

Taiwan

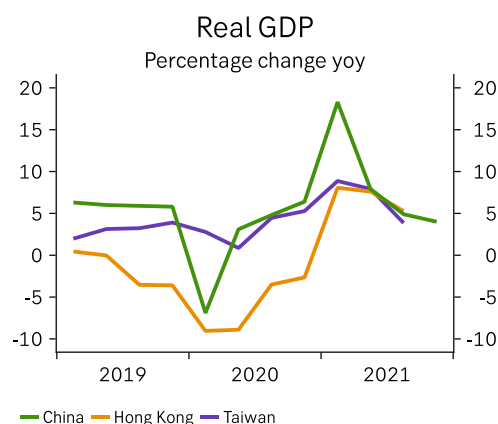
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Growth has been resilient, supported by strong global demand for advanced electronics. Most important credit metrics have held up well over the past year. Rising tensions with mainland China that affect trade and investment remains a key risk.

Country Risk Analysis

Recent economic developments

Economy on recovery path. Developments during the pandemic has proven that the economy, despite its openness and exposure to cyclical industries, is resilient to external shocks and that its exports remain very competitive. Following a small acceleration in 2020, GDP growth is expected to have picked-up further to 6% in 2021. Strong global demand for advanced electronics boosted exports. Higher exports in turn fueled investments while mobility restrictions took a limited toll on household spending. The recovery in domestic demand and higher global commodity prices pushed up inflation in 2021 but the average of 2% for the year is moderate.



Electronics exports remain strong at the start of the year. The economy is very open to trade, with the volume of exports and imports being at par with GDP. China is the single most important export destination taking roughly a quarter of total exports. Electronics is the most important goods category making up about 40% of total exports. Most of this is semi-conductors. Recently, exports of electronics components have been rising by nearly 30% yoy while new exports orders have been beating consensus estimates by a significant margin.

Strong external balances strengthen further. A long track record of significant current account surpluses has helped to build strong external balances. A higher trade surplus contributed to lifting the current account surplus to nearly 15% of GDP in 2021. Gross external debt is low and held by the private sector (mostly banks' short-term trade credits). Given significant liquid foreign assets with the

public sector and companies, Taiwan is one of the strongest net external creditors in the world. The current account surplus helped lifting FX reserves at the central bank to USD 548 bn. by the end of 2021. This is equivalent to roughly 18 months of imports.

Sovereign rating agencies take a more positive view. Over the past year, two of the major sovereign credit rating agencies raised their ratings while the third upped the outlook to positive. They have mainly argued that the economy has proven more resilient than expected through the pandemic and that the outlook for economic growth is superior to rating peers. They also highlighted that already strong external balances had strengthened further. While most of the arguments apply to country risk too, the increasingly tense regional security situation works in the opposite direction.

Economic policies

Fiscal policy. Taiwan has a long track record of fiscal prudence. Given that the slowdown in the economy has been modest, the need for fiscal support has been less than in most countries in the region. The general government budget deficit is expected to have reached 2.1% of GDP in 2021. The 2022 budget includes a rise in defense spending and lower pandemic related spending and targets a slightly lower deficit. A low revenue base compared to GDP remains a weakness.

Government debt relatively stable through the downturn. A suite of low budget deficits has produced a relatively low government debt/GDP. Debt was 33.5% (IMF definition) at the end of 2020 and is likely to have fallen in 2021. Effective debt management and a sound domestic financial sector has also contributed to strong debt affordability, including interest rate costs' share of revenues well in line with peers, despite relatively low government revenues.

Large banking sector has so far weathered the pandemic. The banking sector is very large, with assets equivalent to nearly three times GDP. Being dominated by state-owned banks, the sector thus remains a non-negligible contingent liability for the government. Aggregate asset quality has remained broadly stable over the past years and remained resilient in 2021. Banks have sizeable, albeit decreasing, exposures to China.

Structural issues

Governance indicators broadly in line with peers. The ranking on the World Bank's governance indicators is at par with, or better than, countries at a similar level of country risk. The scores for regulatory quality and government effectiveness are particularly strong while we note that political stability scores have declined over the past five years. GDP per capita is also at or above other countries at a similar level of risk.

Competitive economy. The country ranks 12 of 141 countries in the World Economic Forum's most recent competitiveness index and scores particularly high on innovation capability and ICT adoption.

Political and security developments

President Tsai's second term (running to 2024), has so far been characterized by the relatively efficient handling of the pandemic and by increasing tensions with the Mainland. Strengthened by her strong results in the 2020 presidential elections Tsai has followed a very cautious path of gradual de-coupling from the Mainland, in particular in the area of high-tech electronics, mindful of the still

mutually beneficial investment and trade ties. At the same time, the Chinese leadership has repeated calls for a unification. China's rhetoric has gone hand in hand with a record number of aircraft intrusions in Taiwan's air defense identification zone recently. There are also reports that, in the past year, China has established a constant naval presence in the Pacific Ocean east of Taiwan. This has triggered support for Taiwan from its democratic partners at previously unseen levels.

The US maintains a formal ambiguity regarding defending the country should it be attacked by China. Within this framework, however, Washington has shifted its emphasis towards deterring China. President Biden at two occasions recently stated that the US has a willingness to defend Taiwan but Congress has not made any formal commitment. Close allies, including Japan, Australia and Canada have echoed Biden's commitment. Politicians in European countries and central EU institutions have also made unprecedented gestures of support. Meanwhile, the scale and frequency of joint naval exercises by the US and allies such as the UK and Canada in the region have increased.

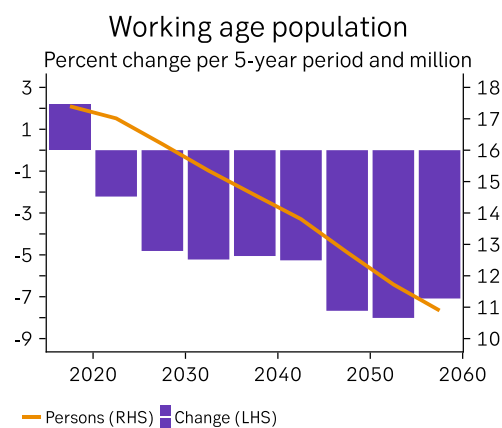
In 2021, trade talks with the US resumed after a five-year pause. The government also formally applied for membership in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). The membership process, some believe, risks being delayed indefinitely due to Chinese pressure on existing members. Taiwan is a member in the WTO.

Outlook

Favourable near-term economic outlook. Growth is set to converge towards trend growth in 2022 as favorable base effects dissipate. Exports should continue to expand as supply-chain bottlenecks are expected to ease and tech demand to stay strong, driven by more 5G applications and digital transformation across the world. However, the pace of growth should moderate. On the other hand, household spending is expected to pick up, helped by a boost from rising real incomes. Oxford Economics expects GDP growth at 3% in 2022.

Threats to Taiwan's high-tech dominance. We assume that the country will maintain its competitive edge in the advanced electronics industries also in the medium term and, given companies' vast experience, that the ongoing shifts in supply chains will create new economic opportunities. However, this is not a given. Taiwan will face intense competition from other economies that will also seek to capitalize on this realignment. With a large part of the world steering away from products of Chinese origin, each country will try to carve out its specialized niche. Competition, particularly in Asia, for supply-chain-related investments in people, plants, and assets is likely to be fierce.

Longer-term. Challenges in the longer-term include a rapidly aging population, like in many advanced economies. Although the population increased 0.2% in 2021 the working age population has been declining for years. Measures to encourage higher fertility rates have so far



yielded little improvements. Aging is likely to weigh on public finances and on savings while a declining contribution to growth from labour should dampen economic growth.

External risks from global trade and ties to mainland China. Risks to our main scenario relate to the country's dependence on foreign trade in general and global demand for advanced electronics in particular. Most importantly, however, they relate to the tense relationship with the Mainland. To maintain economic competitiveness and growth requires that trade and investment activity with the Mainland is broadly uninterrupted.

Military event is a low probability, high impact event. We assume that relations with China will not deteriorate to an extent that would severely damage trade. This includes Taiwan not pushing for formal independence through a cumbersome change in the constitution. There are naturally risks to this scenario. Negative risk scenarios would involve a Chinese blockade or direct military intervention. For example, this could involve China engaging in minor military hostilities, such as an assault on Taiwan's outlying islands, for a limited period of time. Such an assault would likely be too quick for any military response from Taiwan's allies. In such an event, or during a Chinese blockade, the banking system would likely be able to continue business with foreign partners except for China/Hong. Another scenario is the tail risk event of an outright war. This could for example be triggered by an accident or a human error in a tense military situation. In this scenario, most of the trade and investment flows to and from the entire region would be brought to a halt and financial markets could freeze.

Taiwan: Key Economic Indicators

	2017	2018	2019	2020	2021	2022	2023	2024	2025
Macroeconomic									
GDP (% chg)	3,3	2,8	3,0	3,3	6,4	3,0	2,8	2,3	2,1
GDP (USD bn)	591	609	612	670	773	797	835	869	903
GDP/capita (USD)	25082	25831	25917	28383	32725	33755	35368	36797	38266
Investments/GDP	21%	22%	24%	24%	26%	28%	28%	28%	28%
Trade/GDP	102%	102%	99%	91%	106%	111%	102%	99%	98%
Oil production, bpd ('000)	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2
Money & Prices									
CPI inflation (%)	0,6	1,4	0,6	-0,2	2,0	2,6	1,2	1,3	1,3
Money supply, M2 (% chg)	2,4	1,8	2,9	6,2	5,1	1,3	2,1	1,6	1,6
Interest rates, short-term	0,44	0,49	0,55	0,39	0,26	0,36	0,46	0,6	0,81
Oil price (USD, Brent)	54,3	71,1	64,4	41,8	70,7	86,3	73,9	66,4	65,8
Government Finances									
Budget balance/GDP	-0,1	0,0	0,1	-1,0	-2,1	-1,3	-1,1	-1,1	-1,0
Govt debt/GDP	35%	34%	33%	33%	27%	23%	18%	14%	9%
Interest rate costs/revenues	4%	4%	4%	3%	4%	4%	4%	4%	4%
Balance of Payments (USD bn)									
Current account	83,1	70,8	65,2	94,7	113,0	112,9	113,8	118,2	124,8
as % of GDP	14,0	11,6	10,7	14,0	14,6	14,1	13,6	13,6	13,8
Exports of goods	342,7	345,5	330,7	342,2	451,4	488,7	477,7	482,3	499,2
Imports of goods	261,4	278,5	273,1	267,5	364,2	392,9	376,7	378,4	389,0
FDI, net	-8,1	-10,9	-3,5	-5,4	-5,2	-9,3	-9,5	-8,1	-7,7
as % of GDP	-1,4	-1,8	-0,6	-0,8	-0,7	-1,2	-1,1	-0,9	-0,9
Loan repayments	2,4	2,2	2,3	2,3	3,1	3,4	3,8	4,3	4,7
External Debt & Liquidity (USD bn)									
Total debt	181,9	191,2	184,7	189,9	215,2	222,0	228,7	235,2	241,5
o/w short term debt	169,2	178,6	174,7	175,3	201,7	208,5	215,2	221,7	228,0
as % of GDP	29,1	30,8	28,5	25,7	26,0	26,3	26,1	25,8	25,5
Reserves (year-end)	451,5	461,8	478,1	529,9	548,4	570,9	591,2	613,3	637,1
months of imports	20,5	19,8	20,7	22,5	18,1	17,2	18,6	19,2	19,4
Exchange rate vs USD	30,44	30,16	30,93	29,58	28,02	27,91	27,84	27,73	27,62

Source: Oxford Economics, IMF

Rating history (eoy)

Fitch	AA-	AA-	AA-	AA-	AA
Moody's		Aa3	Aa3	Aa3	Aa3 (pos)
S&P			AA-	AA-	AA (pos)

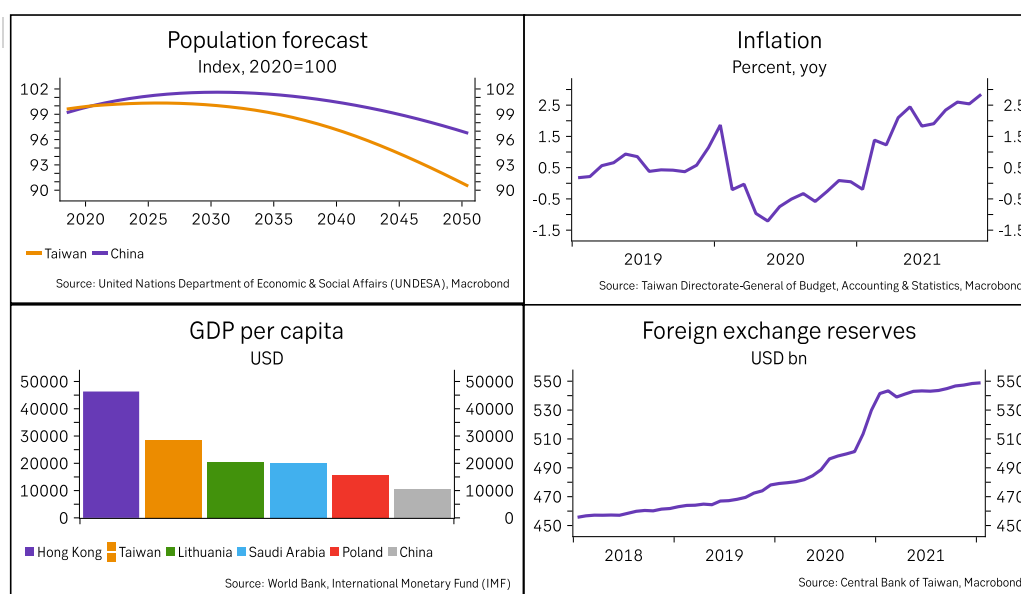
Type of government:

Next elections Legislative and presidential: January 2024

Other:

Latest PC deal None

Latest IMF arrangements: None



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