Taiwan

The economy gets a second wind

Taiwan's export sector has been hit by the slowdown in trade between China and the United States since spring 2018, but it has also benefited rapidly from some of the positive effects of the trade war. US importers have replaced certain Chinese products with goods purchased directly from Taiwan. Plus the US-China trade war provides Taiwanese manufacturing corporates an incentive to leave Mainland China and relocate production in Taiwan, with firm government support. Thanks to these developments, Taiwan's economy reported stronger than expected growth in 2019, and this trend should continue in 2020.

Real GDP growth slowed from 3.3% in 2017 to 2.7% in 2018 before holding at this level in 2019. Last year's economic performance was better than expected at this time a year ago. After a period of growth slowdown between mid-2018 and early 2019, triggered by US-China trade tensions and sluggish global demand, the economy has regained momentum. The manufacturing sector has rapidly benefited from a substitution effect as US importers replaced certain products with goods purchased directly from Taiwan. The US-China trade war has also provided Taiwanese export corporates with an incentive to leave Mainland China and relocate production in Taiwan.

Short-term prospects are still looking upbeat, and we are forecasting real GDP growth of 2.8% in 2020. The export sector should benefit from the expected rebound in the global electronics market and will continue to benefit from the reshaping of supply chains in Asia. Domestic demand is expected to remain robust, bolstered notably by solid investment growth and accommodative monetary and fiscal policies. The January 11th elections handed President Tsai Ing-wen a second four-year mandate, and her Democratic Progressive Party (DPP) held on to its parliamentary majority. This means the authorities should be able to pursue the economic program in place since 2016. Although the election results could aggravate tensions with Mainland China, they are unlikely to have a large impact on economic activity in the short term.

The economy is holding up well

Real GDP growth slowed from 3.3% year-on-year (y/y) in H1 2018 to 2.2% in H2 and 1.8% in Q1 2019, before picking up gradually thereafter (2.6% in Q2 and 3% in Q3). According to preliminary estimates by the Taiwan statistics office, real GDP growth reached 3.4% y/y in Q4 2019 (or 1.7% quarter-on-quarter, seasonally-adjusted). These trends in GDP growth can be attributed mainly to changes in the contribution of foreign trade – which dropped into negative territory in H2 2018 before swinging back into positive territory in 2019 – and to the strong upturn in investment. It began picking up in mid-2018 after several quarters of weak or negative growth. In the first three quarters of 2019, investment rose 7.4% y/y (compared to an average annual rate of 2.5% in 2014-2018), and it probably strengthened further in Q4 2019.

These trends were largely shaped by the US-China trade war. Given the economy's strong dependence on high-tech exports and large exposure to the US and Chinese markets, Taiwan was immediately hit by the knock-on effects of the slowdown in US-China trade. Merchandise exports increased by only 1% y/y in value in H2 2018 (compared to 11% in H1 2018) before contracting by 2% in full-year 2019 (chart 2). Initially, the manufacturing sector scaled back production (-1.2% y/y in the first 10 months of 2019). But soon Taiwan has also benefited from some of the positive effects of the US-China trade war.

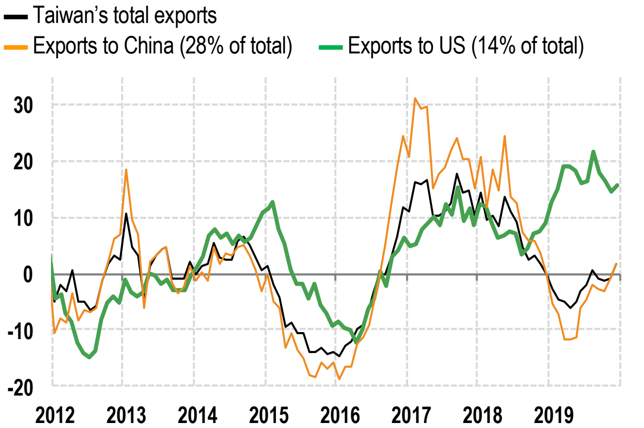
1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	2.7	2.7	2.8	2.3
Inflation (CPI, year average, %)	1.4	0.6	1.2	1.0
Budget balance / GDP (%)	-1.9	-2.0	-2.2	-2.4
Gen. Gov. debt / GDP (%)	35.1	36.0	36.8	38.0
Current account balance / GDP (%)	11.6	11.4	11.5	12.0
External debt / GDP (%)	31.4	34.2	33.6	33.4
Forex reserves (USD bn)	462	478	490	500
Forex reserves, in months of imports	19.4	20.0	19.6	19.0
Exchange rate USDTWD (year end)	30.7	30.1	29.8	29.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Impact of US-China trade tensions on exports

Merchandise exports, USD, y/y in %, 3-month moving average



Source: Ministry of Finance

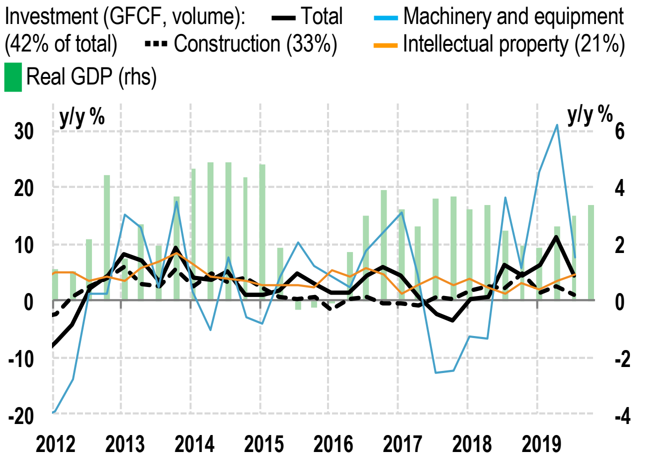
US-China trade war benefits Taiwan's export sector

Firstly, the manufacturing sector benefits from a substitution effect as US importers replaced certain Chinese products by goods purchased directly from Taiwanese companies. Taiwanese exports to the United States jumped by 17% in 2019 (compared to an average annual increase of 4% in 2014-2018). This partially explains why Taiwan's total exports did not decline as much as South Korea's, for example (-10% in 2019). The performance of Taiwan's export sector is still highly correlated to China's total exports, which have picked up slightly over the past 2 months. Very short-term prospects have indeed improved somewhat following the signing of the "phase 1" trade agreement between Beijing and Washington (see pages 3-4). They should also get a boost from the expected rebound in the global electronics market. Taiwan's industrial output rebounded in late 2019 (+6.4% y/y in December), bolstered by stronger sales and the need for stock rebuilding (inventories were scaled back in the first three quarters of 2019). It should continue to pick up in the months ahead.

Secondly, and this is the most interesting positive effect, the US-China trade war has created an incentive for Taiwanese firms to invest in factories in Taiwan. Higher US tariffs on Chinese imports combined with the increase in China labor's costs encouraged a number of Taiwanese manufacturers to review their production strategies and to exit Mainland China by relocating production in Taiwan. The authorities have encouraged this strategic shift and set up an action plan in January 2019 (the "Action Plan for Welcoming Overseas Taiwanese Businesses to Return to Invest in Taiwan"), which aims to provide financial and logistical support to corporates that want to relocate production. The initial plan was complemented by two additional plans in July 2019 that aim to encourage investment by local small and mid-sized enterprises. At mid-January 2020, more than 300 Taiwanese companies had already signed up for one of the three government assistance plans, 169 of which were operating in China (mainly in the high-tech sector). Investment in machinery and equipment (90% of which is private) rebounded by 20% y/y in the first three quarters of 2019 (chart 3) and should continue to rise rapidly in the short term.

The recent trends of the export manufacturing sector (reshaping of trade flows in Asia, relocation of production) should continue in the short to medium term. Yet there are still some downside risks weighing on Taiwan's economic outlook. First, tensions between Taiwan and the Mainland could worsen following the re-election of President Tsai Ing-wen. So far tensions have not really had much of an impact on trade of manufactured goods. Yet Beijing could adopt measures to hurt sales in certain sectors, such as agriculture or tourism. Since China stopped issuing individual travel visas to Chinese mainlanders in August 2019, the inflow of Chinese tourists to Taiwan (38% of total tourists in 2018) fell by half. Yet the tourism sector accounts for only 2% of Taiwan's GDP. Consequently, the impact of tensions between Taiwan and the Mainland should have only a moderate impact on economic growth in the short term. However, pressure from Beijing is severely constraining the development of ties between Taiwan and the rest of the world. Moreover, Taiwan could also become the direct target of US protectionist measures while the increasing shift in focus of the US-China trade war towards technology could have major repercussions on the high-tech sector in Taiwan and the rest of Asia.

3- New investment in production facilities



Source: DGBAS

Robust domestic demand

The export sector's newfound momentum has had positive effects on the job market and private consumption. Real growth in household consumption has already accelerated from 1.7% y/y in H1 2019 to 2.3% in Q3. Public investment has also picked up (+5.9% y/y in the first three quarters of 2019), driven mainly by a vast infrastructure development plan. Accommodative monetary conditions are another factor supporting domestic demand growth.

Thanks to healthy public finances, the government has comfortable manoeuvring room to conduct an expansionist fiscal policy and implement programmes to stimulate private investment. By consolidating production facilities and raising the economy's competitiveness, these policies are an answer helping to address the decline in Taiwan's long-term growth potential registered in recent years, and reinforce the island's economic prospects in the medium term.

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