liquidating debt are added in, outstanding public debt stood at NT$6.82 trillion.

[36] 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*.

[37] Taiwan's legislature has passed the amendment of *Income Tax Act* and *Value-added and Non-value-added Business Tax Act* on 16 May 2014. It will help to promote fiscal health and to improve income allocation.