

## Daily Note

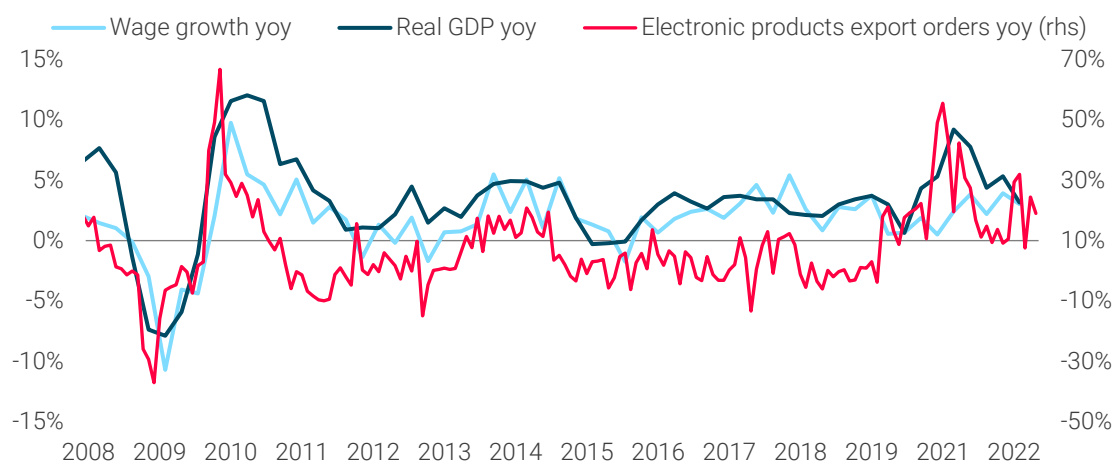
# DUTCH DISEASE IN EAST ASIA

Rory Green

- **Pandemic winners Taiwan and Korea will underperform during the next phase of the Covid cycle**
- **Heavy exposure to advanced electronic exports stops being an asset and becomes a liability as a “perfect storm” deals a blow to global demand**
- **We are negative Taiwan and Korean equities and FX; the Taiwan dollar looks particularly vulnerable as geopolitical risks grow**

Last year we set out [the case for semiconductors as a semi-commoditized product](#) (fungible to a degree, priced in USD set by global supply and demand) and showed that Taiwan and South Korea were exhibiting symptoms of a very modern form of Dutch disease – namely, dependence on commodity like tech exports. Economies geared towards advanced electronic sales have been the major pandemic winners. However, Taiwan and Korea face a perfect storm as the factors that drove exceptionally strong external demand – semiconductor/DM durables demand, China strength, the “bullwhip effect” – go into reverse. As the global goods cycle turns, we think Taiwan and Korea economies, equities and FX will underperform over the next 12 months.

In the classic case of “Dutch disease”, demand for a USD-denominated commodity drives up the current account surplus, causing the domestic currency to appreciate, which makes other exports less competitive. The relative competitiveness of the commodity leads to allocation of human, capital and land resources towards the increasingly dominant sector. The eventual result is an economy increasingly tied to the fortunes of one industry.

**Chart 1: Taiwan tech exports lead growth**


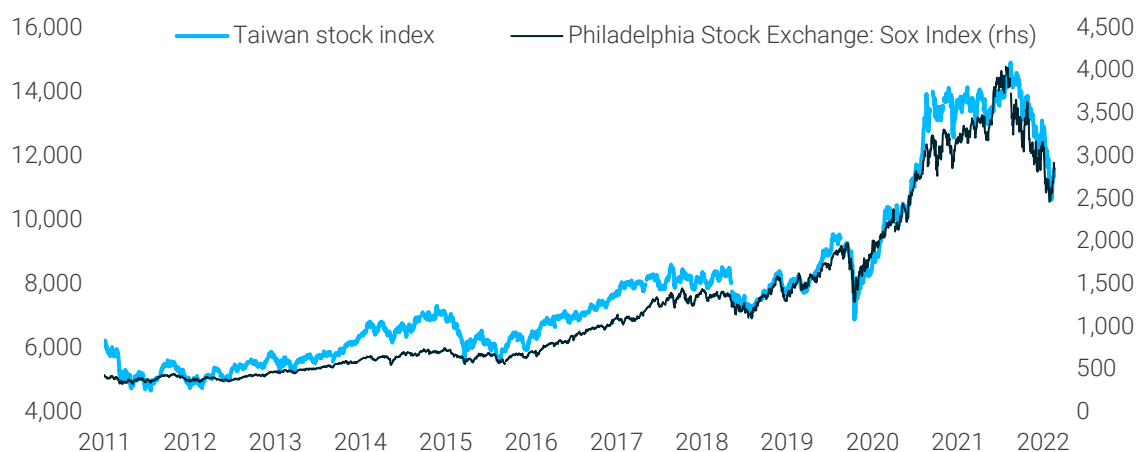
Sources: TS Lombard, CEIC.

**Dutch disease in East Asia.** The benefits of an economy geared towards semiconductor and advanced electronic component exports at a time when Covid-19 delivered an enormous global demand shock to these sectors are clear. The Taiwan and South Korea economies, equities and FX all comfortably outperformed during the first 20 months of the pandemic. The impact went well beyond exports and equities: in East Asia, exports lead economy-wide job creation, capex, wage growth, investment and consumption (Chart 1).

**Thanks to the “Zoom boom”, advanced electronics (largely semiconductors) have accounted for 118% of export growth in Taiwan over 2020-21 and 72% in Korea.** Semiconductor manufacturer TSMC alone accounted for just under 5% of Taiwan’s 2021 GDP. The company’s US\$40-44bn capex plan for 2022 is equal to 20% of total gross fixed capital formation in 2021 (not all TSMC capex is in Taiwan). Semiconductor investment and hiring have spilled over into construction: in 2020 some 50% of total land purchases in Taiwan were by chip firms. And the capacity build-out under way is such that construction wages rose by 25% in 2020.

**The downside of success in semiconductors is pressure on other industries for human, land and financial resources.** The share of non-technology exports in total Taiwan exports has fallen by 10 ppts since 2019 (Chart 3). Part of the story is that currency strength, trade and equity inflows have pushed NTD to its strongest level in 30 years, breaking the “Perng Fai-nan” line, which had held for a quarter of a century. We think defending NTD and preventing further appreciation are key factors behind the loose monetary policy stance of the Central Bank of China (Taiwan) over the past two years. Cutting the base rate to 1%, supporting M2 growth at 9% (4 pts above trend), are hard to justify when GDP growth ran at 6.5% yoy in 2021.

**Chart 2: Taiex is a semiconductor ETF**



Source: Bloomberg.

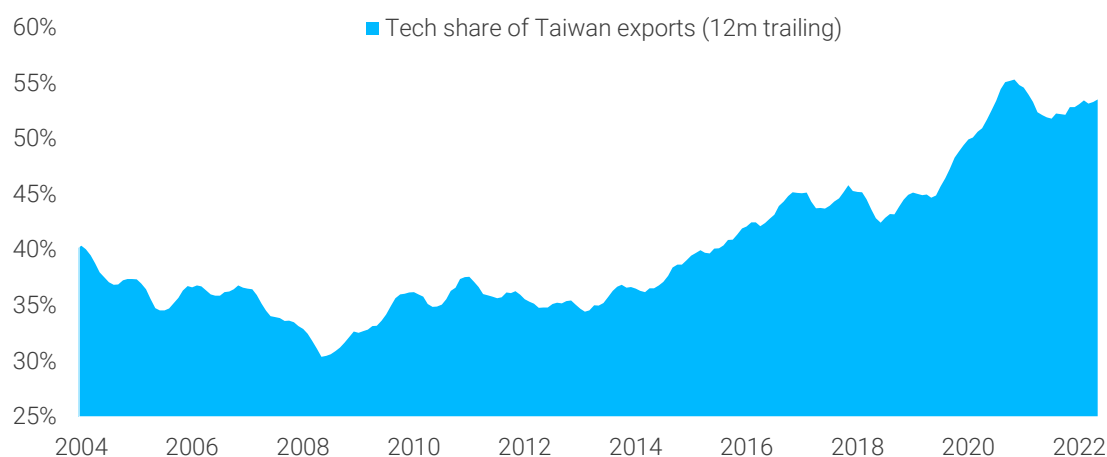
**A perfect storm on the horizon.** The factors that have turbocharged growth – semiconductor/DM demand, China strength, the “bullwhip effect” – are all reversing. At the same time, there is Fed tightening amid a step-up in geopolitical tension. The post-Covid recovery of domestic services sectors will help offset some of the external headwinds. Nevertheless we think Taiwan and, to a lesser extent, Korea economies, equity, and FX will underperform over the next 12 months. We forecast Taiwan to grow at 3.2% yoy in 2022 and 2% yoy in 2023, and Korea to reach 2.5% yoy in 2022 and 2.1% yoy next year.

**Short Taiwan dollar long geopolitical risk.** Against the current macro backdrop, the CBC and the BoK will struggle to match the pace of Fed tightening, particularly as real estate markets (following a long bull run turbocharged by strong growth and cheap money in the past two years)

are vulnerable to higher rates – most home owners have variable rate mortgages. As trade surpluses fall and equity outflows continue, we remain negative on both NTD and KRW, as we have been since March. The Taiwan dollar is our preferred short. The currency is currently range bound thanks to central bank intervention but shorting the Taiwan dollar has a positive carry. Moreover, a trigger for the next leg of depreciation may be imminent: Nancy Pelosi, Speaker of the US House of Representatives, has announced plans to visit Taiwan next month. We expect Beijing to react very strongly to the trip if it takes place. The political and economic backdrop in China favours a large military response. We still think a China invasion is highly unlikely, but risks around the island will certainly grow.

**The pandemic induced advanced electronic demand shock turbocharged Taiwanese and Korean growth, but has increased both countries already high exposure to the tech cycle.** As global goods demand and global growth more generally are set to weaken East Asia is likely to turn from a pandemic winner to re-opening loser.

**Chart 3: Taiwan exports increasingly tech heavy**



Source: CEIC, TS Lombard.