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RISKS TO WATCH

TAIWAN

The threat of military conflict between Taipei and Beijing has faded, raising the appeal of Taiwan for foreign investors, but sudden policy shifts and fractious local politics could cool the investment climate.

INTEREST RATE POLICY AND CAPITAL CONTROLS

Taiwan's central bank raised interest rates in September for the second time since February 2009 [ID:nTOE68T09L], and is expected to hike them 12.5 to 25 basis points each quarter until the end of 2011. However, some analysts say a severe enough slowdown in the United States, Taiwan's second biggest single-country export market after China, could force a pause in those hikes for a quarter or two. An interest rate of 1.25 percent from February 2009 through June this year was an emergency measure to fight the economic downturn. The rate hikes signal that Taiwan authorities believe their \$416 billion export-reliant economy is gathering steam despite sluggish CPI and unemployment that remains stubbornly near an unusually high 5 percent. Recent rate hikes also seek to stop fast-rising property prices in Taipei from forming an asset bubble.

The central bank remains wary of flows of "hot money" that have buoyed Asian asset prices, especially as the Taiwan dollar and other Asian asset prices have risen sharply since Sept. 27 on expectations of quantitative easing in the United States. In October central bank governor Peng Fai-nan said about T\$120 billion (\$3.9 billion) in foreign funds in Taiwan was not invested in securities, a hint that those funds may be invested in the currency market against his wishes. In November the central bank ratcheted up its rhetoric, warning of costs to exporters and saying that to increase the degree of market fluctuations would reduce the impact of foreign fund inflows. Earlier this year, the monetary authority warned banks to follow regulations when trading foreign exchange forward contracts, another move to discourage hot money. However, tough capital controls are considered unlikely unless a new wall of hot money hits.

The interventionist central bank moves almost daily to stop speculation in [the island's currency market](#). Economists say the [Taiwan dollar](#) stands to gain in tandem with the Chinese yuan if Beijing allows its nonconvertible unit to appreciate. The island's currency is an ideal proxy for the yuan due to Taiwan's fast-growing trade ties with China.

What to watch:

- Economists expect the central bank to raise rates again at its quarterly policy meeting in December.
- **Capital controls could be tightened further** if new waves of hot money pour into Taiwan as the United States eases monetary policy. Easing has boosted currencies in emerging markets such as Taiwan, where investors are seeking higher returns than they can get in developed markets.
- The central bank's response to any appreciation of the Taiwan dollar due to a firmer yuan.



CROSS-STRAIT RELATIONS

Taiwan President Ma Ying-jeou's promotion of closer economic ties with China after decades of hostility culminated on June 29 in [a landmark free trade deal](#) that cuts import tariffs on about 800 items and helps the island's financial sector. That economic cooperation framework agreement (ECFA) cleared parliament in August, despite noise from the opposition, and will take full effect on Jan. 1, setting the stage for talks with China on the next round of tariff cuts. The deal also positions Taipei to sign free trade deals with its other major world trading partners. Beijing normally forbids its diplomatic allies, including the world's most powerful nations, from official deals with Taiwan as it sees the island as part of its territory rather than a sovereign nation. But Taiwan says China will allow the island to sign FTAs with its major partners under the World Trade Organisation framework, advancing Taiwan's long-term competitiveness.

Other Asian nations have toyed with how to approach Taiwan about FTAs, but domestic concerns on both sides such as agricultural tariffs may prove a tough nut to crack. China and Taiwan agreed in November to launch new trade talks, possibly covering more tariff cuts.

Still [the issue of ties with China](#) remains highly divisive in Taiwan, and China is gradually ramping up pressure on Ma's government to discuss tough political issues, analysts say. In races seen as a rehearsal for the 2012 presidential race, Ma's ruling Nationalist Party (KMT) won three of five mayoral seats in elections on Nov. 27. Analysts say those results will calm China and strengthen Ma's resolve to talk trade with Beijing

A man walks past thousands of red lanterns at a Taiwan temple on August 16, 2004, the beginning of the "ghost month" in the lunar calendar. REUTERS/ Richard Chung

RISK DATA BOX

Sovereign foreign currency:	
S&P	AA- (negative)
Moody's	Aa3 (negative)
World Governance Indicators:	
Voice & Accountability	72.0
Political Stability	65.1
Govt Effectiveness	81.4
Regulatory Quality	84.3
Rule of Law	79.7
Control of Corruption	72.4
IHS Global Insight	
Country risk	2.21
Sovereign	A+ (stable)
Economist Intelligence Unit	
Sovereign risk	BBB
Political risk	A
Country risk	A

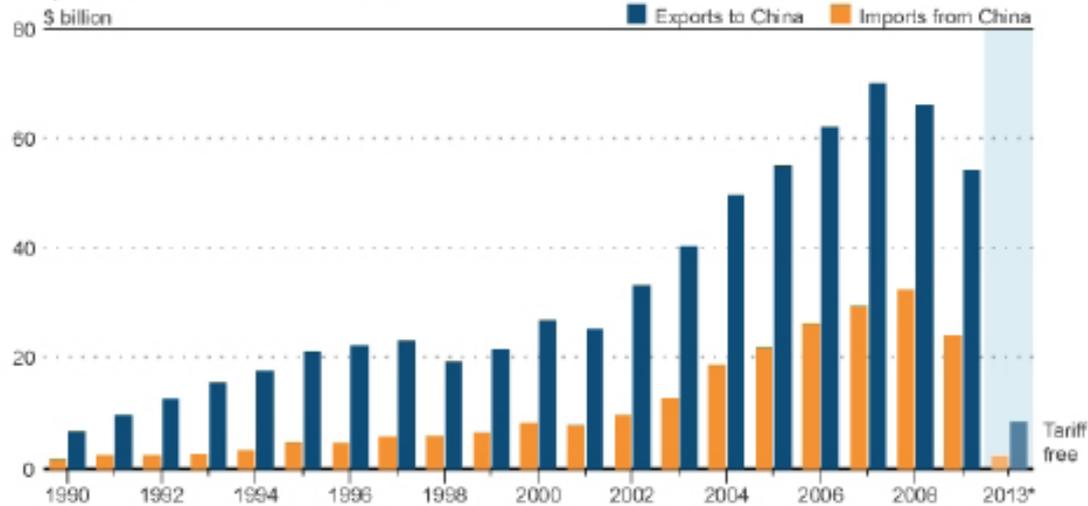
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Taiwan's trade with China

Under the Economic cooperation framework agreement, approximately 16.1 percent of exports to China and 10.5 percent of imports from China will be tariff free in 2013



Source: Taiwan Bureau of Foreign Trade, * 2013 forecast figures are based on 2009 figures



RISK DATA

JLT Group	
Strikes, riots & civil unrest	3
Terrorism	2
War & civil war	1
Economic risk	3
Currency risk	2
Sovereign risk	3
Expropriation	2
Contract repudiation risk	3
Legal & regulatory risk	3
Coface	
Country rating	A2
Business climate	A2
Transparency International	
Corruption Perceptions Index	
Score	5.6
Rank (of 180)	37
World Bank Doing Business	
Rank (of 183)	46
WEF Global Competitiveness	
Score	5.21
Rank (of 133)	13
Reporters Sans Frontières	
World Press Freedom Index	
Score	14.50
Rank (of 175)	48

What to watch:

- Washington is weighing [Taiwan's request for F-16 fighter jets](#), a sale described as a "red line" for Sino-U.S. relations. If a sale threatens economic ties with China, the impact on Taiwan asset prices will be negative, with stocks of firms that have benefited from greater access to China hit the hardest.
- Talks on further tariff reductions that could help Taiwan's biggest industries like electronics, PVC plastics and machine tools. Beijing may resist making concessions on these as it wants to develop its own industries.
- Any firm statements from Beijing, insisting that Taiwan begin negotiating military and political issues with China.
- A twice-yearly summit between the two sides, scheduled tentatively for December in Taiwan. The agenda is thin so far, but the meeting may spark street demonstrations.

GOVERNMENT EFFECTIVENESS

Ma has a strong mandate to govern, though widespread criticism of his response to Typhoon Morakot last year dented government popularity and [led to a cabinet reshuffle](#). A sudden deal in October to allow U.S. beef imports despite mad cow disease fears also backfired, prompting Taiwan's parliament to scrap part of the agreement and irritating Washington. [Cabinet flaps that saw one minister quit and another offer his resignation](#) have raised further questions about ruling party leadership ability, although the president has avoided major flaps over the past three months.

Still, the ruling China-friendly KMT faces what analysts see as a mounting threat from the anti-China opposition Democratic Progressive Party (DPP), though the DPP lost most of the mayoral elections on Nov. 27. If the DPP retakes the presidency in 2012, that shift of power would likely freeze economic ties with Beijing pending new dialogue.

What to watch:

- Markets are unlikely to be impacted much by any political controversies unless they significantly weaken the KMT's hold on power. If that happened, the risk of policy deadlock and frostier ties with China would be a drag markets.

ECONOMIC REFORM

Taiwan puts limits on [foreign portfolio investment](#) and [restricts foreign direct investment in some sectors](#). As the economy recovers, investors will start to focus again on whether economic reform may relax some restrictions. In a sign of growing focus on competitiveness, the government has cut the corporate income tax rate from 20 to 17 percent.

What to watch:

- Any announcement from the government on economic reform and measures to boost foreign investment. This would be broadly positive for the stock market.

KEY DATES

- **December, 2010**
China-Taiwan summit in Taiwan; light agenda but protests likely
- **January 1, 2011**
Free trade deal with China comes into effect
- **March 2012**
Presidential elections

