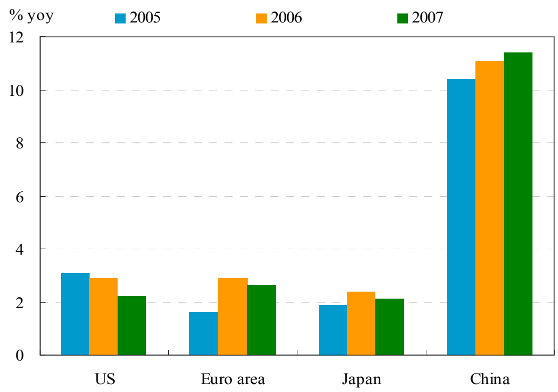
II. International and domestic economic and financial conditions

1. International economic and financial conditions

Slowdown in global economic growth

Following three consecutive years of stable growth, the global economy continued to expand vigorously during the first three quarters of 2007. In the fourth quarter of 2007, however, the expansion slowed dramatically in the advanced economies, particularly in the United States, amid global financial market turmoil emanating from the US subprime mortgage crisis and increasing concern about rising international commodity prices. Nevertheless, strong momentum from continued rapid growth in emerging markets and developing economies partially offset the adverse impact, so the global economic turndown was not very pronounced. The IMF estimates the global economy grew by 4.9%[1] in 2007, declining by 0.1 percentage point from 5.0% in 2006. Growth in the advanced economies, which have been the most affected by global financial market distress, is expected to fall in 2008 as a result of the spillover effect from the subprime mortgage crisis. Meanwhile, growth among emerging and developing economies is also projected to slow due to negative financial shocks. The IMF projects that global growth could decline to 3.7% in 2008[2], 1.2 percentage points lower than in 2007.

Chart 1.1 Economic growth rates in selected economies or areas



Note: Figures for Japan and the US are seasonally adjusted and annualized rates of change from the previous quarter. Those for the Euro area and China are year-on-year growth rates.
Sources: CBC, BEA, Eurostat, Cabinet Office of Government of Japan, and National Bureau of Statistics of China.

Among major economies, economic performance in the United States remained strong in the second and third quarter of 2007, despite sluggish demand in the housing market. This was mainly supported by the combination of expanding domestic investment and government expenditure as

[1] See the IMF World Economic Outlook, April 2008.
[2] Same as Note 1.

well as rising exports. Nevertheless, economic activity slowed substantially in the fourth quarter of 2007, as the fallout from the subprime mortgage crisis broadened, growth in consumer spending and exports decelerated, and private investment declined. GDP growth dropped to 2.2% year on year in 2007 from 2.9% in 2006 (Chart 1.1).

Economic growth in the euro area ranged between 2.4% and 3.1% during the first three quarters of 2007. In the fourth quarter, however, continuing appreciation of the euro and the negative effect of the US subprime mortgage crisis caused fixed capital formation and export growth to moderate and household consumption to contract. Reflecting this, economic growth for the year as a whole came in at 2.6%, down from 2.9% in 2006 (Chart 1.1).

In Japan, although private housing investment fell in 2007 due to the adoption of more stringent building codes, GDP posted stronger than expected growth beginning in Q3, supported by rising manufacturing investment and exports. However, the annual economic growth rate nevertheless fell to 2.1%, down by 0.3 percentage points from the 2.4% of 2006 (Chart 1.1).

Emerging markets and developing countries achieved strong economic expansion throughout 2007, mainly driven by China and India. Despite implementation of tighter macroeconomic control policies, the annual economic growth rate in China remained firm at 11.4% in 2007, higher than the 11.1% registered in 2006, largely due to ongoing robust investment in fixed assets and the sizable trade surplus (Chart 1.1).

US subprime mortgage crisis drove global financial turmoil

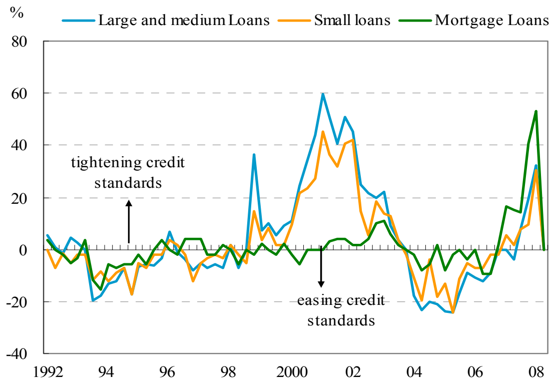
The financial crisis sparked by the US subprime mortgage market in the latter half of 2007 has triggered disturbances in the global financial market. Increasing defaults on US subprime mortgages caused prices to plummet in securities backed by such mortgages and resulted in considerable losses for financial institutions worldwide[3]. Some financial institutions that are highly reliant on short-term funding also faced liquidity pressures due to a spike in short-term lending rates in the interbank market. In addition, lending capabilities of financial institutions were restrained due to enormous losses. They also adopted a more cautious attitude and imposed tighter credit standards in the face of an increase in defaults on loans such as credit card and mortgage loans that had formerly been performing normally. Credit markets were under stress (Chart 1.2). Rattled investors around the world have dumped their equities or

[3] The IMF estimates that the global financial sector as of March 2008 faced potential losses from the US subprime mortgage crisis totaling US$1.17 trillion, including US$225 billion in potential losses on unsecuritized US loans, and US$945 billion on mark-to-market losses on related securities. See the IMF Global Financial Stability Report, Table 1.1, April 8, 2008.

rushed to redeem their fund holdings due to a loss of confidence in the financial markets, and concerns about a global economic slowdown have heightened, spurring a big slump in global equity prices (Chart 1.3).

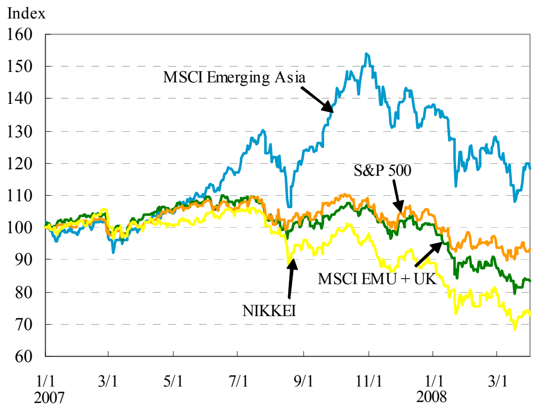
To prevent further contagion of the subprime mortgage crisis and mitigate its adverse impact, leading economies employed a series of contingency measures, including continual easing of interest rates by the US Federal Reserve and a succession of coordinated liquidity injections carried out by several central banks. The US government implemented further support measures, such as a tax break and a freeze on subprime interest-rate resets, to provide assistance to lenders coping with financial distress and to keep the US economy from turning down. The US subprime mortgage crisis is expected to linger over a longer timeframe, but it has already revealed some weaknesses in risk management and financial supervision. Financial authorities and financial institutions around the world should take remedy measures to strengthen the resilience of financial systems to respond to future unexpected impacts.

Chart 1.2 Senior loan officer opinion survey on the US bank lending practices



Notes: 1. Figure of 2008 is for 2008 Q1. The ratios show the difference between the banks tightening credit standards and those easing standards divided by total number of large banks under survey.
2. Mortgage loans refer to prime mortgage loans after 2007 Q2.
Source: Fed.

Chart 1.3 Performance of key international stock indexes



Note: 1 January 2007=100.
Source: Bloomberg.

Prices of crude oil and commodities soared

Growing demand and tight supply for international oil, grains and other commodities, as well as the continued depreciation of the US dollar, caused commodity prices to surge. In March 2008, the spot price of West Texas Intermediate crude oil climbed past US$100 a barrel[4], while the commodity (crude oil excluded) index[5] also rose above 3,000 points, setting a

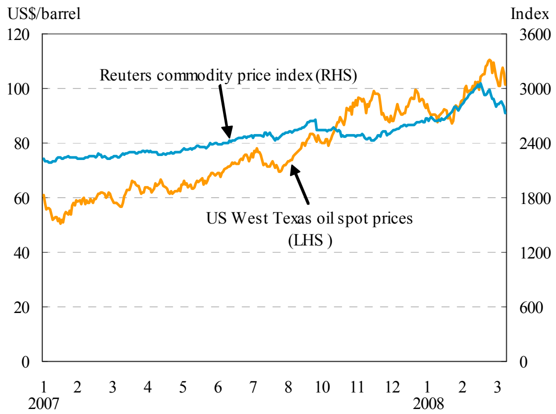
[4] The spot price of West Texas crude oil rose above US$110 per barrel in April 2008.
[5] Commodities (ex-crude oil) includes the following 17 items: wheat, pork, corn, copper, sugar, rapeseeds, rapeseed oil, coffee, soy meal, zinc, rubber, lead, cocoa, wool, rice, tin, and cotton.

record high (Chart 1.4). Soaring international oil and commodity prices have exacerbated global inflationary pressures, while downturn pressure has emerged in the global economy as a result of the US subprime mortgage crisis. This will be a dilemma for central bankers in the implementation of monetary policy.

Global current accounts remained imbalanced

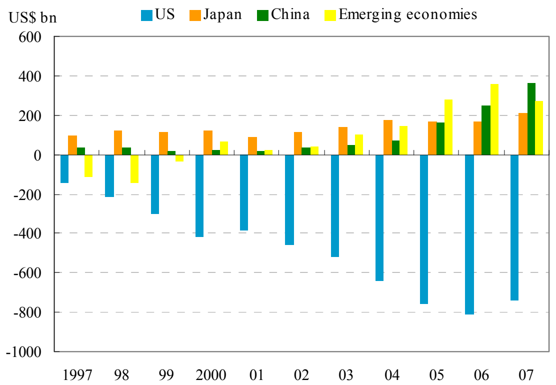
In 2007, the US current account deficit declined to US$735.6 billion after reaching a record US$811.5 billion in the previous year. This was mainly brought about by rising export growth due to the depreciation of the US dollar in the latter half of 2007. Contrary to the US, the sizable current account surplus continued to grow in Japan, China and other emerging markets and developing countries. Among them, Japan's current account surplus in 2007 reached US$212.8 billion, while China's exceeded US$360 billion (Chart 1.5). The continued global current account imbalances could undermine global economic and financial stability.

Chart 1.4 International oil and key commodity price trends



Sources: Bloomberg and Reuters.

Chart 1.5 Current account balances at selected economies



Note: The figures for China and emerging economies from 2006, and for the US and Japan from 2007 are estimated by IMF. Emerging economies include emerging market and developing countries, but exclude China.
Source: World Economic Outlook Database, IMF, April 2008.

2. Domestic economic and financial conditions

Taiwan's economy sustained moderate growth throughout 2007, while consumer and wholesale prices both rose. External debt servicing capacity remained strong, thanks to ample foreign exchange reserves, an ongoing current account surplus and modest external debts.