

# TAIWAN

## ECONOMIC AND STRATEGIC STRENGTH

Taiwanese economic activity has slowed sharply since spring 2022. The island is particularly vulnerable to weakening global demand and the downturn in the electronics cycle due to its dependence on semiconductor exports. At the same time, its position as a quasi-monopoly on the most sophisticated microprocessor market probably protects it against the threat of Chinese aggression, at least in the short term. From a strictly macroeconomic point of view, Taiwan has solid fundamentals – and in particular a very comfortable external financial position – that strengthen its ability to withstand external shocks.

## DEPENDENCE ON THE GLOBAL ELECTRONICS CYCLE

Taiwan was one of the few countries in the world not to record any major deterioration in its macroeconomic performance in 2020-2021 despite the Covid-19 pandemic. Its economic growth even strengthened from an average of 2.8% per year in 2016-2018 to 4.5% in 2019-2021. It was supported by the sharp rise in production and exports in the manufacturing sector, by accommodative monetary and fiscal policies, and by the continued increase in the investment rate (from 21.6% of GDP on average in 2016-2018 to 25% in 2019-2021). Neither public finances nor external accounts deteriorated. The island's high-tech industry has benefited greatly from rising global demand and strengthened its leading position in the production of highly sophisticated microchips<sup>1</sup>. Semiconductor exports, which almost doubled between 2019 and 2022, accounted for 39% of total exports in 2022 (compared to 28% in 2019). The economic situation has turned around since 2022. In spring 2022, an epidemic wave accompanied the gradual abandonment of the zero-Covid policy in Taiwan and led to a further (moderate and temporary) drop in mobility and retail sales indicators. At the same time, the strict lockdowns imposed in Shanghai caused supply-chain disruptions and a drop in Chinese demand that penalised Taiwan's economic activity.

Above all, the international environment deteriorated abruptly following Russia's invasion of Ukraine. On the economic front, the widespread rise in inflation has led to a tightening of domestic and international monetary conditions since March 2022. The subsequent weakening of global demand and the reversal of the global electronics cycle have increasingly weighed on Taiwanese exports of goods. After a rapid rise in 2021 (+29% in current US dollars) and in H1 2022 (+20% year-on-year), exports have fallen since last September. Their drop reached -3% year-on-year in H2 2022 and -18% in H1 2023, in particular driven by the contraction in sales to China and Hong Kong (which absorbed 42% of Taiwanese exports in 2022).

Furthermore, in a geopolitical context that has become more difficult, tensions in the Taiwan Strait have increased sharply since summer 2022, causing concern for foreign investors.

## THE ISLAND STARTED 2023 WITH A RECESSION

As a result, economic growth fell to +2.4% in 2022, then to -2.9% year-on-year in Q1 2023. Taiwan even recently entered a technical recession as activity contracted from one quarter to the next in Q4 2022 (-0.5%) and Q1 2023 (-0.6%).

Industrial production, after having risen by 15% in 2021 and peaked in February 2022, fell steadily until April 2023. It suffered from lower demand and significant stock adjustments, particularly in the techno-

<sup>1</sup> Taiwan has 20% of the world's semiconductor production capacity (2019 data), but its share is much higher for the most sophisticated chips. In particular, it has a quasi-monopoly for logic chips of under 10 nm, with more than 90% of the production capacity

### FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	3.4	6.5	2.4	0.6	2.9
Inflation, CPI, year average, %	-0.2	2.0	3.0	2.2	1.5
General government balance / GDP (%)	-1.0	-0.2	-1.5	-2.8	-2.0
General government debt / GDP (%)	32.1	30.1	30.1	32.1	32.7
Current account balance / GDP, %	14.3	15.2	13.2	11.3	12.0
External debt / GDP, %	28.2	27.5	26.5	26.1	25.0
Forex reserves, USD bn	529.9	548.4	554.9	560.0	565.0
Forex reserves, in months of imports	20.9	16.2	15.0	17.5	16.3

e: ESTIMATES & FORECASTS

TABLE 1

SOURCE: BNP PARIBAS ECONOMIC RESEARCH

### TAIWAN: ADJUSTMENTS IN THE MANUFACTURING SECTOR

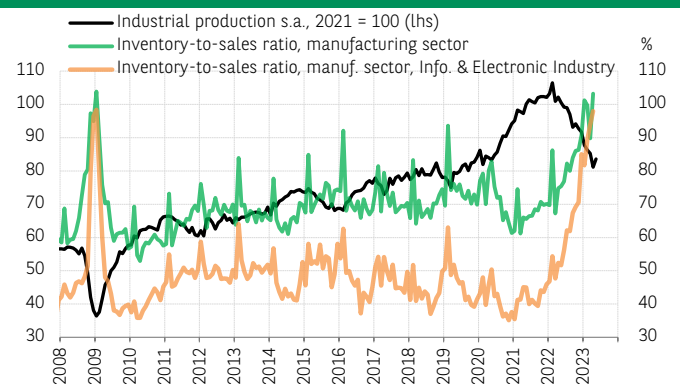


CHART 1

SOURCE: MINISTRY OF ECONOMIC AFFAIRS, BNP PARIBAS

logy sector. The slight improvement in industrial production in May (+3% month-on-month but still -16% year-on-year) could be short-lived. PMI indices in the manufacturing sector remained weak in May and June 2023 (at less than 45). On the one hand, inventories in the electronics industry remain at historically very high levels (Figure 1). On the other hand, global semiconductor demand is unlikely to recover significantly before Q4 2023. However, the outlook is seen as a little more favourable for the most sophisticated chips, used for high-performance computers and artificial intelligence devices, unlike consumer



electronics demand, which is expected to remain depressed until the end of the year.

Investment fell in Q1 2023 (-0.8% year-on-year) for the first time since 2017. This contraction stems from the deterioration in corporate revenue in the manufacturing sector<sup>2</sup>, the weak export outlook in the short term, tighter monetary policy and credit conditions, and the start of a downward correction in the real estate sector. Added to this are investors' uncertainties linked to geopolitical tensions.

Private consumption remained dynamic (+6.5% year-on-year Q1 2023) and retail sales growth accelerated further in May. After a long period of health constraints, household spending has rebounded more strongly since the summer of 2022 and is still benefiting from post-Covid catch-up effects. In addition, it was encouraged by government stimulus measures, the recovery of tourism and the recovery of the labour market. This was driven by employment in services, and it led to a reacceleration in income growth and a drop in the unemployment rate (to 3.5% in May 2023). Consumer confidence has also improved since the beginning of the year (the index rose from a low point of 59.1 in December 2022 to 66.7 in June), but remains below the levels that prevailed over the 2010-2019 decade (during which the index averaged 81.2).

These private consumption dynamics are expected to lose steam in the second half of 2023. In particular, the recovery of the labour market could be interrupted due to the economic slowdown in the manufacturing sector.

## MONETARY TIGHTENING ON PAUSE

Domestic demand should also remain held back by the effects of tighter credit conditions. In response to rising inflationary pressures in 2021 and 2022, the central bank raised its main policy rate from 1.125% in early 2022 to 1.875% in March 2023, the highest level since 2015. The latest quarterly monetary policy committee meeting held in mid-June kept policy rates unchanged. The status quo should be maintained for the remainder of the year due to moderation in inflation and downside risks to growth. Consumer price inflation (CPI) gradually fell by +3.6% year-on-year in July 2022 to 2% in June 2023, and should continue to slow down slowly in H2 2023. At the same time, the very low interest rates in Taiwan compared to the United States should prevent a new cycle of monetary policy easing in the short term.

The rise in nominal borrowing rates, linked to the decisions of the central bank, has added to the effects of disinflation on real rates since summer 2022. In addition, the authorities introduced macro-prudential measures in 2022, and again recently, in order to moderate the rise in housing loans and limit property speculation (the last measure taken in mid-June caps the loan-to-value ratio at 70% for the purchase of second homes in certain regions). Growth in domestic credit to the private sector has thus lost momentum in recent months (Figure 2). The slowdown in bank mortgages has been particularly marked (mortgages rose +3.9% year-on-year in nominal terms in May 2023, compared to +9% at the end of 2021). These trends will continue in the short term.

## ECONOMIC SHIELDS

Finally, uncertainty among investors and consumers could increase and weigh more on activity in the run-up to the presidential and legislative elections, which will take place in January 2024. The most

### TAIWAN: MONETARY CONDITIONS TIGHTENING

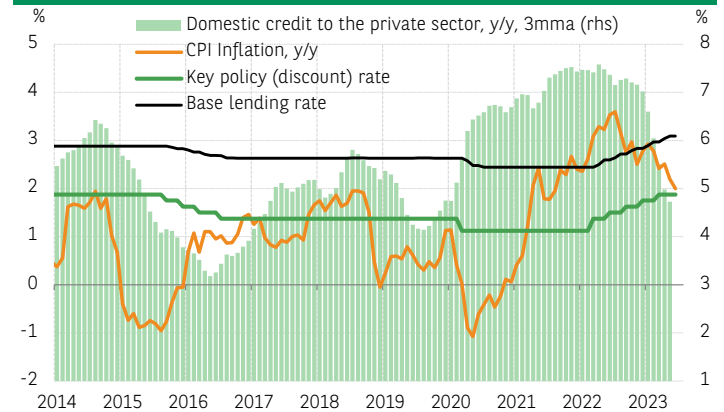


CHART 2

SOURCE: CBRC, DGBAS, BNP PARIBAS

likely scenario at present is the continuation in power of the DPP (Democratic Progressive Party, the party of Tsai Ing-wen, the president since 2016), as well as the preservation of its majority at the legislative assembly. The preparation and holding of the elections will certainly increase nervousness in the Taiwan Strait. Tensions between China and Taiwan have worsened since the summer of 2022 and have reached a level unprecedented in more than twenty years. Chinese military exercises in the strait are increasing, maintaining the risk of more severe incidents at all times. The risk of escalation is high in the medium term. However, the risk of an island invasion seems to be contained in the short term: there are many reasons of a military, geopolitical and economic nature. In particular, Taiwan Semiconductor Manufacturing Co. (TSMC), state-of-the-art semiconductor production plants and Taiwan's position as a quasi-monopoly in the most sophisticated chip market constitute a «silicon shield» that protects the island, at least in the short term. A Chinese military operation would put China's and the rest of the world's semiconductor supply at risk. The crucial role of the Taiwan Strait in shipping (about half of all container ships in operation sailed through the strait in 2022), especially for trade in goods departing from Chinese factories to European and US markets, probably also mitigates the risk of escalation of military manoeuvres or a blockade of strait waters.

Faced with the slowdown in global trade and tensions with China, Taiwan has financial shields that limit its purely macroeconomic vulnerability. Taiwan mainly holds a very solid external financial position, which is based on large current account surpluses (between 10% and 15% of GDP over the last ten years), very comfortable foreign exchange reserves (USD 565 billion at the end of June 2023, i.e. more than 15 months of imports of goods and services), moderate public debt, and limited external debt reflecting a very low dependence on non-resident financing.

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<sup>2</sup> In particular, revenue from the semiconductor industry fell by -13% year-on-year in Q1 2023. After an average increase of 22% per year in 2020-2022, it is expected to fall by -12% over 2023 as a whole, according to the Taiwanese Semiconductor Industry Association (TSIA).