

### Economic

#### Credit Agencies

Moody's: Aa3  
S&P: AA-  
Fitch: A+

#### Nominal GDP (2006)

USD 353.8bn

#### Population (2006):

22.6 million

#### Total Trade / GDP:

120%

#### Currency:

New Taiwan dollar

#### Exchange regime:

Free float

#### Merchandise imports from Canada:

CAD 1,308mn

#### Main sources of Foreign Exchange (excl. FDI):

Electronics and machinery exports (29%)

#### Largest Merchandise Trading Partner:

China (Hong Kong) (16%)  
United States (13%)

#### Main imports:

Intermediate Goods (74%)

#### Risks to the Outlook



Strong US economy  
Robust Chinese growth



Political tensions with China, dependence on IT and links with China

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**Market Spotlight:** Strong global electronics demand has augured well for the Taiwanese economy in recent years. In 2006, real GDP grew at 4.3%, marking the fifth consecutive year of expansion after an output shock in 2001. However, the almost complete dependence on external demand (especially the IT sector) to fuel growth introduces risks to the economy in the event of significant economic slowdowns in key markets.

**Recent Economic Developments:** Real GDP growth estimate for 2006 came in at 4.3% y/y, compared with 4.1% for all of 2005 and marking 18 consecutive quarters of growth after the -2.2% contraction in 2001. In line with the deceleration of private consumption spending the year before at 3%, consumer spending growth in 2006 eased to 1.5% y/y as interest rates have gradually started to rise. Previously, a consumption expenditure revival had been stimulated largely by an accommodative monetary policy, which had kept both short-term and long-term real interest rates at historical lows. Meanwhile, investment demand has put in a disappointing performance with total investment y/y growth at a miniscule 0.2% and private investment a nominal 5.6%. Private sector investment typically accounts for ¼ of total investment. Fortunately, the main engine of growth for the Taiwanese economy over the last several years has been external demand. Export momentum in the present year has picked up with growth estimates of 13.7% y/y and 6% y/y for exports and net exports in 2006, significantly higher than the rates observed in the previous year. Absent strong domestic demand, could dent economic prospects going forward.

**Monetary Policy:** The discount rate has been raised 50 bp. to 2.75% over the past year. Although the Central Bank has pursued a tightening bias since October 2004, interest rates are still relatively low, (real interest, rates adjusted for inflation are around 1%). But the lengthened period of monetary stimulus since 2003 has contributed to domestic growth, and through the impact of declining rates on the flexible exchange rate, provided support for export growth. Going forward, it is likely that the CB will likely tie future rate policy to steps taken in the US. The CB which uses the monetary aggregate M2 as the intermediate target in the implementation of monetary policy has set the target band for M2 growth for 2006 at 3.5% to 7.5% and as of November remained well within range at an annual growth rate of 5.88%.

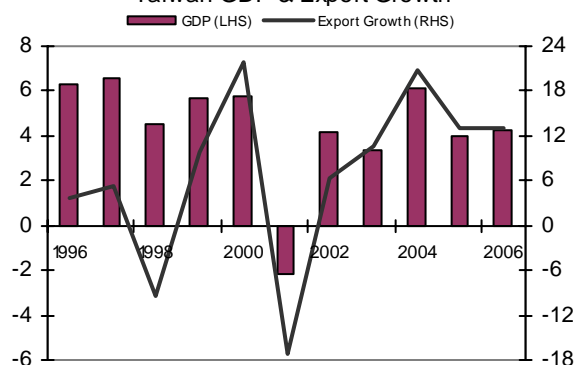
**Fiscal Policy:** Rising fiscal outlays as a share of GDP in 2006 reflects Taiwan's continued commitment to expansionary fiscal policy. Outlays have chiefly concentrated on social security and infrastructure; however, this sizeable expenditure will delay intentions to effectively improve their public finances. Thus, a reduction of their budget deficit would require that taxes be raised. Though, the budget imbalance is anticipated to recalibrate with an estimated reduction in the deficit on the back of stronger revenue from 3.1% of GDP in 2005 to 2.2% of GDP in 2007.

**Outlook:** An expected reduction in trade revenues for 2007 is likely to keep GDP growth stable at 4.3% y/y. Other significant variables that speak to this growth abatement is the dwindling strength of domestic demand, wherein we find 7% y/y growth in 2005 shrink to 1.7% y/y in 2006, and the marked decline in private consumption growth, which currently sits at 1.5% after a 3-year quarterly low of .4% y/y in the third quarter. Although Taiwan's poor domestic and private consumption growth in 2006 were partially offset by robust export and investment growth, its residual effects are likely to dampen industry performance this year. Moreover, household spending will still be constrained by excessive debt. In tune with the deceleration of U.S. economic growth, a further easing of export growth to 6% y/y is envisaged. The trade balance, however, will be nominally affected as weak domestic demand for imports is anticipated to counteract the impact of waning export demand from Taiwan's second largest export market. Given Taiwan's close trade ties with Hong Kong and the U.S., the long term economic outlook appears positive; however, short term prospects could be dampened by slowing U.S. growth.

#### Economic Indicators

	01-05 avg.	2006	2007	2008
GDP (% growth, real)	3.1	4.3	4.3	4.4
Inflation (% , year-end)	0.7	0.6	1.5	1.2
Fiscal Balance (% of GDP)	-3.3	-2.3	-2.2	-2.2
Exports (% growth, BOP goods)	5.8	13.7	6.0	5.2
Imports ((% growth, BOP goods)	5.8	13.7	8.3	5.8
Current Account (% of GDP)	7.0	6.0	4.7	4.4
Reserves (month of imports)	13.8	9.8	12.5	12.4
External Debt (% of GDP)	20.3	27.5	25.4	24.0
Debt Service ratio	2.9	3.4	3.5	3.4
Exchange rate (year-end, per USD)	33.7	32.6	30.8	29.8

Taiwan GDP & Export Growth



### General Political Environment:

Taiwan's politics are closely tied to the People's Republic of China (PRC). In 1949, the Nationalist (KMT) government of Chiang Kai-shek fled to Taiwan after losing a civil war to the communists. The KMT ruled Taiwan as a one-party state until 1987 but since that time democracy has taken root. As is the case in many maturing democracies, Taiwanese political discourse tends to be heavily personality-based and lacking in long-term strategy or vision.

The PRC views Taiwan as a renegade province and wishes to reunite it with the mainland. The PRC has threatened to attack Taiwan if it declares independence or indefinitely delays reunification negotiations.

Taiwan, on the other hand, is generally seeking to guard its democracy and *de facto* independence while growing an economy which is becoming increasingly linked to that of the PRC. Opinion on how best to balance these imperatives is quite diverse.

President Chen Shui-bian of the Democratic Progressive Party (DPP) was re-elected for a second four-year term in March 2004. The PRC leadership was not happy about Chen's re-election. It accuses Chen and the DPP (which is traditionally a pro-independence party) of intending to move Taiwan away from reunification with China by a process of "constitutional reengineering".

Throughout the five and a half years of his presidency, Chen has vacillated on mainland issues – calling for constructive dialogue at some times and making provocative statements at others. Since the beginning of 2006 Chen has been in a provocative phase. His disbanding of the National Reunification Council (NUC) in February 2006, efforts to further restrict Taiwan-mainland commerce and re-iteration of pledges to revise Taiwan's constitution have raised Beijing's ire.

Most analysts contend that these latest salvos were attempts to shore up Chen's standing within the pro-independence constituency in the face of DPP's losses in legislative (2004) and local (2005) elections. However, Chen, who is currently embroiled in a corruption scandal, has become deeply unpopular and generally seen as a liability for both Taiwan and the DPP. There have been and continue to be numerous calls from all quarters for his early resignation; however, Chen has thus far proved to be quite resilient and is likely to remain in office until his term expires in 2008.

The United States toes an ambiguous line between Taiwan and the PRC. It extends diplomatic recognition to the PRC but ensures that Taiwan's defense needs are provided for. It is widely assumed that the U.S. would come to Taiwan's aid in the event of a Chinese attack.

### Investment Environment:

The biggest Taiwanese investment story is that of outbound investment to the PRC. In spite of numerous restrictions on cross-strait financial transactions, travel and communications, Taiwanese companies have invested over USD 150 billion in mainland China. In general, business would like to see a rapid easing of the restrictions while those in national security establishment worry about Taiwan's increasing economic dependence on the PRC.

With respect to inbound investment, the government wants to attract investment in research-intensive, high value-added industries such as biotechnology and optical electronics. However, many of the bureaucratic regulations that have historically impeded business dealings remain even though the government enacted numerous 'business-friendly' reforms in conjunction with Taiwan's 2002 accession to the World Trade Organization (WTO).

### Political Violence:

The PRC threat to Taiwan is reaffirmed in its Anti-Secession Law. The law, which was passed in March 2005, obliges China to employ "non-peaceful means" against "Taiwan independence forces" should they "act [to cause] Taiwan's secession from China." Despite the law, military action in the Taiwan Straits is improbable in the short to medium term as the PRC leadership is focused on economic issues and the Taiwanese government is unlikely to make a clear-cut declaration of independence in the foreseeable future. In addition, the possibility of U.S. involvement in a PRC-Taiwan war will continue to mitigate the risk of a Chinese attack.

## Political

### Political Structure

Parliamentary Democracy

### President

Chen Shui-bian (DPP)

### Vice President

Annette Lu (DPP)

### Premier

Su Tseng-chang

### National Legislative Body

- Li Fa Yuan (225 members)

### Major Parties

- Democratic Progressive Party (DPP)
- Kuomintang (KMT)
- People First Party (PFP)
- Taiwan Solidarity Union (TSU)

### Last Elections

- Presidential: March 20, 2004
- Legislative: Dec. 11, 2004

### Next Elections

- Presidential: 2008
- Legislative: 2007

### Press Freedom Survey:

- 2006 Score: 20 (Free)
- (0: Free; 100: Not Free)
- [freedomhouse.org](http://freedomhouse.org)

### Control of Corruption Index:

- 2005 Score: +0.63
- (-2.5: Worst; +2.5: Best)
- [worldbank.org](http://worldbank.org)

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### Political Outlook

Tensions between Taiwan and China ebb and flow based on political developments on both sides of the Straits. However, continued U.S. involvement in the China-Taiwan relationship should ensure that the actual (as opposed to rhetorical) situation remains stable in the short to medium-term. President Chen is likely to become increasingly irrelevant as the 2008 presidential election (in which he cannot run) draws closer. At this point, KMT Chairman Ma Ying-jeou, who enjoys cordial relations with the PRC government, is favoured to win the presidency but the emergence of a non-mainstream candidate cannot be ruled out.