Chapter 1

The Macroeconomic Environment

The global economic rebound that began in the second half of 2003 continued on into the first half of 2004. However, the recovery lost momentum in the latter half of 2004 amid escalating crude oil prices and rising interest rates in the U.S. Nevertheless, the global economy in the year 2004 as a whole performed significantly better than for 2003.

Taiwan's economy, which is closely related to the performance of the global economy, similarly underwent a recovery in the second half of 2003 and even flashed a "red light" signal in May 2004 which indicates an overheated economy. The economy eventually cooled down its pace since and returned to the steady "green light" status by end-2004. What are the prospects for the global economy and Taiwan's economy in 2005? Below are discussions of changes in the economic environments of the world, mainland China, and Taiwan in 2004, as well as the outlooks in 2005.

I Changes in the International Economic Environment in 2004

1. The Global Economy Rose, then Fell

The global economy in 2004 performed far better than in 2003 in terms of growth (rising from 2.6% to 4.1%), but it did show signs of a slowdown in the second half of the year. The global economic growth was 4.4% for both Q1 and Q2 2004, but reduced to 3.8% and 3.5% for Q3 and Q4, respectively, and this slowdown trend is expected to extend into 2005. The growth forecast for 2005 is 3.1% (Table 1-1-1).

Table 1-1-1 Global Economic Performance

Unit: %

Year \ Region/Country	World	Taiwan	U.S.	Japan	EU-15	China	Asia (excluding Japan)
2003	2.6	3.3	3.0	1.4	0.9	9.3	6.5
2004	4.1	5.7	4.4	2.7	2.1	9.5	7.3
Q1	4.4	6.7	5.0	4.1	1.9	9.8	7.7
Q2	4.4	7.9	4.8	3.1	2.5	9.6	8.1
Q3	3.8	5.3	4.0	2.3	2.1	9.1	7.0
Q4	3.5	3.3	3.9	1.0	1.9	9.5	6.6
2005	3.1	3.6	3.4	1.3	1.6	8.4	6.2

Sources: 1. Global Insight, May 2005.
2. Directorate General of Budget, Accounting and Statistics, Executive Yuan, May 19, 2005.

Under the influence of regional and inter-regional factors, not all regions of the world turned out with equally impressive performances in 2004. To avoid inconsistency between regional and global data, the data (except for cruel oil-related data) used in this section are practically quoted entirely from Global Insight, and unless it is otherwise stated, growth rates are figures compared with the same period of the previous year. Below is a brief analysis of the economic performance of a few leading nations and regions.

(1) The U.S. Economy Boomed, then Faltered

Spurred by strong private consumption and investment in the domestic market, the U.S. economy grew 5.0% in Q1 2004, but the growth momentum faltered starting in Q2. The U.S. Federal Reserve (Fed) adopted a stricter monetary policy by raising interest rates by a quarter point at the end of Q2 2004, and then again in August and September respectively. The Fed succeeded in warding off inflation, but its actions also dampened the force for economic growth, bringing about a continuous downturn in Q3. The Fed raised interest rates a fourth time in the year in November. The negative impact brought about by a succession of interest rate hikes is expected to materialize. Thus, the U.S. economy continued its downward trend in Q4 and saw 4.4% growth for the whole year (Table 1-1-1).

The widening fiscal deficit and trade deficit remained as two thorny problems faced by the U.S. government in 2004 and have kept the US dollar low against major currencies. At the G7 Finance Minister’s Meeting, other nations consensually hoped that the U.S. government would halt the continuing devaluation of the dollar, and the

U.S. government promised to adopt a stronger dollar policy. It is fairly unlikely for the US dollar to bounce back as long as the dual-deficits problem persists.

(2) Japan's Economy Continued to Growth in 2004

Japan's economic growth of 2.7% in 2004 trumped its performance of 1.4% in 2003 (Table 1-1-1) with a boost from its gigantic trade surplus and improved private consumption and investment. Japan can be said to have recovered healthily from the days of its bubble economy in the 1990s.

The Japanese government likes to hold fast to its long-awaited economic recovery. Thus, its central bank indicated firmly and unequivocally in November 2004 in the midst of the U.S. raising interest rates and significant appreciation of the Yen that it would not raise interest rates unless the country's state of deflation had abated. To preserve its hard-won economic growth, the central bank also intends to intervene when the appreciation of the Yen against the Dollar breaks the 103 mark to keep the affected exports from stifling its economic performance.

(3) Economic Upturn of EU-15 Countries

Bolstered by strong external demand, the EU-15 economies turned for the better in 2004 as compared to 2003, but the growth momentum was relatively weak and echoed that of the global economy. That is, the economies heated up in the first half of the year, and then slowed down starting Q3. The EU-15 is expected to see 2.1% growth in 2004 (Table 1-1-1), whereas the 12 Eurozone member states averaged only 1.9% growth and are outperformed by the 3 non-Eurozone countries. The UK, a non-Eurozone country, achieved a relatively impressive growth of 3.2%.

The negligible growth of the Eurozone economies in 2004 is a reflection of their weak domestic demands and stubborn high employment rates.

(4) Continuous High Growth of the East Asian Economies (excluding Japan)

The most dominant economy in East Asia excluding Japan is mainland China. Despite its aggressive macro-control measures that were able to check its robust domestic demands somewhat, mainland China continued to record a high growth of 9.5% in

2004 as its trade continues to expand.

As all the important elections in the region ended peacefully, all Southeast Asian countries experienced steady economic growth in 2004 under the support of strong exports, of which, Singapore gave the most brilliant performance. However, Southeast Asian countries did not fare the same in attracting foreign investments. Singapore and Thailand offered a better investment environment, while Indonesia is ranked by the World Bank as one of the worst in the world in terms of business climate. Indonesia's economy is also adversely impacted by the threat of terrorist attack, and was hit by a calamitous tsunami and earthquake at the end of 2004.

Bolstered by a record-breaking trade surplus, South Korea's economy jumped 4.6% in 2004 from 3.1% in the year before, but the country is saddled with weak domestic demand, lackluster private investment, and a sharply rising won against the US dollar (Won devalued 0.3% against the US dollar in 2003, but appreciated 12.2% in 2004 as of the end of November). To stimulate its economy, South Korea's central bank dropped its interbank overnight rate by a quarter point in November 2004, suggesting the stern challenge faced by its economy.

(5) India, the Rising Star

Goldman Sachs published a "BRIC Report" in October 2003, in which it predicted that Brazil, Russia, India, and China, termed the "four bricks," would become a much larger force in the global economy by 2050, of which, India is the most noteworthy.

Prior to its economic reform that began in 1991, India was not only viewed as a socialist country, but also as a country with the strongest planned economy and the most restrictions on its private economy in the world.

After going through a currency crisis, the Indian government underwent economic reforms in July 1991 and promulgated a succession of new industrial, trade, investment, and foreign exchange policies. In the past decade, India was able to post impressive economic growth disregarding a global recession. Its real economic growth averaged 5.4% a year from 1998 to 2003, went up to as high as 8.2% in 2003, and held onto a 6% level in 2004. Despite the enormous wealth gap between the rich and the poor and between cities and countryside, India is estimated to have a 300 million strong middle class with spending power out of a population of 1 billion people.

India is known for its IT and software industries. It is the second largest software exporting country in the world, and its software exports account for 22% of total exports. The emergence and development of IT-based high technology in India are largely credited to the government policies and the outsourcing strategy of multinational corporations, in particular American firms.

Another feature of India's industrial development that warrants attention is the trend of multinational corporations setting up R&D center there. This trend goes hand in hand with the country's strength in software development.

2. The End of Lax Monetary Policy

The U.S. economy recorded 5.0% growth in Q1 2004, which slowed down in Q2, but still gained 4.8%. Over the same period of time, consumer prices in the U.S. rose by 1.8% in Q1 and 2.8% in Q2, prompting the Fed to increase the federal funds rate by a quarter point on June 30. By December, the Fed had raised the rate five times, for a total of one percentage point. The U.S. economy (expressed by real GDP) accounts for 30% of the world. Its rate hike put considerable pressure on other countries to follow suit. It could also spell the end for this round of lax monetary policy, which has been ongoing in the past three years.

Before the U.S. began to raise its interest rate, the UK had taken the same action as early as February to harness its overheated real estate market and increased the rate four times, a quarter point each time, by November. Japan and the Eurozone countries elected to keep their interest rates unchanged in consideration of their own economic situations. Nevertheless, the central banks of Japan and Europe are under tremendous pressure to raise their interest rates.

3. Escalating World Oil Prices

By monthly averages, the per barrel crude oil prices of OPEC, Brent, WTI, and Dubai's Fateh climbed throughout 2004. Even when the rising trend came to a halt for periods of one month, the prices always bounced back the following month.

Skyrocketing oil prices were the least expected development on the world scene in 2004. The underlying causes include: (1) higher-than-expected demands – the global oil demand in 2004 grew 3.4%, higher than the level estimated by the International Energy Agency, thereby driving global demand to new heights; mainland China's surging demand growth of 14.6% was the main reason; (2) production problems of oil producing countries – a strike in Venezuela, Russia's Yukos was plagued with tax problems, unrest in Nigeria, and the U.S. was hit by Hurricane Ivan which affected the steady production and supply of crude oil and drove up oil prices; (3) instability in the Middle East – Iraqi insurgents kept attacking the U.S. army and targeted oil pipelines; (4) oil speculators.

High oil prices led to rising consumer prices worldwide and dampened global economic growth. Practically all economic forecast institutions pointed to surging oil prices as the main culprit for global economic slowdown that surfaced in Q3 2004. (Table 1-1-2)

Table 1-1-2 Growth Rate of Consumer Price Index in Major Countries

Unit: %

Year \ Region/Country	World	Taiwan	U.S.	UK	Eurozone	EU	China	Japan	South Korea
2000	3.4	1.3	3.4	2.1	2.1	2.1	0.4	-0.7	2.2
2001	3.1	-0.0	2.8	2.1	2.5	2.4	0.7	-0.7	4.0
2002	2.6	-0.2	1.6	2.2	2.1	2.1	-0.8	-0.9	2.8
2003	2.9	-0.3	2.3	2.8	2.0	2.1	1.2	-0.3	3.5
2004	2.7	1.6	2.7	2.2	2.0	2.0	3.9	-0.0	3.6
Q1	2.2	0.5	1.8	2.3	1.6	1.7	2.8	0.2	3.2
Q2	2.7	1.2	2.8	2.2	2.2	2.1	4.4	-0.3	3.4
Q3	2.8	2.9	2.7	2.1	2.2	2.1	5.3	-0.1	4.3
Q4	3.0	1.9	3.4	2.3	2.1	2.1	3.2	0.5	3.4
2005	2.7	1.7	2.6	2.5	1.8	1.9	3.4	-0.1	3.6

Sources: 1. Global Insight, May 2005.
2. Directorate General of Budget, Accounting and Statistics, Executive Yuan.

4. The US Dollar Staying Low

The US dollar fell broadly against major currencies in 2003, depreciating by 15.8%, 10.2%, and 11.3% against the Euro, Japanese Yen, and the Pound Sterling respectively. The US dollar continued its decline in 2004, but by a smaller percentage of 4.8%, 2.4%, and 3.3% up to the end the year. Thus, it continued to stay at low levels throughout 2004. (Table 1-1-3)

Table 1-1-3 Exchange Rates between one US Dollar and Major Currencies

Unit: %

Time	Yen	Euro	Pound	NTD	Won
End of 2002	119.90	0.95	0.62	34.75	1,197.20
End of 2003	107.10	0.79	0.56	33.98	1,197.80
End of 2004	104.12	0.73	0.52	31.91	1,035.60

Source: /www.imf.org/external /np/fin/rates/param_rms_mth.cfm/

The U.S. largely opts for a laissez-faire attitude towards a weak currency in light of its dual-deficits problem. The Japanese government on the other hand takes all possible actions to prevent a halt to its genuine but moderate economic recovery from the bubble. That means Japan's central bank is prepared to intervene in the foreign exchange market at any time and there is little room for more appreciation of the Yen. The European Central Bank, reined in by the varying economic situations of the twelve member states of the Euro, has limited intervening power. Thus, the Euro is expected to fluctuate more widely.

5. The Global Trade Liberalization in Full Swing

After rounds of negotiations, the World Trade Organization (WTO) signed a July package on July 31, 2004, reaching agreements on the issues of trade facilitation, non-agriculture market access, agriculture, and services. In principle, the U.S., Europe, and Japan will eliminate their export taxes on agricultural products and reduce export subsidies, and all WTO members will reduce tariffs.

The negotiation of free trade agreements (FTA) was also in full swing around the world in 2004. The ASEAN countries and Japan in particular are seeking bilateral trade pacts and have made substantial progress. For example, Japan has signed a free trade agreement with Mexico and Singapore and is negotiating with South Korea, Malaysia, and Thailand. Mainland China is expanding trade talks with ASEAN countries and opened more of its markets to Hong Kong and Macau under the second stage of a Closer Economic Partnership Arrangement (CEPA) agreement.

6. Global Economy Will Slow Down in 2005

As described earlier, the global economy was robust in the first half of 2004, but slowed down in the second half of the year, mainly due to higher-than-expected oil prices and continuing interest rate hikes in the U.S., while the low level of the US dollar and the threat of terrorist attacks in 2004 had been in existence since 2003. Factors most critical to the world economy in 2005 should be oil prices and interest rates. Both will have a negative effect on economies. In addition, as the effects of mainland China's macro-control measures materialize, the forecast for 2005 global economic growth is 3.1% (Table 1-1-1).

The continuous interest rate increases in the U.S. are expected to thwart domestic investment, weaken productivity growth, cause a decline in economic growth, and shrink demands for imports, which will have negative impacts on many other countries. The U.S. interest rate is expected to raise another one percentage point in 2005. The big challenge is whether the Japanese Yen and the Euro could stay put against the U.S. interest rate hike rally.

Crude oil prices in 2005 are expected to slide to around US$40 per barrel by the end of 2004 on the beliefs that oil-producing countries will increase output, high oil prices will suppress demand, and a soft global economy will curtail demand. However, by the end of June 2005, oil prices reached US$60 per barrel.

A few uncertainties might impact the global economy. For instance, the interest rate movement in the Eurozone and Japan, whether mainland China's economy will achieve a "soft landing," and the political situations in the Middle East all warrant close observation.

II Economic Trends and Major Issues in China

1. High Economic Growth Continued in 2004

Mainland China shredded the negative impact from the SARS epidemic and picked up the pace of economic growth in the second half of 2003. However, under heavy investments in infrastructure projects that drove up demand for raw materials, booming real estate markets galvanized in part by a lax monetary policy, and strong demand for durable consumer goods, there lies the risk of supply/demand spiraling out of control.

In the second half of 2003, the Chinese authority raised the bank deposit reserve rate by 0.5% in an attempt to contract money supply and put a brake on steel, cement, electrolytic aluminum, and real estate investment projects in the hopes to rein in the investment craze. Despite these efforts, its economy grew by 9.8% in Q1 2004. More surprisingly, its fixed asset investment soared by 47.8%, and the prices of raw materials skyrocketed.

In April 2004, Chinese Premier Wen Jiaobao announced the halting of Jiangsu Tieben Iron and Steel Plant construction. Since then, the Chinese government has instituted a series of control measures targeting a few overheated sectors, including steel, cement, and hydrolytic aluminum, and implemented stringent policies over bank lending and land use. This new round of macroeconomic control has caught the attention of the world.

In April 2004, the Chinese authority raised the deposit reserve rate of commercial banks by another 0.5%, adopted the practices of differential reserve rates and a floating rediscount rate, and shrank the lending power of commercial banks. The central government also coordinated its industrial policy and credit policy to better harness the credit risks.

In the aspect of land supply control, mainland China's State Council announced its decisions on restoring land market order in the second half of 2003, which stressed the management of land development, rigorously investigating illegal land use, and a gradual implementation of the support systems for land management. By the end of July 2004, the Chinese authority had cancelled 4,735 land development projects, reduced the planned land use by 24,100 acres, and identified 61 non-complying golf courses. The central government also repossessed 2,617km^2 of land and redesignated 1,324km^2 of cultivated land.

Aside from the demand side cool-down measures, mainland China's macro-control policy also targeted the supply side. In 2004, the government raised the capital requirements for fixed asset investments in overheated sectors, including steel, cement, hydrolytic aluminum, and real estate. In addition, a few planned or ongoing projects were stopped by administrative means that were either illegal or inconsistent with industrial policy.

Rising raw material and steel prices in the second half of 2004 proved indirectly that measures implemented on the basis of administrative control might produce pronounced results in the initial stage, as demonstrated by the statistical data in Q2 2004. However, relying on administrative approaches alone to “control land use and rein in lending practices” without the complement of market tools and further tuning based on price signals, the macro-control measures will be hard pressed to achieve the intended goal and whatever effects they have produced will be difficult to sustain.

Judging from the cost of funds, the interest rate, mainland China’s real interest rate was in fact negative in view of its fast rising consumer price index that exceeded the 5% inflation level for three months in a row, making funds awfully cheap and conducive to expansion activities. Once administrative control is relaxed, investments might surge and push up the prices of steel and other raw materials. If the interest rate is unable to reflect the availability of funds and is unable to reflect the normal supply and demand of funds, then the effect of macro-controls, if any, might be hard to sustain in the absence of price signal consideration.

Accompanying the implementation of macro-control policy, mainland China faces four major problems - rising consumer prices, appreciation of the RMB, interest rate hike, and shortages of water, electricity, and energy.

2. The Problem with Rising Prices

The rising consumer price index (CPI) in mainland China was attributed mainly to grain and crude oil price hikes. Grain price hikes, the most dominant contributing factor to rising CPI there since 2003, has largely played out its influence and will be mitigated in the future.

Oil prices in the international market have risen 60% since early 2004. Escalating oil prices drove up the prices of petroleum products and raw materials. This has become an important cause of the rising prices of upstream products in mainland China. Although many uncertainties remain as to whether oil prices will come down in the future, the likelihood of a massive price hike based on its current level is small. In light of the downward trends for both grain and oil prices, mainland China's CPI growth should be around 4% in 2004 and 3% in 2005.

3. The Problem of RMB Appreciation

Mainland China's US$500 billion plus foreign exchange reserves have kept the pressure and expectation of RMB appreciation high. Nevertheless, its leaders have declared on many occasions since 2003 that their decision is not to revaluate the RMB over concerns that RMB appreciation would erode mainland China's export competitiveness and bring about a series of negative effects. However, as the prices of imported raw materials and energy stay high, the US dollar continues to depreciate in international markets, hot money pours in under the speculation of RMB appreciation, and domestic commodity prices surge, the RMB is faced with increasing pressure to appreciate.

In the three years since its accession to WTO, Chinese products have displayed considerable competitiveness in the international markets, and mainland China can no longer dodge the issue of RMB appreciation. Stalling the issue will give rise to other problems, such as low efficiency of resource allocation, economic inflation, and increasing trade frictions with other countries, which might not benefit its economic development in the long run. The Chinese government lately has taken a series of actions to relax foreign exchange controls and curtail export subsidies in the hopes at slowing down the growth of foreign exchange reserves. Those measures are still measures of expediency. More pertinent long-term approaches require systemic reforms that lead to a floating exchange rate in order to render its economic systems more flexible and efficient.

Mainland China's foreign exchange reserves have grown rapidly in recent years and reached the level of US$514.5 billion at the end of September 2004, an increase of US$111.5 billion from the beginning of the year. Over the same period of time, the country generated a trade surplus of US$10.97 billion, attracted US$53.8 billion of foreign investment, and generated an income of US$10 billion on its foreign exchange reserves. That means that about US$45 billion of hot money flowed into the land in 2004, representing 40% of its foreign exchange reserve increase. This hot money has been awaiting the arbitrage opportunity brought about by the anticipated appreciation of the RMB. In addition, international hedge funds in the range of over US$1 trillion in amount have also been eyeing covetously the chance to bet on RMB appreciation. How to prevent the speculative attack of hot money poses a considerable challenge to the Chinese government in its handling of the RMB exchange rate issue.

4. The Problem of an Interest Rate Hike

Mainland China announced a small interest rate hike of 27 basis points (0.27%) in October 2004, which seemed to have signified the start of a series of rate hikes. However, while it is still lingering at the crossroad of a planned economy and a market economy and many of its state-run enterprises serve the function of "hiding unemployment," undertaking a massive rate increase to curb inflation is an apparent path that is nevertheless difficult to implement.

Interest rate hikes are a premonition to the adjustment of the RMB exchange rate. This is apparently what the currency speculators expect from the way "international hot money" has accelerated their inflow into mainland China. In fact, its interest rate hike eyes the long-term deposit rate, not the lending rate, mainly because the Chinese authority is afraid that a real negative deposit rate will cause a massive outflow of funds from the banking system. The growth in savings by Chinese citizens has been dropping since early 2004, and part of the deposit money was diverted to other investment channels.

A government should generally control its lending rate instead of the deposit rate if it wishes to cool down its economy. By relaxing control over the interest rate, the Chinese government can still institute control through the loan approval process, but it has less control over what its citizens do with their money. Thus, its interest rate hike should be a decision targeting the flow of private deposit funds. The general public in mainland China has also noticed the expectation of the RMB appreciation, and some have converted their USD deposits back to RMB.

5. Water, Electricity, and Energy Shortages

Mainland China's water and electricity shortage problems in recent years will probably not be resolved in the immediate future. The practice of "transferring water from the south to the north” to address the severe water shortage problem in the northern part of mainland China will take at least twenty years to see any material effect. The electricity shortage is a problem plaguing practically every province, in particular the coastal areas. In light of that 80% of power generation there relies on fossil fuel, chronic electricity shortages have pushed up coal prices, much to the chagrin of power plants. Judging from the current circumstances, it will take the country at least a year or two to see any alleviation to its electricity shortage problem.

Mainland China’s reliance on imported oil has been rising. It is now the second largest oil consuming country in the world (next to the U.S.), consuming as much as 6.4 million barrels of oil a day. As a lack of steady oil supply will be adverse to its economic development, mainland China has been looking at alternatives to ensure a steady oil supply, including working with other countries in oil exploration projects and seeking methods of oil transport other than tankers.

6. Economic Growth in 2005 Will Slip

Based on the macroeconomic forecast of the Chinese Academy of Social Sciences, mainland China should see more than 8% GDP growth in 2005, which is comparable to the 8.4% forecast made by Global Insight in May 2005 (Table 1-1-1). However, as the global economy slows down, its economic growth will inevitably dip in 2005. The year 2005 should be a crucial year for mainland China where market opportunities are accompanied by considerable risks. Under the notion of “China’s emergence,” the country has seen incidents of domestic unrest and political squabbles with other countries rising. Coupled with the recent passage of its Anti-Cession Law and coastal provinces hiking basic wages for workers, companies intending to make more investment in mainland China should pause, listen, and observe before jumping in.

III Changes in Taiwan’s Economic Environment and its Economic Reliance on Mainland China

1. Apparent Economic Rebound in 2004

Taiwan’s economic growth rose consistently from -0.12% in Q2 2003, to 4.17%

in Q3, and went up again to 5.88% in Q4. The upward trend continued into 2004, with economic growth reaching 6.72% and 7.88% in Q1 and Q2, respectively. It then fell to 5.27% in Q3 and went further down to 3.25% in Q4. Looking into 2005, the growth rate of Q1 decreased to 2.54%, but is expected to pick up gradually. In terms of annual economic growth, Taiwan enjoyed 3.33% growth in 2003 and 5.71% in 2004. The forecast for 2005 is 3.63% (Table 1-3-1).

Table 1-3-1 Major Indicators of Taiwan's Economy, 2002–2005

Unit: %

Year \ Index	Economic growth rate	Consumer spending	Fixed capital formation	Government spending	Exports	Imports	CPI	Unemployment
2002	3.94	2.07	-1.61	1.47	10.48	5.71	-0.20	5.17
2003	3.33	0.84	-2.05	0.71	10.94	6.72	-0.28	4.99
2004	5.71	3.13	15.40	-0.69	15.27	18.56	1.60	4.44
2005	3.63	3.00	7.59	0.09	2.56	0.80	1.70	—

Notes: 1. With the exception of the unemployment rate, all other figures are annual growth rates.
2. The 2005 data are forecasts.

Sources: 1. Directorate General of Budget, Accounting and Statistics, Executive Yuan, *Statistical Summary of Gross Domestic Product*, February 2005.
2. *Statistics of Gross Domestic Product and Outlooks of Domestic Economic Situation*, May 19, 2005.

2. Trade is Stimulating Economic Growth

The upturn in Taiwan's economy is attributable mainly to the continuing rebound of the global economy, while exports were the most important factor fueling economic growth. Exports for the whole of 2004 amounted to US$174.014 billion, representing an increase of 20.69% from 2003 and recording the second best performance in the past five years, next only to the increase of 21.98% in 2000 (Table 1-3-2).

Table 1-3-2 Taiwan's Exports and Imports, 2000–2004

Unit: US$ billion; %

Year \ Item	Exports		Imports		Trade dependency ratio (import + export) GNP
	Value	Growth	Value	Growth	
2000	148.32	21.98	140.01	26.49	104.28
2001	122.87	-17.16	107.24	-23.41	94.66
2002	130.60	6.29	112.53	4.94	98.14
2003	144.18	10.40	127.25	13.08	102.72
2004	174.01	20.69	167.89	31.94	113.21

Source: Ministry of Finance, *Imports and Exports Statistics*; /www.mof.gov.tw/

Driven by rising prices of raw materials and stronger domestic demands, Taiwan's imports in 2004 totaled US$167.890 billion, up 31.94% from 2003 and hitting a five-year record high. This indicated an increased willingness to invest in the private sector and injected fresh vigor into investing activities.

The trade dependency ratio dropped to below 100% in 2001 and 2002, but went back to 102.72% in 2003, and increased to 113.21% in 2004. The trade dependency ratio reached the highest level in 5 years.

3. Steady Growth in Domestic Demand

Amid steady economic growth in 2004, Taiwan's stock market began to slide and fluctuated considerably after hitting a high point of 6,666 in April. With the CPI rising more than 1% in Q2, signs of inflation became all the more prominent. Discouraged by the negative wealth effect and the expectation of inflation, consumer spending became more conservative. Although the data of the Directorate General of Budget, Accounting and Statistics showed real growth of 4.32% in consumer spending in Q2, a record high in the past year, this growth figure was based on a low base of -2.18% in the same quarter the year before when consumer spending was ravaged during the SARS epidemics. The growth of consumer spending went back to normal in Q3, up only 1.41%, suggesting a conservative pattern of private consumption.

Despite growing sales turnover, which registered 8.84% growth in September 2004, a gradual slowdown of economic growth and a lackluster stock market are expected to suppress consumer spending which has recorded high growth consistently in the past. Although the stock market seems to have showed a rising trend since September, its high volatility has not benefited individual investors. Even more so, the Central Bank and Chunghwa Post raised rediscount rates and deposit rates consecutively in September and October. All these developments had a negative impact on consumer spending. As a result, consumer spending grew by 3.13% in 2004 (Table 1-3-1).

Spurred by a rising global economy and an improved economic climate in Taiwan, the private sectors have stepped up their investment activities. Preliminary statistics recorded 19.44% growth in domestic investment in Q2 2004, the highest since Q4 2000, of which private-sector investment rose 33.13%. The Q3 performance, though slightly down from Q2, remained impressive, recording double-digit growth of

13.72%. Private-sector investment increased by 26.44% in Q3, becoming the primary force of investment in Taiwan as investments by state-run enterprises and governments continued to decline. After years of negative growth, fixed asset formation in Taiwan for all of 2004 increased by 15.40% (Table 1-3-1).

4. Continuing Improvement in the Job Market

Taiwan's unemployment rate averaged 4.44% in 2004, down 0.55 percentage points from 4.99% in 2003. The average number of unemployed fell by 49,000 from 2003 to around 494,000. Going into 2005, the unemployment rate is expected to stay about the same as that in 2004. Aside from the improving economy, government's job creation program has also helped lower the unemployment rate.

5. Widening Budget Deficit

Based on the 2004 government budget planning prepared by the Directorate General of Budget, Accounting and Statistics, both government spending and infrastructure investments were expected to increase in 2004, but skyrocketing steel and cement prices in the international markets forced some of the projects to be put on hold. As a result, the government's real investment in 2004 was actually -4.22% by rough estimation. The contribution of public spending to Taiwan's economic growth in 2004 was -0.57%. This is the eighth consecutive year of negative contribution, indicating a limited role by public spending in boosting economic growth.

In 2003 the government's tax revenues plus other income accounted for only 12.8% of GDP. Too little revenue is the main cause of a worsening government deficit. As the government continued to launch big-budget projects in 2004, including the New Ten Development Projects, outstanding public debt in the next five years is expected to reach 39.9% of GDP, nearing the 40% cap stipulated in Article 4 of the Public Debt Act. Improving the government's deficit problem has become a vital issue at the present time.

6. Moderate Changes in CPI

Taiwan's CPI increased by 1.6% in 2004, which is markedly higher than the -0.3% in

2003, but the rise is still considered moderate. The CPI growth was 2.9% in Q3 2004, and then dropped to 1.9% in Q4. The CPI rise was attributed mainly to higher food prices and petroleum product prices, as food prices rose 6.42% over the same period of previous year, of which fruit prices had the biggest increase, up 15.49%. Because fruit prices represent the biggest share in food prices, rising fruit prices became the primary cause of higher food prices. Rising crude oil prices have driven up the prices of petroleum products. As public utility companies are planning rate increases and the prices of petroleum products remain high, the CPI is expected to continue its rise in the future, while only the magnitude of the rise will depend on the movement of petroleum product prices and its rippling effect.

Driven by persistently higher raw material and energy prices, wholesale prices in Taiwan have been on the rise since early 2004, up 2.5% in Q1, up 6.5% in Q2, and up as much as 10.4% in Q3 before dipping slightly to 8.9% in Q4. The rising trend is expected to halt in 2005 with a 1.0% increase in wholesale prices for the whole year.

7. Trade with Mainland China Grew 32.13% in 2004

According to the data of the Board of Foreign Trade under the Ministry of Economic Affairs, Taiwan's trade with mainland China totaled US$82.940 billion in 2004, an increase of 32.13% from the year before and accounting for 24.26% of external trade, which represents an increase of 1.13 percentage points over the same period of the previous year. Of total trade, exports to mainland China amounted to US$64.140 billion, up 28.10% from the year before and accounting for 36.86% of total exports, an increase of 2.14 percentage points as compared to the previous year. Taiwan's imports from mainland China in 2004 totaled US$18.800 billion, an increase of 47.9% and accounting for 11.12% of total imports, which also represents an increase of 1.13 percentage points over the same period of the previous year. Taiwan enjoyed a trade surplus of US$45.330 billion with mainland China in 2004, up 21.39% from the year before (Table 1-3-3).

By product structure, electrical and mechanical equipment and parts represented the bulk of Taiwan's exports to mainland China in 2004, accounting for 28.7%, followed by optical products and parts, machineries, and steel products. Electrical and mechanical equipment and parts also represented the bulk of Taiwan's imports from mainland China, accounting for 31%, followed by machineries, and steel products. It can be surmised that the trade structure between Taiwan and mainland China is characterized by "intra-industry trade, IIT" – the higher the IIT index id, the higher the degree is of industrial integration. The "intra industry trade" tells a similar nature of industries in Taiwan and mainland China.

Table 1-3-3 Trade between Taiwan and Mainland China, 2001–2004

Unit: US$ billion; %

Year	Total trade			Export (estimate)			Import			Surplus/deficit (-)	
	Value	Share	Change	Value	Share	Change	Value	Share	Change	Value	Change
Taiwan's statistics (including Hong Kong and Macao)											
2001	39.78	17.29	-10.25	31.99	26.03	-10.82	7.79	7.27	-7.8	24.19	-11.75
2002	50.78	20.89	27.66	41.07	31.45	28.39	9.72	8.63	24.64	31.35	29.60
2003	62.77	23.13	23.61	50.06	34.72	21.89	12.71	9.99	30.86	37.34	19.12
2004	82.94	24.26	32.13	64.14	36.86	28.12	18.80	11.12	47.90	45.33	21.39
China's statistics (excluding Hong Kong and Macao)											
2001	32.34	6.30	5.92	5.00	1.90	-0.79	27.34	11.20	7.24	-22.34	-9.30
2002	44.65	7.20	38.06	6.59	2.00	31.72	38.06	12.90	39.23	-31.48	-10.90
2003	58.37	6.90	30.72	9.01	2.10	36.73	49.36	12.00	29.68	-40.36	-9.90
2004	78.32	—	34.2	13.55	—	50.4	64.78	—	31.2	-51.23	—

Sources: 1. Board of Foreign Trade, MOEA website; /www.trade.gov.tw/
2. *China Monthly Customs Statistics Bulletin* (collated by the Hong Kong Office of the Far Eastern Trade Services Center).
3. China Customs Administration website; /www.customs.gov.cn/

8. More than 60% of FDI Going to Mainland China

There has been no slowdown in outward investment from Taiwan in recent years. Total investment in regions other than mainland China came to US$3.97 billion in 2003, while investment in mainland China totaled US$7.7 billion. The outward investment came down slightly in 2004 with US$6.94 billion going to mainland China and US$3.38 billion to other regions of the world.

In the past three years, Taiwan's investment in mainland China has surpassed its total investment in other regions, accounting for nearly 70% of total outward investment. By looking at the percentage of mainland China investment in total outward investment – which was only 38.8% in 2001, then jumped to 66.6% in 2002, stayed around 66.0% in 2003, and edged up to 67.2% in 2004 – Taiwanese enterprises apparently have shifted the focus of their operations to mainland China. From a strategic perspective of global deployment, such a concentration in one country increases investment risk. Mainland China's passage of the Anti-Cessation Law in March 14, 2005 should be a warning to Taiwanese enterprises that in mainland China politics takes precedence over and meddles in economic affairs.

9. Shares in the Import Markets of the U.S., Japan, and Mainland China Falling

From the trend of Taiwan's performance in its three major export markets – the U.S., Japan, and mainland China in recent years, it is found that U.S. imports from Taiwan as a share of its total imports have been dropping to 2.51% in 2003 and went further down to 2.36% in 2004. While total U.S. imports grew by 16.91%, the country's import share from Taiwan declined by 0.15 percentage points (Table 1-3-4). A similar phenomenon could be seen in Japan's imports from Taiwan.

Table 1-3-4 Taiwan's Exports to the U.S., Japan, and China, 2001–2004

Unit: US$ million; %

Item \ Year	2001	2002	2003	2004
US				
1. Amount of total U.S. imports	1,140,999	1,161,365	1,259,395	1,469,671
2. Share of U.S. imports from Taiwan	2.93	2.77	2.51	2.36
3. Growth rate of total U.S. imports	-6.24	1.68	8.44	16.91
4. Growth rate of U.S. imports from Taiwan	-17.62	-3.52	-1.70	9.55
Japan				
1. Amount of total Japanese imports	349,235	337,957	383,026	455,292
2. Share of Japanese imports from Taiwan	4.06	4.02	3.72	3.66
3. Growth rate of total Japanese imports	-7.99	-3.23	13.34	18.76
4. Growth rate of Japanese imports from Taiwan	-20.70	-4.35	5.07	16.52
China				
1. Amount of total China imports	243,567	295,303	413,096	560,811
2. Share of China imports from Taiwan	11.23	12.90	11.95	11.55
3. Growth rate of total China imports	8.21	21.24	39.89	35.76
4. Growth rate of China imports from Taiwan	7.24	39.27	29.62	31.19

Source: Bureau of Foreign Trade, MOEA, *Trade Competitiveness Database*.

Mainland China's total imports jumped 39.89% in 2003 and sustained another increase of 35.76% in 2004. However, its imports from Taiwan as a share of its total imports edged down to 11.95% in 2003 from 12.90% in 2002. Whether it is a sign of mainland China's decreased reliance on trade with Taiwan warrants further observation.

10. Economic Growth in 2005 Will Slip

Led by strong growth in the U.S. and Asia, the global economy turned out a brilliant performance in the first half of 2004, but under the interference of escalating oil prices and interest rate hikes in leading countries, the pace of economic expansion slowed down. According to the forecasts of Global Insight published in May 2005, the world economy will see slower growth in 2005. Global economic growth looks to drop to 3.1% from 4.1% in 2004, and world trade turnover will grow 4.2% in 2005, down from 8.9% in 2004.

As the pace of global economic expansion dwindles, Taiwan's economy will also slow down. According to the forecasts of the Directorate General of Budget, Accounting and Statistics published on May 19, 2005, Taiwan's economic growth in 2005 will drop to 3.63%, its CPI will rise by 1.70%, and GNP will reach NT$10,950.5 billion, which is equivalent to US$349.3 billion or US$15,419 per capita.

To sum up, the global economy underwent a turnaround in the second half of 2003, reached a peak in the first half of 2004, and diminished again in the second half of the year. The forecast for 2005 is that the global economy will stay on a mild course in the first half of 2005 and rise gradually in the second half of the year. Taiwan's economy basically mirrors the movement of the global economy. Under such a macroeconomic climate, the status of Taiwan's small and medium enterprises will be discussed in the following chapter.