

I. Overview

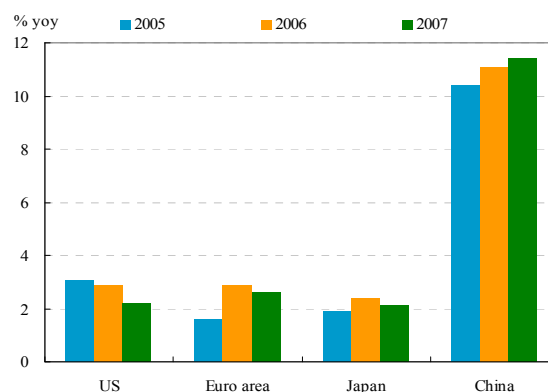
Turbulence roiled international financial markets, economic growth declined in major economies

Global economic growth continued to be strong in the first half of 2007, but tailed off in the second half of the year due to the subprime mortgage crisis in the United States and rapidly rising oil prices. Fortunately, however, the underlying adverse impact was partially offset by continued strong growth in emerging markets and developing countries. The International Monetary Fund (IMF) estimates that the global economy grew by 4.9% in 2007, down slightly from 5.0% in 2006. It is expected that global financial and credit market turmoil arising from the US subprime mortgage crisis, ongoing global current account imbalances as well as skyrocketing oil and commodity prices could continue to threaten global financial stability and economic growth. The IMF forecasts global economic growth of 3.7% in 2008, lower than the 4.9% growth achieved in 2007.

Taiwan economy grew steadily, while inflationary pressures stepped up

Statistics from the Directorate-General of Budget, Accounting & Statistics (DGBAS) indicate that Taiwan's economy grew 5.72% in 2007, up from 4.89% in 2006, primarily attributable to stable export growth and a rebound in domestic demand. In 2008,

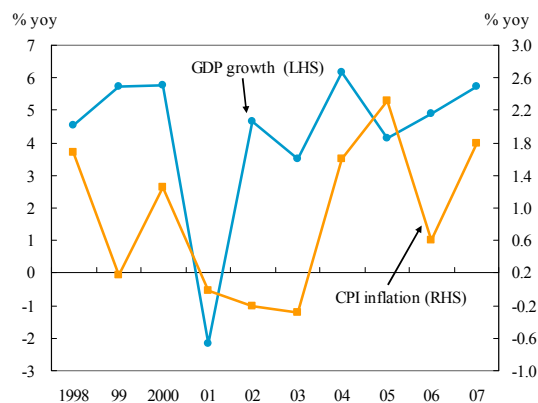
Economic growth rates in selected economies or areas



Note: Same as chart 1.1.

Sources: CBC, BEA, Eurostat, Cabinet Office of Government of Japan and National Bureau of Statistics of China.

Economic growth and consumer price inflation rate in Taiwan



Note: Figure of 2007 GDP growth is preliminary statistics.
Source: DGBAS.

however, the DGBAS expects slowing growth in Europe and North America to pull Taiwan's economic growth back down to 4.78%. In addition, rising international commodity prices have pushed up domestic consumer prices. Reflecting this, the consumer price index (CPI) rose by 1.8% in 2007, up sharply from the 0.6% registered a year earlier. The DGBAS projects the CPI inflation rate to reach 3.29% year on year in 2008. Inflationary pressures are stepping up.

Financial system remained stable

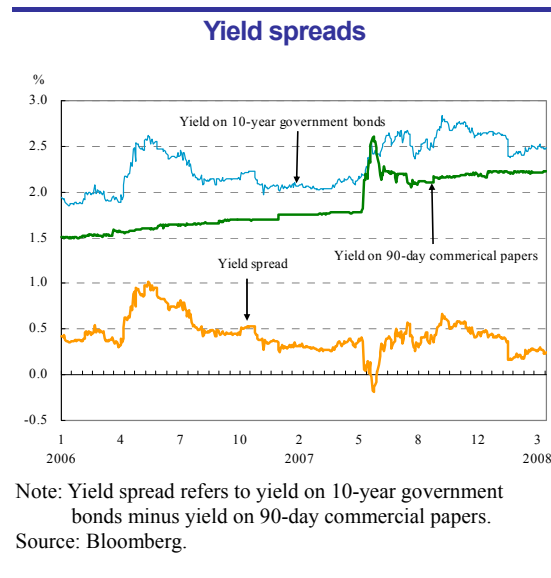
The collapse of the China Rebar conglomerate triggered the runs on its subsidiary financial institutions and disrupted Taiwan's financial system in the first half of 2007. However, the government dealt with them appropriately and prevented the problems from triggering a systemic crisis.

In the latter half of 2007, domestic financial markets continued to function normally, although their volatility increased due to the contagion effects of international market turmoil emanating from the US subprime mortgage crisis. Domestic financial institutions, in spite of some weaknesses, were sufficiently resilient to implement their intermediary function in the face of external and internal shocks. Payment and settlement systems also operated smoothly. Overall, the financial system in Taiwan has remained robust. However, the global financial turmoil and credit crunch caused by the US subprime mortgage crisis have not yet settled down. Close monitoring for any possible impacts upon the financial system and macroeconomic conditions in Taiwan is still needed.

Financial markets

Bills and bond markets contracted, while yield spreads remained tight

Issues outstanding and trading volume in the short-term bills market both declined in 2007, while trading volume in the bond market also fell sharply from the previous year due to rising yields and rotation of investor funds into the equity markets. Interest rates on both bills and bonds gradually trended higher, but yield spreads remained tight. Shrinking yield spreads



are unfavorable to financial institutions which use short-term financing to fund long-term bond positions.

Stock indices on choppy upward trend

Sharp volatility in stock markets worldwide caused Taiwan's stock markets to fluctuate dramatically in 2007. However, stock indices trended upward in 2008 Q1, thanks to a buoyant mood spurred by elections and continued capital inflows. Rising stock price volatility, however, has increased the risks of investing in stocks.

Volatility in foreign exchange market increased

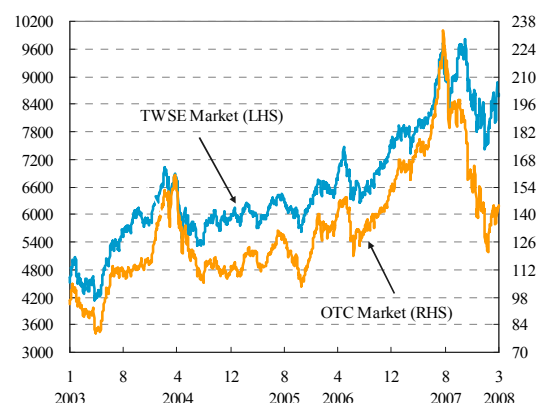
The New Taiwan dollar (NT dollar) generally traded in a tight range near 33 against the US dollar in the first three quarters of 2007, but appreciated slightly in Q4 as the latter weakened. Appreciation of the NT dollar continued in 2008 Q1, and was further strengthened due to large capital inflows. This would cause financial institutions holding large foreign currency assets to suffer considerable foreign exchange losses, and could also be unfavorable to export industries.

Financial institutions

Profitability improved and asset quality remained satisfactory at domestic banks

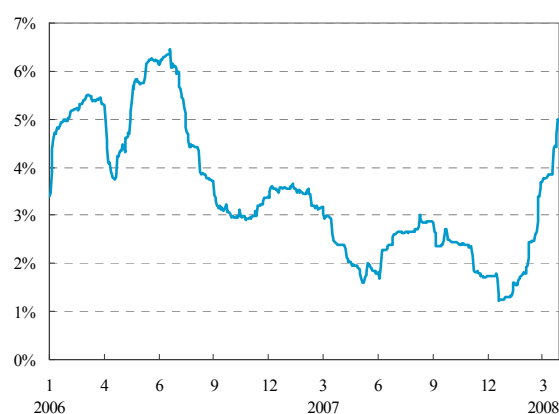
Profitability at domestic banks improved markedly from the previous year. Asset quality

Taiwan stock market indices



Sources: TWSE and GTSM.

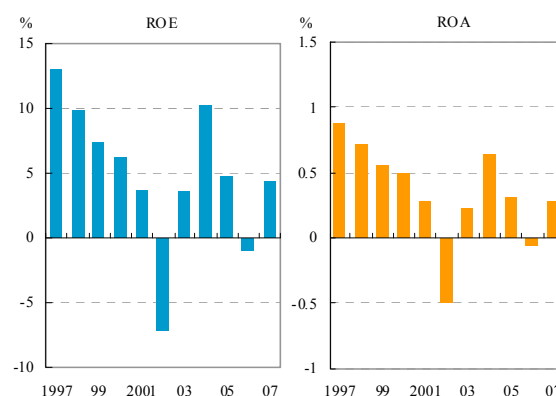
NT\$/US\$ exchange rate volatility



Note: Volatility refers to the annualized standard deviation of 60-day daily returns.

Source: CBC.

ROE and ROA of domestic banks



Note: Same as chart 4.1.

Source: CBC.

also remained satisfactory. Capital adequacy ratios resumed their gradual upward climb after dropping off abruptly following implementation of Basel II. Future profitability and asset quality at domestic banks may be affected by a number of factors, including shrinking interest rate spread between deposits and loans, implementation of the Consumer Debt Clearance Act, frequent disputes involving wealth management business, possible further losses on subprime mortgage related investments, as well as concentration risk from heavy lending to real estate, electronics and machinery sectors. In addition, domestic banks face stepped up competition from foreign banks, which have expanded their business units through cash acquisitions of local banks or tender acquisitions of problem banks that were cleaned up by the Financial Restructuring Fund after being taken into conservatorship.

Community financial institutions in gradually improving health

Profitability at community financial institutions is gradually improving, while NPL ratios are decreasing each year and capital adequacy ratios are slowly rising. Overall, the operations and financial conditions of these institutions have improved markedly. However, some credit departments of farmers' and fishermen's associations hold poor quality assets. The average capital adequacy ratio of credit departments of fishermen's associations is below the statutory minimum of 8%.

Rapidly growing assets at life insurance companies

Life insurance companies are enjoying rapid asset growth, and their overall profitability has clearly improved. Nevertheless, the risk-based capital (RBC) ratios at some companies are below the statutory minimum of 200%. Negative interest rate spreads and foreign exchange losses on overseas investments are expected to erode future profitability.

Continued contraction in assets and profitability at bills finance companies

Bills finance companies are facing the situation of contracting assets, declining profitability and falling capital adequacy ratios. Some companies with huge long-term bond holdings, moreover, could encounter the risk of insufficient liquidity.

Ongoing improvements in payment and settlement systems

In recent years, Taiwan has undertaken a number of reform measures to improve the efficiency and safety of payment and settlement systems. Among these measures, the CBC

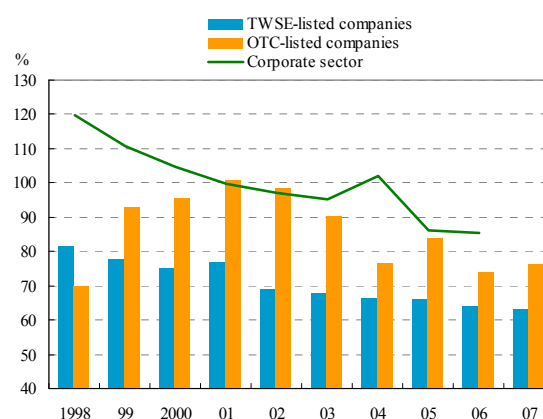
Interbank Funds-Transfer System has switched to a real-time gross settlement (RTGS) mechanism, and the securities settlement system and the book-entry central government securities system have adopted a simultaneous delivery versus payment (DVP) scheme. The CBC is also encouraging important domestic payment and settlement systems to establish business continuity plans, and is calling upon the operators of these systems to carry out self-assessments in order to improve system efficiency and maintain sound operations.

Financial conditions in the corporate sector improved

The corporate sector has achieved markedly improved profitability amidst strong economic conditions in recent years. Financial structure has also improved as leverage ratios have fallen, and interest servicing capacity has significantly strengthened over the same period. TWSE-listed companies, in particular, have on average outperformed the corporate sector as a whole. OTC-listed companies, in contrast, have been subject to wider swings in performance, and saw a weakening of financial ratios in 2007 due to the impact of lower earnings. Compared with other countries, the average leverage ratio of Taiwan's listed companies was lower than those in the United States and South Korea, but was still higher than in Australia and Malaysia.

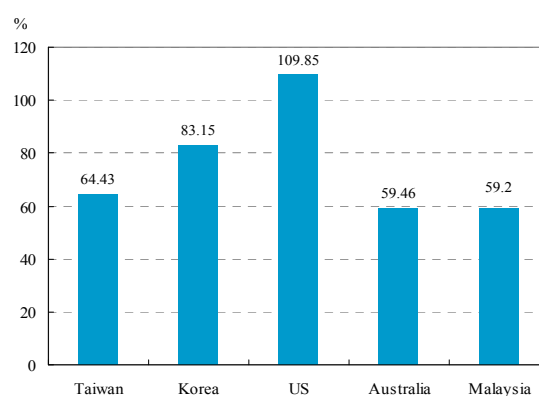
Although its overall financial conditions have improved, the corporate sector still faces the problem of slowing global economic growth, continued appreciation of the NT dollar and rising international commodity prices, which may impact the revenues and financial conditions of domestic companies. Close monitoring is therefore needed. In addition, enterprises with investments in China also face increasing risk due to the adverse effects arising from the implementation of the Employment Contract Law and tax reforms in China.

Leverage ratios in corporate sector



Note: Same as chart 6.2.
Sources: JCIC and TEJ.

Corporate sector leverage ratios in selected countries

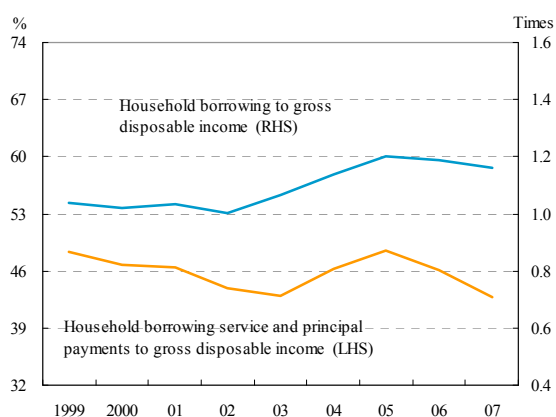


Note: Same as chart 6.3.
Sources: TEJ, BOK, Fed, ABS and BNM.

Household debt burden remained heavy

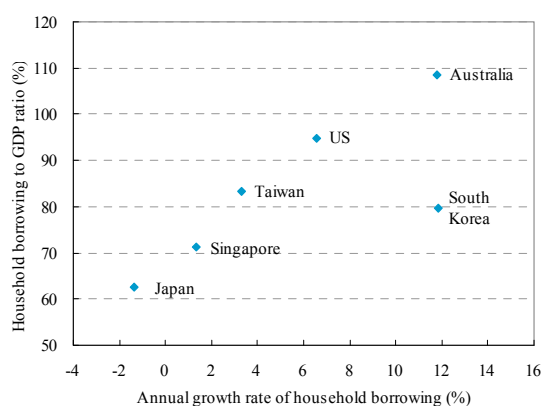
Growth in household borrowing has slowed since credit card and cash card defaults emerged as a major problem in 2005. Principal and interest payments therefore have become less burdensome, and debt servicing capacity has strengthened. However, household borrowing remains higher in Taiwan than in neighboring countries such as South Korea, Singapore, and Japan. Household borrowing to gross disposable income ratios have fallen, but remain high, reflecting considerable debt burdens. Rising domestic inflationary pressures and successive expiration of interest-only periods on high loan-to-value (LTV) mortgage loans may undermine the real income and debt servicing capacity of households.

Household debt servicing ratios



Note: Figure for gross disposable income of 2007 is CBC estimate.
Sources: CBC, JCIC and DGBAS.

Household indebtedness in selected countries

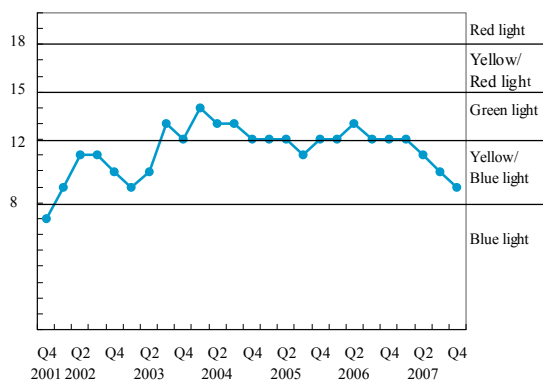


Note: Same as chart 7.3.
Sources: Fed, BEA, BOJ, Cabinet Office of Japan, BOK, ABS, DGBAS, CBC and JCIC.

Real estate market cooled off

Real estate prices continued to rise and rental rates also trended gently upward. Market growth, however, turned moderate due to a slowdown in real estate market transactions. Moreover, rising housing vacancy rates and tightening real estate lending standards are likely to put downward pressure on the market.

Real estate cycle indicators



Source: "Quarterly Report of Taiwan Real Estate Cycle Indicators," Architecture and Building Research Institute, MOI.