15 CHINESE TAIPEI

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2004: GROWTH MOMENTUM RETURNS

The global economic upturn in 2004 helped Chinese Taipei to regain its economic growth momentum. An increase in world demand stimulated industrial output and exports, which also helped to encourage private consumption and capital investments. As a result, both the employment market and the financial market performed better than expected.

Riding on the back of a very strong recovery of 2003, GDP growth for the first quarter of 2004 was a very vibrant 6.72%, with exports of goods and services and fixed capital formation growing at 20.27% and 13.63% respectively. Then the uncertain political landscape following the presidential election of March 2004 caused the financial market to plummet. Luckily, this was short lived. The strong global cyclical upturn persisted and production output and exports remained bullish. Aided by the government's financial reform bill and a low base point as a result of the SARS epidemic in 2003, GDP growth in Q2 was better than expected at 7.88%, year-over-year (yoy). Exports of goods and services and fixed capital formation grew by 25.02% and 19.44% respectively. The strong global expansion and bullish domestic demand translated into GDP growth of 7.3% in the first half of 2004. The increase was higher than expected partly due to the change in the base year of calculation, from 1996 to 2001.

The economic performance for the second half of 2004, however, was less upbeat for a number of reasons. First, the soaring oil price has far more implications than the rise in the price of energy, especially when some 99% of total energy consumed in Chinese Taipei is imported. Secondly, China's economic tightening measures introduced in April 2004 had far reaching implications for Chinese Taipei given China's importance in the local economy's bilateral investment and trade. Thirdly, the US Fed's consecutive increases in interest rates dented business confidence as the cost of borrowing went up.

The customary booming third quarter for Chinese Taipei was repeated in 2004. Exports of goods and services grew by 15.06% and fixed capital formation grew by 13.72% in Q3. GDP growth for the third quarter was 5.27%, which is marginally less than previously forecast. The softer economic activity was due to a slowing external sector as well as the phasing out of the SARS-related low-base effect. The fourth quarter saw a sharp decline in GDP growth to 3.25%. According to the Directorate General of Budget Statistics and Accounting figures, the decline was due to lower-than-expected manufacturing output as well as lower exports of goods and services. In an effort to curb inflation, as well as to keep in line with the Fed's interest rate hike, Chinese Taipei's central bank raised interest rates in October to 1.25%, the first increase in four years. The final quarter data suggests that despite relatively strong domestic activity, an external sector slowdown is imminent.

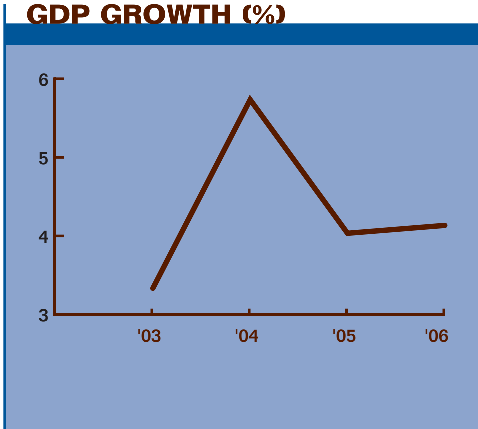
Taken as a whole, 2004 saw the highest economic growth since 1998, estimated at 5.7%. Most notably, manufacturing production, that makes up just over a quarter of the total GDP, grew by 9.36% yoy. Consumer prices increased by 1.6%, a figure that was dampened by the appreciating New Taiwan Dollar as well as softer oil prices toward the end of 2004.

Economic indicators pointed to a further slowdown due to sluggish external sector growth. The indicator of Business Climate of the Manufacturing Industry of the Taiwan Institute of Economic Research (TIER) was on the decline throughout the second half of 2004. Business monitoring indicators of the Council for Economic Development and Planning of the Executive Yuan, that include both financial sectors and real sectors, saw a yellow-red light from December 2003 to September 2004 (except for an overheating in May), signalling a fast expansion for the first three quarters of 2004. For the last quarter however, the Indicator flashed green, which indicates a slowing down of the expansion.

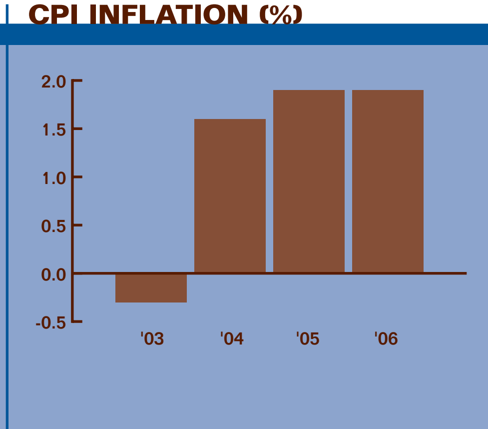
OUTLOOK FOR 2005

The soaring oil price, the continual interest rate hikes by the Fed and uncertainties associated with China's economic tightening measures, look to dampen world economic growth in 2005. All major international

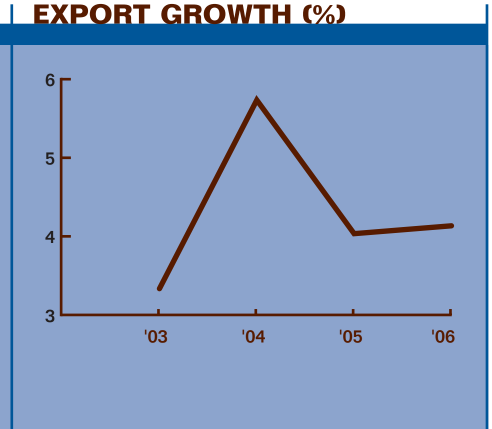
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



forecasting agencies agree that 2005 will see slower economic growth than 2004. Being a small, open economy that relies heavily on trade, this will noticeably affect Chinese Taipei's economic outlook for 2005. *Global Insight* has lowered its growth forecast for Chinese Taipei from 5.8% in 2004 to 4% in 2005. Other agencies including the World Bank and IMF have similar projections, with 5.8% and 5.6% for 2004 and 4.3% and 4.1% for 2005 respectively. In short, with external sector growth slowing, Chinese Taipei is expected to see more subdued economic growth for 2005.

On the external front, exports are expected to slow in line with a global economic downturn. The increase in exports of goods and services is expected to slow to 4.39% in 2005, from the 2004 level of 15.27%. In the same way, private consumption is expected to dampen from 3.13% to 2.94% in 2005, according to the latest TIER forecast. While large-scale private investment projects are expected to continue over into 2005 from the previous year, the growth rate is expected to ease from an extreme high of 28.2% in 2004 to a more sustainable 8.81%.

A number of policies were put in place in order to better deal with the fast-changing global climate facing Chinese Taipei. For cost-push inflationary pressure, the inter-Ministerial price monitoring taskforce that met in September 2004, has introduced a number of measures: 1) switching from "loose" to "neutral" monetary policy; lowering tariffs on energy and consumer goods imports; 2) adjusting the price for public utilities based on consumer affordability, economic climate and business profitability; and 3) the petroleum industry has been asked to avoid supply risks as well as increasing emphasis on energy efficiently for the long-run.

In terms of domestic factors, the improvement in the employment outlook has helped to stimulate domestic demand. Furthermore, there are a number of infrastructure developments worth some US$15 billion by the Chinese Taipei Government and a further US$6 billion by private sector investors planned over the next five years, including the improvement of infrastructures and construction of a new high-speed railway system. These fiscal stimuli are expected to sustain Chinese Taipei's economic growth momentum.

The latest figure from TIER's monthly survey of the manufacturing sector paints a very buoyant picture. The February figure showed the proportion of manufacturing firms that perceived business would be as least as good as currently, if not better, for the next six months soared from 26.97% in January to 54.6%. The number of firms that believed the economic outlook was worsening declined from 18.2% in January to 8.5%. Most businesses surveyed (91.5%), agreed that the business outlook for the next six-months will be as good as the business climate now, if not better! The composite indicator, after adjustment for seasonal factors on moving average, rose to 101.40 points, up from 100.55 in the previous month.

With domestic economic prospects remaining bullish, the TIER forecast for GDP growth in 2005 is an upbeat 4.03%.

RISKS AND UNCERTAINTIES

There are a number of uncertainties that might affect the economic outlook for Chinese Taipei. First, the implementation of the Kyoto Protocol at the beginning of 2005, is expected to have a great impact on Chinese Taipei's industry, in areas such as iron and steel production, petrochemicals, cement, paper pulp and synthetic fibre industries. Even though Chinese Taipei is not a party to the agreement, the government is committed to further reduce its carbon dioxide emissions. There may be costly consequences for local industries.

The fiscal deficit is another issue for concern. The government deficit has increased rapidly over the last decade as the government found it increasingly difficult to raise enough revenue to cover its outgoings. With its declining tax base, the Chinese Taipei Government will need to find ways to raise enough capital in order to maintain its public projects or risk loosing its economic growth momentum.

Thirdly, the non-performing loans (NPL) can be another area of great risk. The NPL ratio in the banking sector has been greatly improved from 8.8% in 2002 to 3.2% by the end of 2004. However, community financial institutions still saw a NPL level of 10.7%. This needs to be improved to maintain financial and social stability.

Fourthly, the economy is over exposed to a faltering technology industry. A decline in external demand might change the entire economic makeup of Chinese Taipei. Furthermore, as a highly export sensitive economy, Chinese Taipei's central bank is averse to a stronger New Taiwan Dollar, which also might affect export growth.

Last but not least, the political outlook might also affect economic development. The 2005 budget was finalized in Parliament in January 2005. The opposition parties rejected the government's plan to privatize several state-owned enterprises as well as forcing through some major spending cuts. The partisan bickering during the budget negotiations look to impede future economic policy-making and that can only cloud Chinese Taipei's economic outlook for 2005.