III. Financial sectors

3. Financial markets

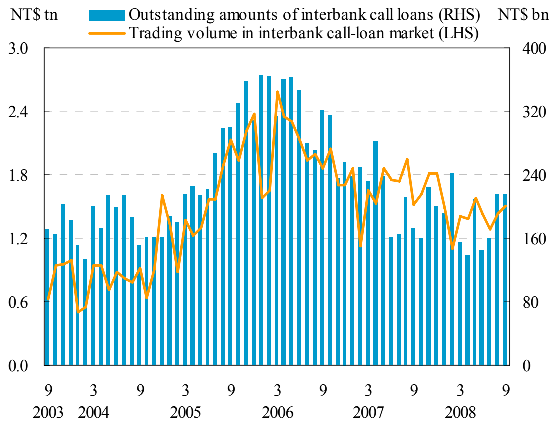
The trading volume in Taiwan's bond market continued to shrink, along with the once-negative yield spreads registered in 2008 Q3. This situation is unfavorable to financial institutions which use short-term financing to fund long-term bond positions. Local equity prices slumped and volatility increased amid the global stock market crash, resulting in higher risks in stock investments. Large cross-border capital flows caused the NT dollar exchange rate against the US dollar to shift from appreciation to depreciation, with volatility gradually stabilizing after experiencing large fluctuations. The depreciation of the NT dollar helped reduce the pressure of foreign exchange losses on financial institutions while strengthening the competitiveness of export enterprises.

3.1 Money and bond markets

Trading volume picked up in bill market but contracted notably in bond market

The average monthly trading volume of interbank call loans was off 15.84% year on year from January through September of 2008, but both the trading volume and outstanding amount of interbank call loans trended upwards from August 2008 onwards (Chart 3.1), indicating that allocation of funding resources was somewhat uneven along with a rise in demand for interbank call loans. The average monthly trading volume of interbank call loans from January through September of 2008 consisted mainly of overnight call loans, accounting for 54.19% of average interbank call-loan transactions over the same period, a slight increase compared to the same period last year, followed by one-week call loans, with a declining share of 26.80%.

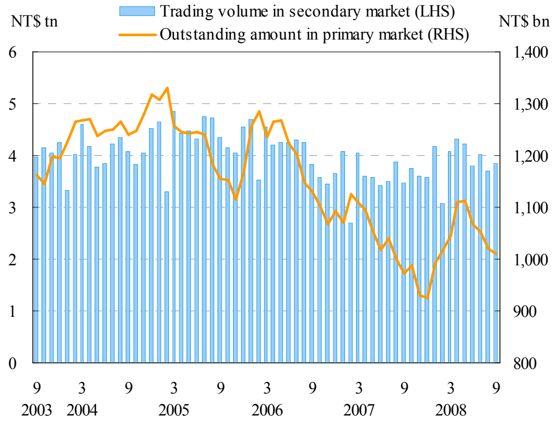
Chart 3.1 Interbank call-loan market



Source: CBC.

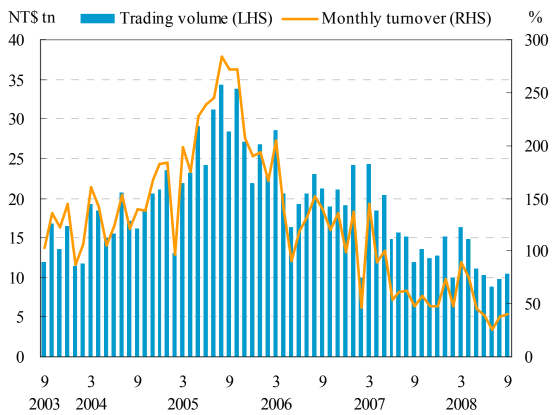
The outstanding amount of bills issuance ascended in early 2008 but turned to contraction in June. In September, the figure declined by 9.14% compared to the previous year end, primarily because of a marked reduction in the outstanding issuance of treasury bills, while that of commercial paper rose by 6.40%. Affected by a rise in the issuance of commercial paper, the secondary market saw an expansion in trading volume in the first half of 2008. The average monthly trading volume rose by 9.27% year on year from January through September (Chart 3.2).

Chart 3.2 Primary and secondary bill markets



Source: CBC.

Chart 3.3 Bond market size and turnover



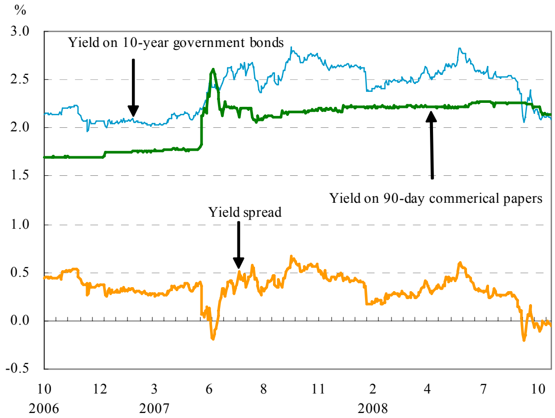
Note: Monthly turnover ratio = trading value in the month / average bonds issued outstanding.
Sources: CBC and FSC.

In the bond market, both trading value and monthly turnover rate expanded in 2008 Q1 due to sizable capital inflows. However, trading activities cooled from 2008 Q2 onwards as financial institutions sought to reduce their spare funds through purchases of bonds, causing bond yields to decrease, which in turn discouraged bond trading. The monthly turnover rate fell notably to a trough of 25.75% in July, a five-year low. In August, both bond trading value and monthly turnover rate rebounded slightly as investors redirected funds from the lackluster equity markets into the bond market, but they still remained in low gear (Chart 3.3).

Bond yields fell markedly along with narrowed and once-negative yield spreads

In 2008, the average overnight interbank call-loan rate increased steadily in response to rate hikes by the CBC, peaking at 2.166% in July, and then fell back to 2.092% in September as the CBC shrank the issuance of certificates of deposit to maintain market liquidity at an appropriate level against the backdrop of unfavorable financial conditions domestically and overseas. Interest rates on bills first rose and then fell, with the average rate on 1-30 day commercial paper in the secondary market falling to 2.01% in September after rising slightly to 2.03% in July. As for long-term interest rates, the yield on 10-year government bonds began a gradual rise in 2008 Q2, peaking at 2.82% in mid-June on the back of a rebound in equity prices, rate hikes by the CBC, and heightened inflation expectations. The bond yield dipped appreciably afterwards and registered 2.15% in September. This was led by increasing inflows of funds into the bond market supported by the CBC's rate cuts and expanded Repo facility operations (Chart 3.4).

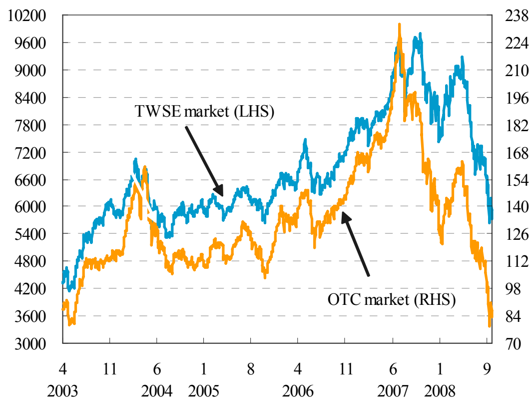
Chart 3.4 Yield spreads



Note: Yield spread refers to yield on 10-year government bonds minus yield on 90-day commercial papers.
Source: Bloomberg.

The spread between the yields of 10-year government bonds and 90-day commercial papers began to widen in 2008 Q2 as bond yields trended upwards. Bond yields dropped noticeably afterward, resulting in a convergence of yield spreads between 10-year government bonds and 90-day commercial papers. The yield spreads even became negative in mid-September and troughed at -20 basis points (Chart 3.4). Declining bond yields are unfavorable to financial institutions which use short-term financing to fund long-term bond positions, despite the fact that they generate capital gains for financial institutions holding long bond positions.

Chart 3.5 Taiwan stock market indices



Sources: TWSE and GTSM.

3.2 Equity markets

Stock indices continued to fall with record high volatility

Motivated by the developments of cross-strait economic and trade issues after the presidential election in March 2008, the Taiwan Stock Exchange Weighted Index (TAIEX) of the Taiwan Stock Exchange (TWSE) market trended upward and reached a high of 9,295 in mid-May 2008. Afterward, two gigantic US mortgage lenders (Fannie Mae and Freddie Mac), Lehman Brothers, and AIG faced difficult financial conditions, and the consequent blow to market