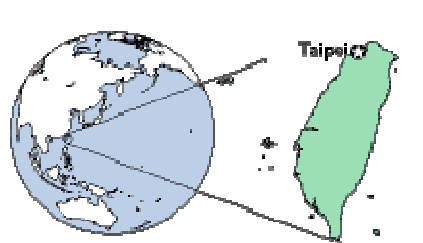


COUNTRY REVIEW

Taiwan



28 October 2010

ANALYST: David Atkinson

EULER HERMES COUNTRY RISK GRADE: A

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

The content of the report (which is subject to change without notice) reflects only our opinion, which is based on information received by us. Accordingly no warranty, representation or other assurance is given as to the accuracy or completeness of the report. The report is for general information and is not intended to address any requirements you may have, for which you must obtain independent advice. The report does not constitute any form of advice, recommendation or arrangement by Euler Hermes UK plc or by the Euler Hermes Group of Companies and must not be relied upon in the making of any decision, agreement or arrangement. © Euler Hermes UK plc 2010

Strengths

- A functioning, stable democracy
- Good record of sound economic management
- Demonstrated flexibility of economy, enabling rapid shifts along the value-added scale
- High domestic savings and investment
- Very strong external liquidity

Weaknesses

- Uncertain and tense relations with Mainland China
- Concentration on IT/electronics sectors

Country Risk Assessment

Ratings	Taiwan		Median Grade A	Peers		
	Latest	Previous		Singapore	Hong Kong	Chile
Systemic Political Risk:	P2+	P2+	P2+	P1	P2+	P2+
Systemic Economic Risk:	E1	E2	E2	E1	E2	E2
ME rating:	ME2	ME2	ME2	ME1	ME2	ME2
<i>Structure</i>	3.3	4.0	3.3	2.6	2.1	4.0
<i>Policy</i>	1.9	1.9	2.2	1.7	2.8	2.2
<i>Solvency</i>	1.0	1.0	1.9	1.3	1.9	2.3
<i>External Liquidity</i>	1.3	2.8	2.8	1.3	2.8	2.9
SBE rating:	SBE1	SBE2	SBE2	SBE1	SBE1	SBE2
COUNTRY GRADE:	A	A	A	AA	A	A

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Taipei
Population:	23.1 mn (2009)
GDP:	USD 414565 mn (2009)
Currency:	New Taiwanese Dollar (NTD)
Form of state:	Representative democracy
Head of government:	President Ma Ying-jeou
Next elections:	2012

Major Industries (% of GDP at market prices, 2009)	Global Assumptions	2010	2011	
Agriculture, fishing & mining	1.6%	Real GDP grth (% yr/yr) *	3.3	2.9
Manufacturing	27.8%	Inflation (% , av) *	1.2	1.4
Utilities	1.8%	Dated brent (USD/b)	75	70
Construction	2.1%	* World		
Services	66.7%			

Main Exports (% of total, 2009)	Main Imports (% of total, 2009)		
Agricultural products	0.3%	Consumer goods	9.3%
Processed agricultural products	1.4%	Agricultural & industrial raw materials	76.0%
Industrial products	98.3%	Capital equipment	14.8%
Heavy industries	80.0%		
Non-heavy industries	18.3%		

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	386,654	397,014	414,565	429,510	461,869
Population (mn)	23.00	23.00	23.10	23.10	23.20
GDP per capita (USD)	16,811	17,261	17,947	18,594	19,908
Real GDP growth (% yr/yr)	6.0	0.7	-1.9	10.2	4.0
Inflation (% , eop)	3.3	1.3	-0.2	0.5	0.5
Fiscal balance (% of GDP)	-0.4	-0.8	-4.5	-3.8	-3.2
Current account balance (% of GDP)	9.1	6.9	10.4	9.6	8.6
External debt/GDP (%)	24	23	20	20	20
External debt/Exports of goods & services (%)	33	30	34	28	29
Interest payments/Exports of goods & services (%)	3	2	1	1	1
Foreign exchange reserves (USD mn)	270,311	291,707	348,198	380,505	410,000
Import cover (months)	12.9	12.9	20.6	16.4	16.5
Exchange rate assumption, NTD:USD (av)	32.84	31.52	33.05	31.90	31.00
f: CRU central forecast					

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

A functioning democracy has evolved since martial law was lifted in 1987 ending autocratic rule by the Kuomintang (KMT). It was not until 2000 that the Democratic Progressive Party (DPP) first won the presidency, but the hand-over was peaceful and although the presidential election in March 2004, in which President Chen Shui-bian was narrowly re-elected, was a contested result it was resolved through the legal system. The latest presidential election in March 2008 (in which Chen Shiu-bian was not allowed to stand by the constitution) was won by opposition KMT candidate, Ma Ying-jeou, with 58.5% of the vote, the highest winning margin since direct presidential elections began in 1996.

The presidential election result cemented the KMT's grip on power as the party had won a majority in the Legislative Yuan (parliament) elections in January 2008 (81 of 113 seats) and for the first time since 2000 one party has control of both the executive and legislative branches of government. This has facilitated the passage of legislation and policy implementation, though in the near-term policies have focused on measures to deal with recession, tempering pursuit of more vigorous pursuit of fiscal and financial reforms. Overall, policy is generally pro-business and market-oriented and is likely to remain so, though government direction of industrial development still plays an important role, notwithstanding greater liberalisation of the economy in the 1990s.

President Ma Ying-jeou and the KMT are pro-unification with Mainland China, in contrast to the outgoing president's pro-independence stance. As a result, relations with Beijing are improving and tensions have lessened. Several bilateral agreements have been signed aimed at improving trade and investment, including an Economic Co-operation Framework Agreement (ECFA) with Mainland China in 2010. Nevertheless progress towards unification is likely to be limited in the near-term to incremental economic steps rather than a major political/constitutional move, as there remains a strong pro-independence current in Taiwan.

This pro-independence current will make unification based on the "one country, two systems" formula applied in Hong Kong and Macao difficult to sell in Taiwan, but much deviation from this formula is unlikely to be acceptable to Beijing at present. So while a broader interpretation of the "two systems, one country" formula may be the way forward ultimately, it remains a fairly distant prospect. Until the unification issue is resolved, however, cross-straits tensions—though lowered for now—will remain one of the more sensitive potential global flashpoints.

Taiwan is not a member of either the IMF or the World Bank.

Economic Stability

The economy has been transformed over the past 50 years from a poor, agrarian base to a modern, high-income industrialised state where agriculture accounts for less than 2% of GDP, industry 33% and services 67%. So far, business has been successful in moving up the value-added chain, in the process shifting lower value-added production to Mainland China. Manufacturing accounts for 28% of GDP. Electronics and information technology account for 35% of industry—Taiwan is the world's third largest manufacturer of hardware products for personal computers and the fourth largest supplier of semi-conductor components for the IT industry. The service sector has also been expanding strongly and in recent years has been a key driver of growth.

Taiwan's long-term growth record has been good—real per capita GDP increased by an annual average 3% in 2000-09. Future growth will depend on the development of high value-added, capital and research intensive sectors, which are supported by the government's development strategy. Domestic savings are high, but the isolation of Taiwan geo-politically is likely to be an inhibitor. As an open, export dependent economy Taiwan is highly vulnerable to global trade cycles and was hit hard by the global recession in 2009.

Real GDP contracted dramatically in Q4 2008 (down 8.6% yr/yr) and Q1 2009 (down 10.2% yr/yr) as world trade collapsed in the wake of the global financial crisis causing a massive drop in exports, not fully matched by imports, de-stocking and a collapse in fixed capital formation, but re-bounded equally dramatically, supported by a fiscal and monetary stimulus, from Q3 2009, with growth in H1 2010 of 13% yr/yr. Real GDP contracted by 0.3% in 2009, but is set to increase by around 10% in 2010, as the economy returns to more sustainable growth in H2 2010, and by 4% in 2011.

In response to falling domestic demand in 2009 the government introduced several stimulus packages. These added to government spending at the same time as revenues were falling and as a

result the fiscal deficit widened to 4.5% of GDP in 2009 from 0.9% in 2008 (compared with an annual average of 1.7% of GDP in 2002-08) and is targeted to narrow to 3.8% in 2010 and 3.3% in 2011, both of which look credible. The Public debt-GDP ratio is relatively low at an expected 47% in 2010 and external public is very low.

Interest rates were cut quickly in response to recession from 3.6% to 1.25% between September 2008 and February 2009 and then left on hold until June 2010 when the policy rate was raised by 12.5bp, followed by the same small rise in September to 1.5%. Inflation has returned after a period of deflation in 2009, but remains very low and will probably remain below 1% in 2011. With growth of the monetary aggregates under control, low inflation and moderating real GDP growth there does not appear to be much need to raise interest rates much further if at all in the immediate future. The managed exchange rate has tended towards appreciation but intervention is likely to lead to further FX reserve accumulation. The real effective exchange rate does not appear to be significantly overvalued.

The financial system held up reasonably well during the global financial crisis, though the government had to inject liquidity in the period of acute strain and there was a shift of domestic deposits from private to state-owned banks. As the banks have a net foreign asset position and largely domestic deposits and government owned banks dominate, the system remains among the less vulnerable.

The external balance is very strong. In the past ten years there was an annual average current account surplus of 7.3% of GDP. In 2009 the surplus increased to 10.4% but will fall in 2010 to 9.7% and 8.7% in 2011, as import growth recovers and outpaces that of exports. Net FDI flows are usually negative, largely reflecting Taiwanese investment abroad, and inflows are relatively low as a proportion of GDP as well, underscoring Taiwan's longer term issue of relative isolation. However, net FDI outflows are not a short term problem given the structural current account surplus. External debt repayments are low and short-term debt, though large in absolute terms, is easily covered by foreign exchange reserves. Indeed, FX reserves cover the entire debt stock more than four times and also provide 16 months of import cover. The external debt stock is very low (20% of GDP and 28% of exports of goods and services) and is unlikely to be a problem.

Overall, the economy proved very resilient to the global crisis. However, in the medium-term structural issues could inhibit growth, along with potential isolation if cross-straits relations are not maintained.

Structural Business Environment

The Structural Business Environment is strong, ranking 42nd of 210 in our ratings.

The World Bank's 2010 Ease of Doing Business survey ranks Taiwan 46 of 183 surveyed. Based on data and definitions from the World Bank's 2010 Doing Business Survey, of ten areas surveyed, only one—Employing Workers—was particularly weak and well below average, while two—Starting a Dealing with Construction permits and Paying Taxes—were below average.

The World Bank Institute's Governance Research Indicator 2008 puts regulatory quality, control of corruption and the rule of law all well above average for the East Asia region, but control of corruption and the rule of law were just below average for the High Income group of economies.

Transparency International's Corruption Perception Index, 2010, assigns Taiwan a score 5.8—on a scale of 1 (bad) to 10 (good)—and a ranking of 33 out of 178. As a broad measure of the pro-business environment The Heritage Foundation 2010 Index of Economic Freedom ranks Taiwan 27 out of 183.

David Atkinson

London: +44 (0)20 7860 2807

Charts

