Taipei,China

Softer external demand tamped down growth in 2018, and inflation remained low even as it doubled with higher food and transportation prices. Growth is expected to moderate further in 2019 and 2020 as global growth slows and business sentiment wanes. Inflation should trend down as oil prices moderate, and the current account surplus will shrink as export growth slows. Improving export competitiveness is essential for diversifying exports in terms of both products and destinations.

Economic performance

GDP growth moderated from 3.1% in 2017 to 2.6% in 2018 as export growth decelerated with softer external demand. Growth in exports to the People's Republic of China (PRC), which accounted for 28.8% of the total, slowed sharply from 20.4% in 2017 to 8.8%, while growth in exports to the US, the second biggest market, slowed to 7.5%, dragging total export growth down by more than half to 5.9%. Exports of manufactured goods and of machinery and transport equipment were especially hit, rising by only a fraction of their 2017 growth rate. As the decline in import growth was more moderate, from 12.5% in 2017 to 10.6% last year, net exports deducted 0.5 percentage points from GDP growth (Figure 3.13.1).

Domestic demand, in particular investment, was the engine of growth. Gross capital formation expanded by 6.1% in 2018, reversing a decline in 2017 and adding 1.3 percentage points to GDP growth as public infrastructure investment accelerated and spurred private investment. Consumption added 1.6 points to growth as government consumption recovered from a decline of 0.6% in 2017 to increase by 3.5% on election-related spending, but private consumption grew less than in 2017. The unemployment rate edged down from 3.8% in 2017 to 3.7%.

On the supply side, growth in services improved from 2.5% in 2017 to 2.6%, adding 1.6 percentage points to growth. It was sustained by tourist arrivals that rose by 3.0% in 2018 as a decline in arrivals from the PRC was offset by increases from Southeast Asia, Japan, and the US (Figure 3.13.2). Industry growth slowed as production for export moderated but still added 1.1 points to growth, while the contribution of agriculture was minimal.

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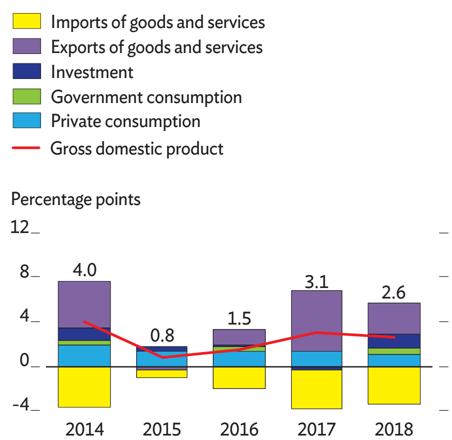
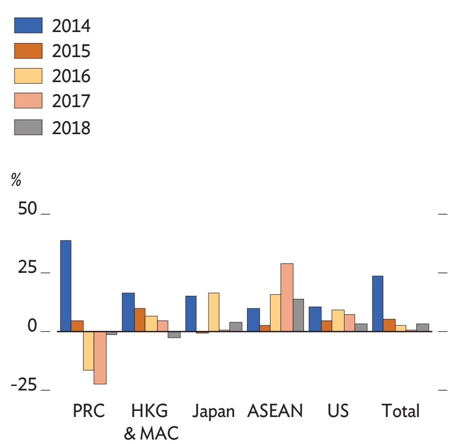
3.13.1 Demand-side contributions to growth



Source: Haver Analytics (accessed 8 March 2019).

3.13.2 Growth of tourist arrivals



ASEAN = Association of Southeast Asian Nations, HKG = Hong Kong, China, MAC = Macau, China, PRC = People's Republic of China, US = United States.

Source: Haver Analytics (accessed 8 March 2019).

Average inflation more than doubled to 1.3% in 2018 on rising prices for food, transportation, and communication (Figure 3.13.3). Core inflation, which excludes food and energy, also increased, from 0.7% in 2017 to 1.0%, and wholesale price inflation averaged 3.6%, pushed up from 2017 by higher prices for petroleum and wooden products, with sizable fluctuations during the year reflecting exchange rate movements.

The budget recorded a deficit equal to 0.3% of GDP in 2018, reversing a surplus of 0.1% of GDP in 2017 and pushing government debt to the equivalent of 31.0% of GDP. Revenue growth decelerated to 0.5%, while expenditure rose by 2.1%, mainly government investment under its Forward-looking Infrastructure Development Program, which is entirely debt financed.

The central bank kept its policy rate unchanged at 1.375% in 2018 as inflation remained moderate and economic growth slowed. Outstanding credit to the private sector rose by 5.4%, and net foreign assets in the banking system grew by 1.0%, but broad money growth slowed from 3.6% in 2017 to 2.7%.

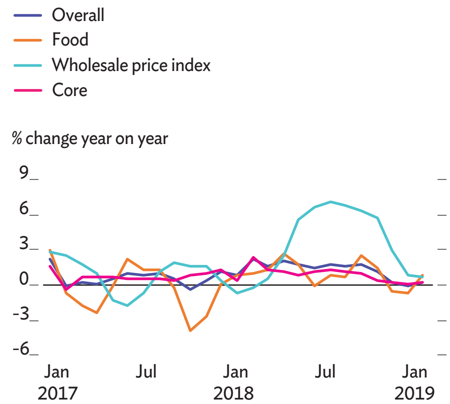
The current account surplus narrowed from the equivalent of 14.4% of GDP in 2017 to 11.6% in 2018 as the trade surplus narrowed and net income receipts declined, and despite lower net service payments. Gross foreign exchange reserves grew by 2.3% in 2018. The local dollar appreciated by 0.9% against the US dollar, by 0.5% in nominal effective terms (against a trade-weighted basket of currencies), and by 0.7% in real effective terms (taking inflation into account) (Figure 3.13.4).

Economic prospects

Economic expansion is expected to moderate this year and next, reflecting the impact of the global economic slowdown, trade tensions, and deteriorating business sentiment. The Nikkei manufacturing purchasing managers' index tumbled in January 2019 at its fastest pace in more than 3 years. GDP growth is therefore forecast at 2.2% in 2019 and 2.0% in 2020. Services will make the largest contribution to growth this year and next on the growing strength of tourism. Planned cuts to individual income tax may also boost consumption. Meanwhile, substantial investment growth in 2018 is expected to become tepid this year and next, though kept positive by outlays under the Forward-looking Infrastructure Development Program and recent government incentives for investors, such as income tax credits for 5G mobile networks and smart machinery investments.

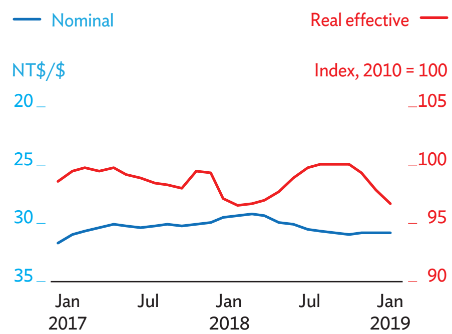
Export growth is projected to moderate primarily in response to weakening global economic conditions and US–PRC trade tensions. Exports of semiconductors to the PRC, used as inputs for PRC products exported to the US, are particularly likely to be adversely affected. Imports of capital and intermediate

3.13.3 Inflation



Source: CEIC Data Company (accessed 8 March 2019).

3.13.4 Exchange rates



Source: Haver Analytics (accessed 8 March 2019).

goods are likely to remain modest, considering weakness in export demand, and overall import growth will slow further. On balance, net exports are expected to contribute little to GDP growth this year and next. The trade surplus is projected to trend downward, narrowing the current account surplus to the equivalent of 6.0% of GDP in 2019 and 2020, despite a likely increase in net receipts from services on continuing strength in inbound tourism.

Inflation is forecast to slow to 1.1% in 2019 in line with a gradual decline in oil prices and then edge up to 1.2% in 2020 as the currency weakens along with the current account. Given the tame inflation forecast, the central bank will likely keep its policy rate unchanged at least until the end of 2019.

The budget deficit is projected to shrink from the equivalent of 0.3% of GDP in 2018 to a mere 0.03% as revenue grows more than expenditure despite planned income tax reform. The outstanding debt of the central government has declined in recent years and is projected to equal 32.2% of GDP at the end of 2019, which is well below the 40.6% ceiling mandated by the Public Debt Act. As the debt is entirely domestic, there is little exchange rate risk.

Downside risks to the outlook are external threats, such as further worsening of global trade tensions or a deeper slowdown in the advanced economies and the PRC, which might reduce demand for exports. Tighter global financial conditions, in particular unexpectedly high interest rates in the US, could reduce capital flows into Taipei,China. Possessing ample fiscal reserves, however, Taipei,China is in a position to address threats as they materialize.

Policy challenge—diversifying exports by raising competitiveness

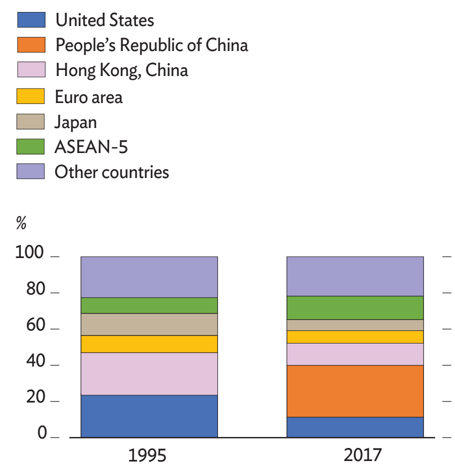
Rising global trade tensions and the slowdown in the major industrial economies and the PRC pose significant risks for an export-oriented economy like Taipei,China. These vulnerabilities are accentuated by high concentration of exports in terms of both products and destinations. Data on export concentration in 1995 and 2017 show more than half of exports going to the top three export destinations: the PRC and then the US and Hong Kong, China (Figure 3.13.5). Data further show that the top five exported goods occupy a larger portion of total exports than in peer economies (Figure 3.13.6). Moreover, the number of products exported by Taipei,China has increased only marginally and has yet to catch up with the major industrial economies (Figure 3.13.7). To reduce vulnerability to external shocks, the government seeks to diversify exports by generating comparative advantage in a wider range of products, which should also help to expand the scope of export destinations.

3.13.1 Selected economic indicators (%)

	2019	2020
GDP growth	2.2	2.0
Inflation	1.1	1.2
Current account balance (share of GDP)	6.0	6.0

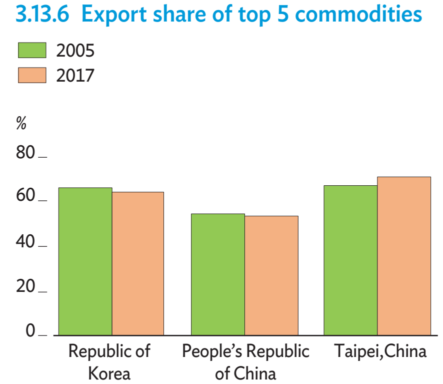
Source: ADB estimates.

3.13.5 Main exports destinations, Taipei,China



ASEAN-5 = Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam.
Source: Haver Analytics (accessed 8 March 2019).

3.13.6 Export share of top 5 commodities



Source: Haver Analytics (accessed 8 March 2019).

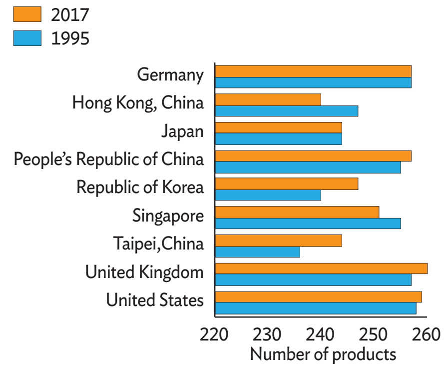
To diversify export destinations more directly, the government has introduced its New Southbound Policy to deepen economic ties with Australia, New Zealand, and countries in Asia. The policy aims to encourage industrial collaboration, conduct outreach sessions, provide strategic guidance, and organize trade promotions to gauge demand in nascent markets. The government also looks to sign multilateral and bilateral free trade agreements. However, for these initiatives to expand the operations of existing export-oriented companies and encourage new export industries to emerge, exports need to become competitive in overseas markets. The first steps toward enhancing competitiveness are to improve exporters' emissions footprints and, more importantly, ensure the adequacy of skilled labor supply.

Owing to reliance on fossil fuels as a primary source of energy, a number of products are reportedly unable to meet the emissions standard for world trade, making them less competitive. Possible approaches to reducing emissions include phasing out energy subsidies and offering financial incentives to develop low-carbon technology or switch to renewable energy.

A shortage of skilled workers in Taipei,China was documented in a recent manpower survey. Alleviating this shortage requires a multipronged approach, which should include the following: First, planned income tax reform can be amended to improve compensation for skilled workers, which has not kept pace with inflation even in major export industries and is not internationally competitive. Second, female workforce participation, which is low at 51%, should be raised by offering special pensions, longer working years, and flexible parental leave. Third, the government should operate training programs for local labor or extend incentives for companies to do so.

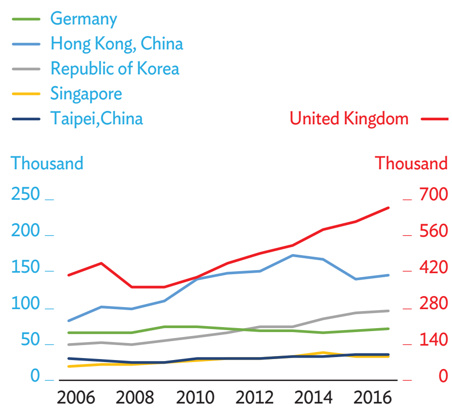
Finally, overcoming barriers to forging new export destinations requires innovation and entrepreneurship. In 2006 and 2016, Taipei,China lagged behind its peers in the number of newly registered firms (Figures 3.13.8). The indicator of new business density, which measures the number of newly registered firms per 1,000 working-age people per calendar year, also shows Taipei,China lagging behind its peers (Figure 3.13.9). While this shortcoming may have multiple causes, providing a healthier entrepreneurial ecosystem will be an important step toward alleviating it. To this end, the government can help by encouraging research and development, funding business incubators in colleges and universities, and relaxing regulations to encourage the launch of new industries and products.

3.13.7 Number of export products



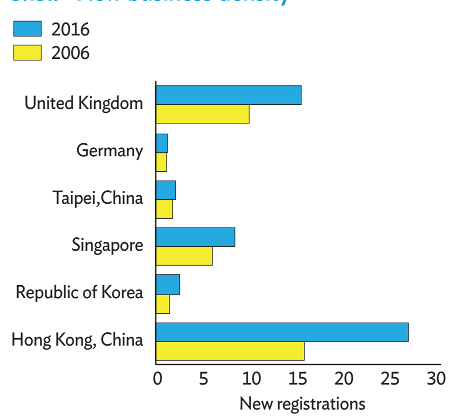
Source: UNCTADstat. https://unctadstat.unctad.org (accessed 19 January 2019).

3.13.8 Number of new limited liability companies



Source: World Bank. Doing Business Indicators. https://www.worldbank.org/.

3.13.9 New business density



Source: World Bank. Doing Business Indicators. https://www.worldbank.org/.