

Taiwan Quarterly: Semiconductors take charge

Taiwan, like other Asian economies, faces weaker demand for export orders even as Covid-19 starts to subside in many countries. But the technology war between the US and Mainland China has benefited Taiwan's semiconductor sector



Xinyi District in downtown Taipei, Taiwan

Preventative measures for Covid-19 don't offset weak demand

Taiwan has been very successful at implementing measures to contain the spread of Covid-19 and its economic situation is a bit better than other Asian economies, which have all been hit by domestic and external factors.

But despite positive GDP growth of 1.59% year on year in 1Q20, Taiwan's retail sales have fallen, and global demand for its products has been very weak.

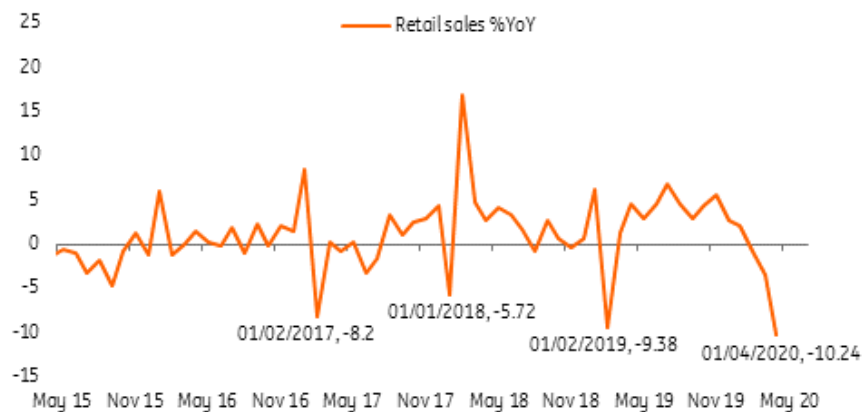
Consumption has been hit, even though there was no lockdown in Taiwan

Let's start by looking at the domestic economy because Taiwan has been very good at preventing Covid-19 infections. But does this protect it from the economic damage associated with this

pandemic?

Retail sales have a seasonal pattern in Taiwan because some shops close during the Chinese New Year holidays. Covid-19 has resulted in retail sales contracting even more than they usually do on average during the Chinese New Year holiday. Although shops have not been forced to close by the government, sales have been few and far between.

Retail sales in May were even worse than during the Chinese New Year



Source: National Statistics of Taiwan, ING

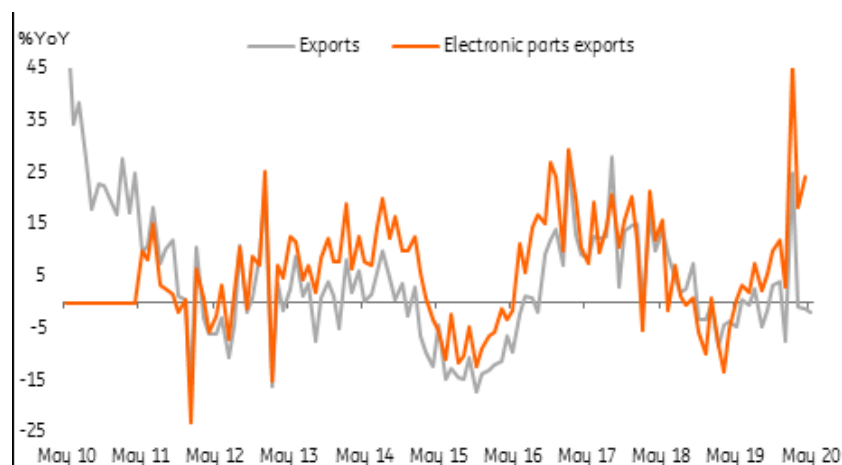
Exports have been hurt by weak global demand

Exports have contracted since March, though electronic exports continued to outperform the average. Growth in electronic parts exports is mainly due to the growth in exports to Mainland China. Chinese companies have had to find substitutes for US advanced semiconductor chips, and Taiwan semiconductor companies have helped to fill the void.

But even strong export growth of electronic parts cannot prevent overall exports from shrinking on a yearly basis. We believe this is because global demand has weakened considerably during this pandemic and will continue to be weak, with social distancing measures lingering even as economies begin to reopen.

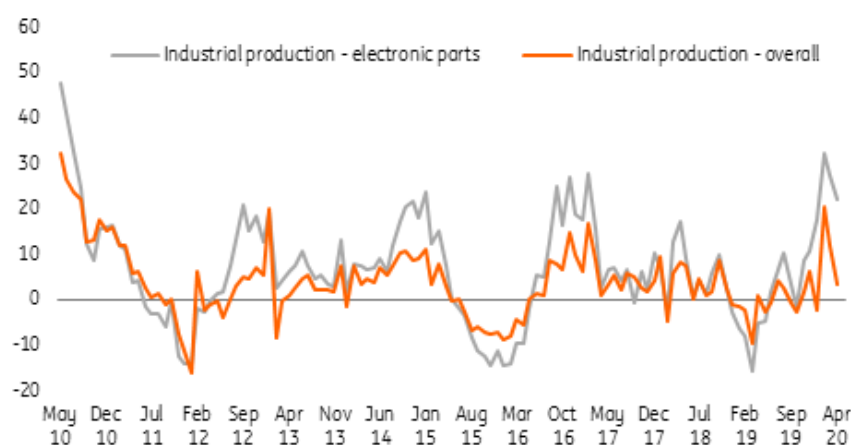
Weak exports have resulted in weaker industrial production, though again, electronics have helped overall industrial production to look better than it otherwise would.

Taiwan overall export growth has been mainly led by electronics



Source: National Statistics of Taiwan

Industrial production growth has been led by electronics



Source: National Statistics of Taiwan

Unemployment and negative inflation paint a weak economic picture

Taiwan's unemployment and low inflation have become an increasingly serious problem since the Covid-19 outbreak.

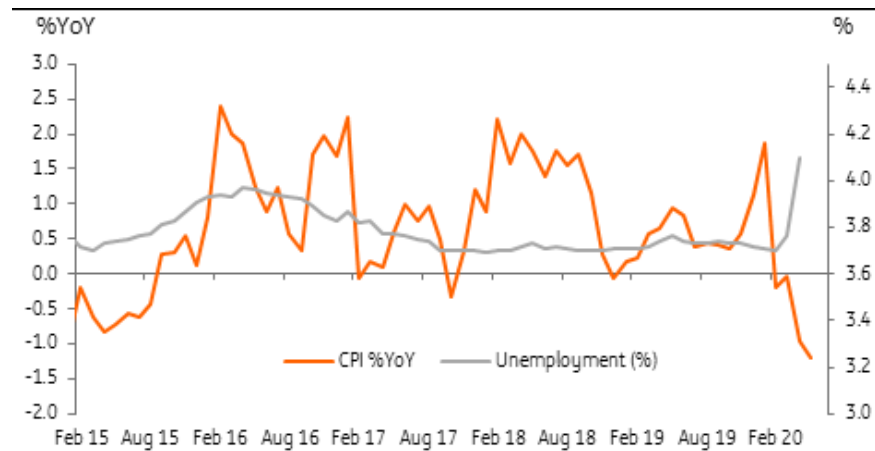
The unemployment rate - 4.16% in May has not been this high since December 2013. The situation is better now than it was in 2009 because Taiwan's semiconductor companies have been able to sell more chips to Mainland China.

Negative inflation has risen quickly due to the lack of consumer demand, even though there has been no lockdown or forced closure of retail businesses to limit the spread of Covid-19.

With contracting retail sales and exports overall, the job market is likely to remain in a dismal state. The unemployment rate is expected to continue to edge up and is therefore likely to put

additional pressure on retail sales. Negative rates of inflation could linger.

Taiwan unemployment rises with deflation



Source: National Statistics of Taiwan, ING

Some government stimulus policies work. Others don't

Government attempts to stimulate consumption do not seem to be working. This ineffectiveness was widely expected within Taiwan because most of the stimulus comes from consumption coupons. With more people unemployed, consumers are likely to use these coupons simply as a substitute for spending they would have done ordinarily. It won't encourage them to spend more.

Regarding investment stimulus policy, since late 2018-2019, the government has asked Taiwanese manufacturers to move factories from Mainland China or build additional factories in Taiwan. Some Taiwanese have bought land as a result, pushing prices higher. This has raised the cost of investment and has made the policy less effective than expected. Another reason that this policy is not effective is that most manufacturers who "registered" an investment amount have held back their investment plans because of Covid-19. So even though some Taiwanese started to invest in Taiwan in 2019, the contribution of investment to GDP is not expected to be big in 2020.

Still, we expect investments from semiconductors and related equipment factories to increase, as they have orders from Mainland China to support the expansion of their operations. This could be the major economic growth engine for Taiwan in 2020.

Expect one more rate cut from central bank

The central bank kept policy rates on hold in June, mainly because some other central banks also adopted the wait-and-see approach. This was the first reason stated in the central bank's decision. It expects a quick economic recovery from Covid-19 - a view which we do not share.

As such, we think a rate cut of 12.5 basis points is still on the cards for the rest of 2020 (i.e. one more rate cut).

TWD has strengthened but weakening factors exist

USD/TWD has increased due to foreign capital flowing into the Taiwan stock market (mostly into

semiconductor companies).

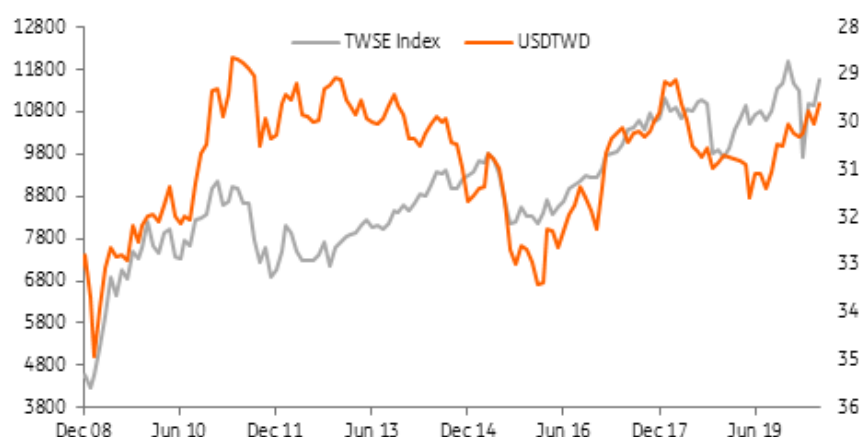
This is expected to continue until:

1. Mainland China is self-reliant on developing the most advanced semiconductor chips, which is impossible this year;
2. The US stops targeting Chinese technology companies (also hard to imagine in 2020);
3. Fund managers reallocate funds to other stock markets that regain momentum when Covid-19 subsides, which is possible by 4Q20.

But the Taiwan dollar could weaken if the economic situation deteriorates, particularly if exports continue to contract, which is likely given the weakness of global demand. The central bank would then be expected to cut rates once more in 2020.

Combining all the factors, we have revised downward USD/TWD slightly to 29.6 by the end of 2020 from 29.7.

TWD has been affected by capital flows into the stock market



Source: CEIC

Summary

The main bright spot for Taiwan comes from its semiconductor companies filling the gap left by US companies (which can't do business with Mainland Chinese companies included in US entity list).

Put simply, Taiwan has been affected by Covid-19 like other economies and faces weak global demand for its products (think of the delayed new iPhone release, fewer upgrades to new smartphones and other consumer electronic gadgets).

But it also has additional business with Mainland Chinese technology companies because the US has slapped sanctions on Chinese companies and placed several firms on its so-called 'entity list', which are essentially blacklisted companies on national security grounds.

Forecasts

	2019	2020F	2021F	2022F
Real GDP (YoY%, period average)	2.7	-0.4	2.8	2.3
CPI (YoY%, period average)	0.6	0.3	1.3	0.9
Central bank policy rates (% , end period)	1.375	1.00	1.00	1.00
FX Forecasts (end period)	29.99	29.70	29.00	28.60

Source: ING