Taiwan

Exposed to external shocks, but solid

Export and real GDP growth have started to suffer from US-China trade tensions and from the mounting difficulties of China's external trade sector. Taiwan is highly exposed to this type of external shocks due to its heavy reliance on exports of tech products to the Chinese and US markets. However, Taiwan is also well-armed to absorb shocks. External accounts and public finances are strong, and the authorities have a good margin of leeway to act. They are expected to maintain accommodative monetary and fiscal policies in order to stimulate domestic demand in the short term, and should continue some structural reform measures aimed at improving Taiwan's longer-term economic prospects.

Exposed to US-China trade tensions

Economic growth strengthened gradually from 2016 to early 2018 thanks to a more favourable external environment and policy support. The global tech cycle rebounded and boosted exports in 2017, but then lost steam in 2018, while fiscal stimulus measures and the loose monetary conditions have supported domestic consumption. However, real GDP growth slowed again in Q3 2018, reaching +2.3% year-on-year (y/y) vs. 3.2% in H1 2018. Investment rebounded after four consecutive quarters of negative or flat growth, but private consumption growth lowered and government spending contracted. Moreover, export growth slowed rapidly and net exports had a negative contribution to real GDP growth in Q3 2018.

Recent foreign trade and manufacturing PMI data point to further weakening in economic activity in Q4 2018 and early 2019. Exports started to lose steam during the summer (rising by 4.1% y/y in USD value in July-Oct18 vs. 10.7% in H1 2018) and contracted in the last two months of the year (-3.3% y/y). The deterioration has initially stemmed from the slowdown in global trade and, more recently, from the weakening performance of Chinese trade resulting from the US-China dispute (Chart 2).

In the short term, the main uncertainty comes from US-China trade tensions (see note on China, page 4). Taiwan is highly vulnerable to this type of external shocks due to its very high degree of trade openness (exports represented 60% of GDP in 2017), high exposure to the Chinese market (28% of total good exports, or 40% including Hong Kong) and US demand (12% of total exports) and high participation in regional value chains. Its export base is solid but not widely diversified, given the heavy weight of tech products (electronic goods account for 34% of total exports and information & communication goods for another 11%).

Some Taiwanese enterprises are already adjusting their production strategy. Given US tariff hikes on Chinese good imports, added to rising labor costs in China, certain industries have announced partial relocation of production units from the Mainland to Taiwan. Moreover, the authorities have recently announced a plan to assist corporates to return to invest in the island. Some enterprises may also plan to shift production capacity to other countries with lower labor costs such as Vietnam, the Philippines or even Mexico.

The authorities have adopted an accommodative economic policy mix over the past two years and will continue to do so in the short term. Public infrastructure and social spending will be sustained. Meanwhile, monetary policy should remain accommodative despite increasing US interest rates, given both external trade uncertainty and low inflation pressures. Inflation accelerated last year but has abated rapidly since October as a result of lower energy and food prices.

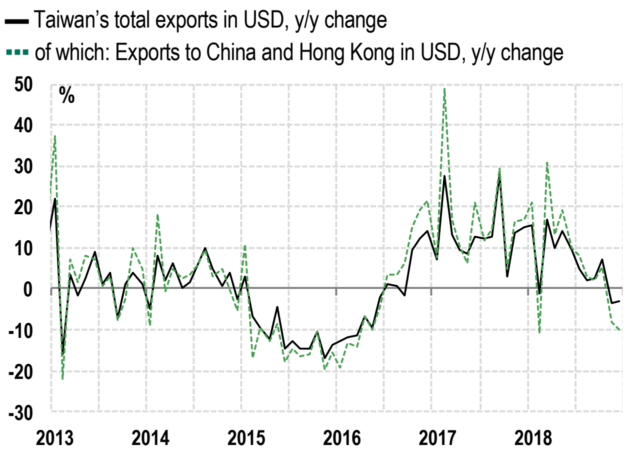
Taiwan's economic growth is affected not only by cyclical factors but also structural constraints, which will contribute to a continued slowdown trend in the coming years. On the internal front, the main constraints come from the decline in the labor force (which started in 2016) and the insufficient diversification of its manufacturing base. Positively, the Tsai government has taken actions to improve

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	2.9	2.8	2.2	2.0
Inflation (CPI, year average, %)	0.6	1.4	1.3	1.3
Budget balance / GDP (%)	-2.0	-2.1	-2.3	-2.3
Gen. Gov. debt / GDP (%)	35.7	34.4	34.6	35.0
Current account balance / GDP (%)	14.5	13.1	12.6	13.0
External debt / GDP (%)	31.8	31.3	31.5	31.0
Forex reserves (USD bn)	452	462	473	486
Forex reserves, in months of imports	16.8	16.0	15.5	15.0
Exchange rate USDTWD (year end)	29.8	30.7	31.0	31.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Taiwanese exports hit by the fall in Chinese external trade



Source: Ministry of Finance

competitiveness and develop new industrial sectors: in addition to an infrastructure development program for 2018-2021, an industrial innovation plan has been launched, aimed at boosting higher value-added tech sectors. Measures to ease restrictions on employing foreign workers have also been announced.

On the external front, Taiwan faces economic challenges (rising protectionism, uncertain prospects for world demand of tech products) and geopolitical challenges. Cross-Strait tensions have worsened since President Tsai and her DPP government took power in May 2016. Difficult relations with China may dampen the activity of some enterprises, notably in the tourism sector. Most importantly, the strategy of the DPP government to diversify Taiwan's relations away from China (in particular with its "Southbound policy" aimed at developing agreements with South and South-East Asian countries) is threatened by Beijing's pressure on potential economic partners.

Strong cushions

Despite multiple headwinds that will weigh on its future economic growth performance, Taiwan's macroeconomic strength is not threatened. Firstly, external accounts are very strong and should remain so in the coming years. Taiwan's large current account surpluses of more than 10% of GDP, extremely comfortable external liquidity cushions (covering 16 months of imports) and solid net foreign creditor position largely mitigate concerns arising from the island's exposure to trade war risks or other external trade shocks, cross-Strait tensions and diplomatic isolation.

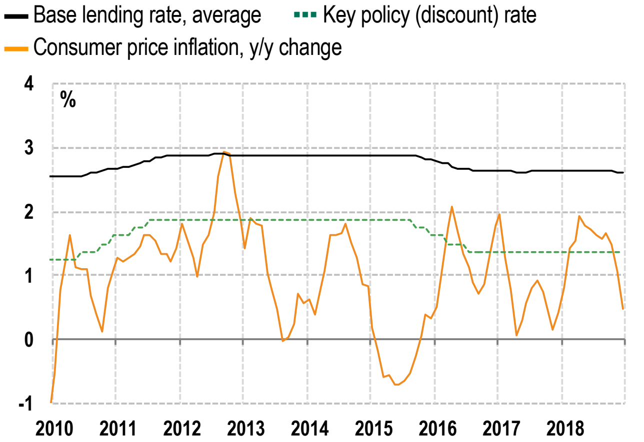
Secondly, Taiwan enjoys solid public finances. The fiscal balance is structurally in deficit and the tax base is narrow, but policy discipline is strong. The deficit of the general government (including social security funds) has averaged a moderate 2.2% of GDP since 2014 (based on IMF estimates). General government debt is moderate, expected at 34% of GDP at the end of 2018. It has declined slightly in the past five years (from 39% in 2013). The government benefits from very low borrowing costs and a large domestic investor base. Moreover, it is little exposed to changes in global financial conditions (it has no foreign currency-denominated debt). All this gives the government ample leeway to act in case in adverse shock, implement counter-cyclical measures and introduce structural reforms to improve long-term prospects.

Fiscal policy: a combination of stimulus and reform

As a matter of fact, the Tsai administration has been active in trying to find solutions to stimulate domestic demand, strengthen Taiwan's economic growth potential, and anticipate the ageing of the population.

Fiscal policy has become more expansionary since 2016. The Tsai government has launched a four-year infrastructure program since 2017, with additional budget funding equivalent to 2.4% of GDP. Other increases in government spending are focused on social welfare programs, education, science and culture, and national defence; they are expected to remain of reasonable extent.

3- Accommodative monetary conditions



Source : DGBAS, Central bank

The government has also introduced important reforms of the tax system. Tax reforms enacted at the beginning of 2018 raised the corporate income tax rate to 20% from 17% and cut individual income taxes. The changes in the tax structure are unlikely to address much the problem of the narrow tax base, and are rather aimed at stimulating private consumption while maintaining moderate fiscal deficits. In fact, the general government deficit is projected to deteriorate only slightly to 2.3% in 2019 and 2020 from 2.0% in 2017.

Last but not least, a reform of the public service pension system was approved in 2017. Taiwan officially became an "aged society" in early 2018, i.e. its population aged 65 and over started to make more than 14% of the total population (United Nations definition). Its dependency ratio (elderly people as a percentage of the working-age population) is approaching 20% (vs. 14% ten years ago) and could reach an extremely high 64% by 2050 according to United Nations projections. In response to fast ageing and its impact on long-term fiscal sustainability, the government set up a pension reform committee in 2016. Reforms that were approved in 2017 have led to substantial cuts in the pension benefits of civil servants, state school teachers and military personnel. According to official projections, the pension fund for teachers was projected to go bust by 2030 before the reform and the fund for military personnel by 2020. The government now estimates that, thanks to the reforms, the viability of the public pension system is ensured for at least 30 years.

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