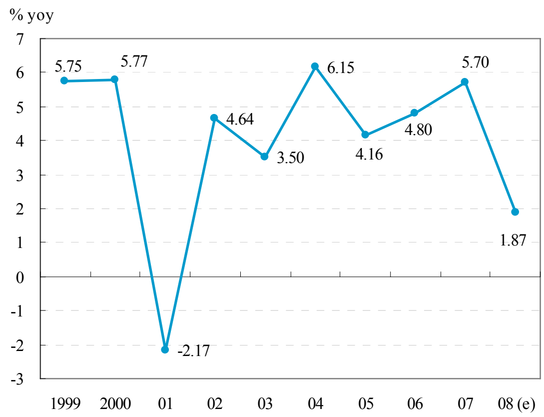
2. Domestic economic and financial conditions

Taiwan's economy was expected to moderate in 2008 while inflationary pressures eased. The economy exhibited resilience supported by ample foreign exchange reserves, a sustained current account surplus, and strong short-term external debt servicing capacity despite increases in the scale of external debt. Although the government's fiscal deficits could widen along with rising government debts, the ratio of outstanding government debts to GDP was still below the international warning level.

Domestic economy expected to moderate in 2008

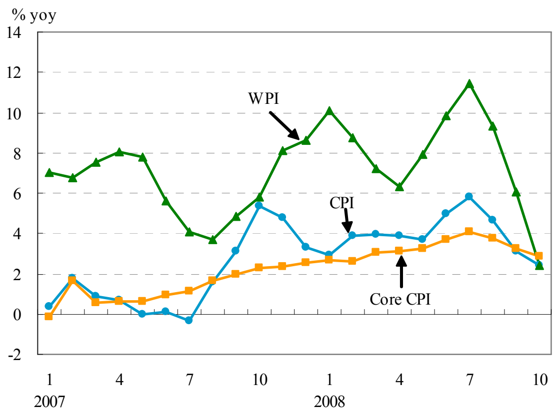
Taiwan's economic growth reached 5.4% in the first half of 2008, underpinned mainly by robust export growth against the backdrop of strong intra-Asian trade performance. However, export momentum weakened in the face of the global economic downturn, coupled with sluggish private consumption and private investments. Preliminary statistics from the DGBAS indicate that Taiwan's economy turned to a negative growth of -1.02% in 2008 Q3, and further contracted to -1.73% in 2008 Q4, causing annual economic growth to decline considerably from the previous year's 5.70% to 1.87% in 2008 (Chart 2.1). Looking ahead, despite sharp expansion in public fixed investments and mild growth in private consumption, the slowing of the global economy may continue to impact Taiwan's exports and exert adverse effects on private investments through reduced external demand. The DGBAS forecast Taiwan's economy to grow 2.12% in 2009, slightly up 0.25 percentage points from 2008.

Chart 2.1 Economic growth in Taiwan



Note: Figure for 2008 is DGBAS estimate.
Source: DGBAS.

Chart 2.2 Consumer and wholesale price inflation rates



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

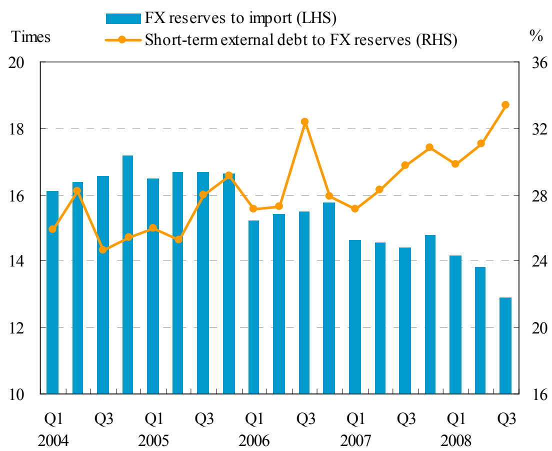
Inflationary pressures eased

From the beginning of 2008, high international raw material and commodity prices had driven up wholesale prices. Consumer prices also continued to rise, attributable to price hikes in crude oil, electricity, fuel, agricultural and industrial raw materials as well as heightened food prices due to damage from several typhoons. The Wholesale Price Index (WPI) reached a peak of 11.44% year on year in July, while the Consumer Price Index (CPI) and core CPI[6] stood at 5.81% and 4.06%, respectively, reflecting increased inflationary pressures. However, the upward pressure on inflation eased subsequently, thanks to declining prices of international raw material that led to a drop in wholesale and consumer prices (Chart 2.2). The average WPI, CPI, and core CPI from January through October of 2008 increased notably by 7.95%, 3.92%, and 3.23% year on year, respectively. The DGBAS projected the annual WPI and CPI inflation rates to reach 6.33% and 3.64%, respectively, in 2008. Furthermore, the CPI inflation rate is expected to decline to 0.37% year on year in 2009, and the WPI to contract to -2.18%, largely driven by the ongoing global economic downturn, falling commodity prices, and higher figures for the base year of 2008.

Current account remained in surplus, and foreign exchange reserves stayed sufficient

With sizable foreign capital inflows, Taiwan's foreign exchange reserves grew substantially in the first half of 2008 and reached a peak of US$291.4 billion as of the end of June. The outstanding amount, however, trended generally downward as a result of net foreign capital outflows in Q3, and declined to US$281.1 billion at the end of September, slightly up 4.00% from the end of 2007. Nevertheless, foreign exchange reserves remained adequate, enough to cover 12.91 months of imports,[7] while the ratio of short-term external debt to foreign exchange reserves registered 33.35% at the end of

Chart 2.3 Short-term external debt servicing capacity



Note: FX reserve balances are end-of-period figures, while imports are quarterly averages of monthly imports.
Sources: CBC, DGBAS and MOF.

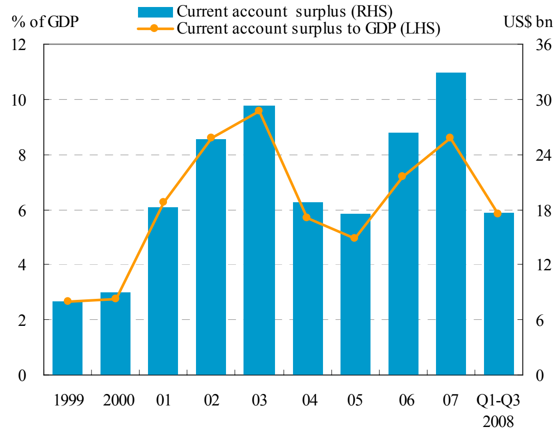
[6] The term "core CPI" in this report refers to a consumer price index excluding perishable fresh fruits and vegetables, fish and shellfish, and energy.
[7] See "Damocles: Testing Times Ahead," Lehman Brothers, 22 July 2004. For import cover of foreign exchange reserves, the cutoff point for risk is three months. A country with an import cover of less than three months is considered to be at relatively high risk.

September 2008.[8] These data indicated that Taiwan's foreign exchange reserves have a strong capacity to meet payment obligations for imports and to service short-term external debt (Chart 2.3). In addition, the current account surplus during the first three quarters of 2008 stood at US$17.6 billion, down by 19.13% year on year. The reduction in the current account surplus was due mainly to a sharp expansion in imports, especially imports of mineral products (e.g. crude oil), steel, and steel-related products. Reflecting this, the ratio of current account surplus to GDP decreased to 5.85% over the same period (Chart 2.4).[9]

External debt trended upward, but servicing capacity remained strong

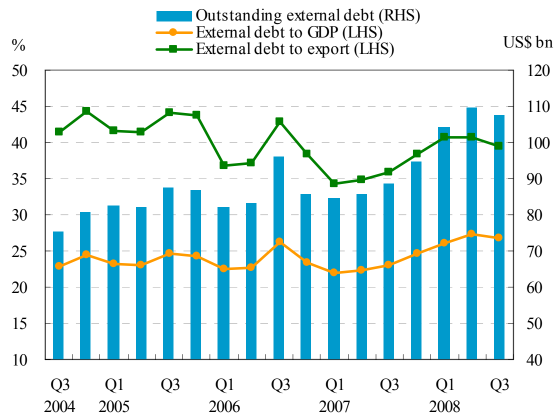
External debt[10] reached US$107.5 billion at the end of September 2008, fueled by a significant rise in private short-term debts that mainly emanated from increased deposits of overseas correspondent banks and foreigners. Meanwhile, the ratio of external debt to annual GDP[11] stood at 26.78%, still far lower than the internationally recognized warning level of 50%.[12] In addition, external debt as

Chart 2.4 Current account surplus



Note: Ratio of 2008 Q1-Q3 is measured by dividing the current account balances during the first three quarters of 2008 by GDP over the same period.
Sources: CBC and DGBAS.

Chart 2.5 External debt servicing capacity



Notes: 1. External debts are end-of-period figures, while GDP and exports data are annual figures.
2. Ratios herein are measured as quarterly external debts balances divided by annualized GDP or exports.
Sources: CBC and DGBAS.

8 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.

9 See Note 7. 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.

10 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.

11 The figure for the GDP of 2008 is based on DGBAS statistics released on 20 November 2008 (hereafter quoting the same source).

12 See Note 7. For the ratio of external debt to GDP, the cutoff point for risk is 50%. A country with a ratio of 50% or higher is deemed to be at relatively high risk.

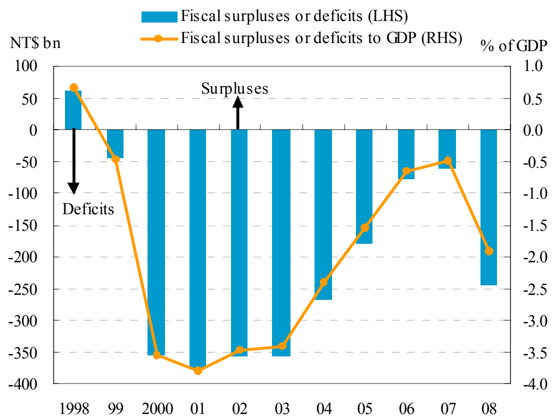
of the end of September 2008 was equivalent to 39.45% of annual exports,[13] higher than the 38.32% registered at the end of 2007. Nevertheless, export revenues were still sufficient to cover external debt (Chart 2.5), and there was no clear sign of pressure on external debt servicing capacity.[14]

Fiscal deficits could grow, while government debts increased steadily

Fiscal deficits shrank gradually from 2002, falling to a low of NT$62.1 billion at the end of 2007. In 2008, however, the government increased infrastructure spending to spur domestic demand, thereby boosting overall economic growth. As a result, the fiscal deficit budget expanded to NT$244.1 billion or 1.93% of GDP (Chart 2.6). The ratio, however, is still below the internationally recognized warning level of 3%.[15]

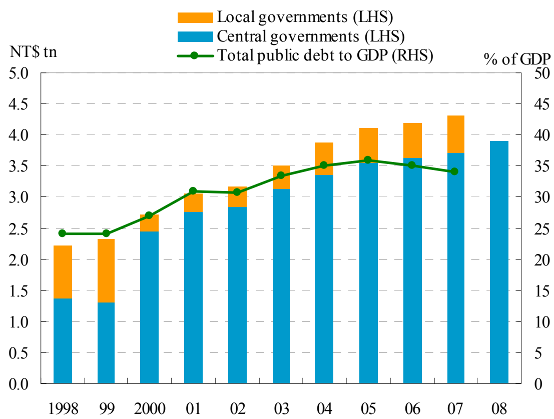
As fiscal deficits rose and governments relied on debt issuance to finance debt servicing expenditures, outstanding public debt of central and local governments[16] increased steadily over the past decade and stood at NT$4.3 trillion in 2007,[17] up slightly from NT$4.2 trillion as of the end of 2006. The ratio of outstanding public debt to annual GDP fell back

Chart 2.6 Fiscal positions



Notes: 1. Data of fiscal surpluses (deficits) are end-of-period figures. Figures for 2008 are budgeted ones.
2. Fiscal positions data include those of central and local governments.
Sources: MOF and DGBAS.

Chart 2.7 Public debts



Notes: 1. Outstanding public debt refers to non-self-liquidating debt with a maturity of one year or longer, excluding external debts.
2. Outstanding public debts for 2008 are budgeted figures, while the 2008 data for local governments are not available.
Sources: MOF and DGBAS.

[13] Figures for exports refer to Ministry of Finance statistics for the total amount of annual exports on a customs basis. The figure for 2008 is an annualized figure up to 2008 Q3.
[14] See Note 8. A ratio of external debt to exports of less than 100% indicates relatively low risk.
[15] See Note 8. 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.
[16] 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$4.3 trillion) issued by all levels of government during the 2007 fiscal year within their general budgets and extraordinary budgets is equivalent to 36.5% 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.
[17] This figure indicates the amount of non-self-liquidating debt 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$5.2 trillion.

to 34.07% in 2007, well below the internationally recognized warning level of 60%,[18] mainly due to sustained economic growth. In 2008, the central government's outstanding public debt was projected to increase to NT$3.9 trillion following the expansion in infrastructure investments, compared to NT$3.7 trillion in the previous year. Consequently, the public debt is likely to grow further (Chart 2.7).

[18] See Note 8. 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.