Taiwan continues to enjoy the benefits of a solid investment grade sovereign credit rating by major international credit rating agencies (current long-term foreign-currency ratings are: Moody’s: “Aa3”, Standard & Poor’s (S&P): “AA-”, and Fitch: “A+”), reflecting a very strong net external creditor position, sound monetary management, and a resilient economy supported by a dynamic and competitive information technology sector. Taiwan’s gross public debt remains at manageable levels, averaging 40% of GDP in 2013-14.

Economic Outlook

Growth ► Taiwan faces challenges in establishing a sustainable economic recovery, with real GDP growth unlikely to reach the last decade’s average pace of 4½% in the next two years. The economy expanded by 1.7% y/y in the first quarter of the year following a 4.0% gain in the final three months of 2012. With leading indicators implying that momentum will pick up in the coming months, we expect output to advance by around 2½% in 2013 as a whole followed by a modest improvement to 3% in 2014. The economy is highly externally oriented, with exports of goods and services equivalent to around 75% of GDP. So far, the export sector remains relatively sluggish with shipments abroad up by 2.2% y/y in the first four months of the year in local currency terms: a pickup in activity will likely become more substantial in the second half of 2013 along with a rebound in global demand. To the nation’s benefit, close to 60% of Taiwan’s exports are directed towards relatively rapidly growing economies in Asia. In this context, the economic recovery in China will be highly significant for Taiwan’s external prospects as the country purchases more than a quarter of Taiwanese shipments. In terms of domestic demand, household spending growth will be supported by decent employment conditions and increasing real wages, while investment will receive a boost from planned projects in infrastructure and high-technology industries.

Inflation & Monetary Context ► Taiwan’s inflationary pressures will remain manageable through 2014. A planned increase in electricity prices in October 2013 will be reflected in consumer prices, taking the headline rate from the current level of 1.0% y/y towards 1½% by the end of the year, with the inflation rate remaining near the 2% mark in 2014. The Taiwanese monetary policy stance will likely remain unchanged in the coming months as authorities consider the current policy stance to be conducive to maintaining price and financial stability and promoting economic growth. The benchmark discount rate has been held steady at 1.875% since September 2011. We expect that the monetary authorities will respond to rebounding economic activity and gradually accelerating inflation by adopting a measured monetary tightening bias in early 2014.

Fiscal & Current Account Balance ► Taiwanese public finances are set to improve through 2014 with the general government deficit—measured by the International Monetary Fund’s standards as net borrowing—narrowing to around 3.0% of GDP in 2013. Nevertheless, policymakers have noted that the funding of public infrastructure projects is of higher importance than fiscal consolidation. With Taiwan’s export sector in gradual recovery mode, the trade account will remain in substantial surplus. This, combined with sizable offshore earnings, will allow the current account surplus to hover around 10% of GDP through 2014. Net investment income accounts for roughly one-third of the overall current account surplus, a legacy of the buildup in international assets, including massive private sector investment in the PRC.

Institutional Framework & Political Environment

Governance ► President Ma Ying-jeou remained in office following elections in January 2012. Both the legislature and the executive office are controlled by the same party, the Kuomintang. While the PRC maintains that “Taiwan is an inalienable part of Chinese territory”, the Taiwanese administration favours a preservation of the status quo in relations, with Taiwan effectively remaining as independent territory. Nevertheless, the deep differences within Taiwan over the matter of its formal political relationship vis-à-vis the PRC will remain a source of internal tension. Meanwhile, commercial ties between Taipei and Beijing will continue to deepen, with Mr. Ma focusing on expanding beneficial bilateral trade agreements.

Financial Sector ► Fitch Ratings assesses that the risk of a systemic crisis in the Taiwanese banking sector is low. Nevertheless, the agency points out that the heavily state-owned sector is large and thinly-capitalized, with banks deeply exposed to real-estate loans, and vulnerable to credit deterioration in the technology sector. Financial institutions’ lending growth remains relatively subdued, growing at slightly less than 3% y/y in March compared with annual gains of over 8% two years earlier. Asset quality remains high with the nonperforming loans ratio at a very low level of 0.4% in March.

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