

II. Financial Developments

1. Overview

With the spread of the European sovereign debt crisis and a weakened global economy, domestic economic activity in 2012 advanced at a tepid pace and the demand for funds was not strong. These factors led to slower expansion in bank loans and investments, thereby curbing M2 growth. As uncertainty intensified for the global economy and domestic inflationary pressures increased, the Bank decided to keep policy rates unchanged. As a result, most banks held their posted interest rates on deposits and loans steady for the year. In terms of exchange rate movements, the NT dollar fluctuated against the US dollar with modest volatility during the year. In Taiwan's stock market, both the price indices and trading volume fell mainly owing to unstable international financial markets, fuel and electricity price hikes, and debate over a capital gains tax on income from securities. In addition, bond yields trended lower compared to those of the previous year because of the sluggish global economy and weak domestic demand.

Growth in Monetary Aggregates Decreased

Affected by the spillover of the European debt problem and frail domestic demand, the growth in banks' corporate lending moderated in 2012. The monetary aggregate M2 recorded an annual growth rate of 4.17 percent, lower than the previous year's 5.83 percent and remaining within the Bank's 2.5 percent to 6.5 percent target range for the year. The annual growth rate of M1B decelerated to 3.45 percent, decreasing by 3.71 percentage points from the previous year. The decline mostly reflected weakened demand for funds owing to sluggish economic activity and the shift of funds from transaction deposits to non-transaction deposits and foreign currency deposits. Moreover, strained by the issue of reintroducing a capital gains tax and fuel and electricity price hikes, stock market trading volume shrank for the year, which also depressed the growth rate of M1B.

Growth in Bank Loans and Investments Slowed

In the first three quarters of the year, the growth rate of bank loans and investments slid from 5.22 percent in January to 4.51 percent in September, mainly because the demand for funds was dampened by the economic slowdown. However, the growth in bank loans and investments soared as the economy recovered in the fourth quarter. At the end of December, the loans and investments of monetary financial institutions grew at an annual rate of 5.69 percent, slightly lower than 6.00 percent registered a year earlier. If the loans and investments of life insurance companies, non-accrual loans reclassified, and bad loans written off by monetary financial institutions, as well as

funds raised directly from capital markets, were all taken into account, the total funds raised by the non-financial sector would register an annual growth rate of 4.55 percent at the end of December, lower than the 5.06 percent recorded a year earlier.

Financial Health of Domestic Banks Continued to Improve

Although the European debt crisis heightened the uncertainty surrounding global financial markets, the asset quality of Taiwan's banks remained sound owing to limited exposure to European debt. The overall non-performing loan ratio decreased from the previous year end's 0.43 percent to 0.40 percent at year end. The pre-tax profits of monetary financial institutions kept growing during the year, and their average return on assets and return on equity were both higher than those of the previous year, rising respectively from 0.59 percent and 9.33 percent to 0.68 percent and 10.41 percent.

Average Interest Rates on Deposits and Loans Rose Mildly

In view of greater uncertainty in the global economy and the increasing pressures of domestic inflation, the Bank decided to keep policy rates unchanged to maintain price and economic stability. As a result, most banks held their posted interest rates on deposits and loans steady throughout 2012. The average fixed rate on one-year time deposits of the five major domestic banks maintained the same level as that at the end of December 2011, while their weighted average rate on new loans rose slightly because of increases in the rate on current operations loans. For the whole year of 2012, the weighted average interest rate on deposits in domestic banks showed an increase from 0.75 percent in the previous year to 0.82 percent, mainly owing to the flat transaction demand for money and the shift of funds from demand deposits to time deposits in the first half of the year. The average interest rate on loans also rose slightly from 2.16 percent to 2.24 percent during the same period because some banks raised their base lending rates.

Money Market Rates Rose Slightly

As the government announced the prices of both fuel and electricity would be adjusted upward in April, the Bank conducted open market operations more aggressively to ensure price stability and prevent excess liquidity from affecting the stability of financial markets. As a result, the interbank overnight call loan rate rose from 0.402 percent in March to 0.513 percent in June. In the second half of the year, the eurozone recession, China's cooling economy and the weak expansion of the US economy added to the risks to Taiwan's economic outlook. Consequently, businesses and consumers became cautious, and the interbank call-loan rate trended down and then remained steady. For the year 2012, the average interbank overnight call loan rate was 0.428 percent, increasing by 8.7 basis points from the previous year. Compared to the overnight call loan rate, the rate on commercial paper was more stable, mainly attributable to the easy funding conditions in

primary and secondary markets.

Exchange Rate Movements Were Mixed

From January to April, the NT dollar appreciated moderately against the US dollar and the closing interbank exchange rate climbed up from 30.290 the previous year end to 29.232 at the end of April. Thereafter, hedge demand caused the US dollar to strengthen, mainly because of the deteriorating European sovereign debt crisis, decelerating global economic growth and sluggish international stock markets. Meanwhile, foreign investors sold off in Taiwan's stock market. All these factors led the interbank closing exchange rate down to 30.010 at the end of July. From September, with the Fed's third round of quantitative easing (QE3) and the ECB's Outright Monetary Transaction (OMT) bond buying program, international capital flowed into Asia's emerging economies and the NT dollar firmed. At the end of 2012, the NT dollar appreciated against the US dollar by 3.96 percent compared to the end of the previous year. However, the NT dollar depreciated against the US dollar by 0.51 percent on a daily average basis.

Stock Market Experienced Sharper Swings

Early in the year, with rising hopes for the resolution of the European sovereign debt crisis and the improved US economic performance, Taiwan's economy was expected to grow mildly and the Taiwan Stock Exchange Capitalization Weighted Stock Index (TAIEX) reached a yearly high of 8,144 on March 2. From April, the issue of capital gains tax and a price hike for fuel and electricity, combined with the European debt woes and the sluggish economic growth of the US, Europe and China, caused the TAIEX to fall to a yearly low of 6,895 on June 4. In August, coupled with the easing of the European sovereign debt crisis, investors turned optimistic and Taiwan's stock market turned bullish. In September, bolstered by the ECB's announcement of the OMT and the US and Japan both adopting quantitative easing, global stock markets rallied. Moreover, with the recovery of Taiwan's exports and the signing of the MOU on cross-strait currency settlement, the TAIEX continued to soar. In October, the confidence of investors turned weak and the TAIEX declined, owing to the uncertainties of the US "fiscal cliff", a change in the National Health Insurance regime to require a supplementary premium from stock dividends, and the investment losses of the government pension funds. Afterwards, with positive developments in US "fiscal cliff" negotiations and a stimulus package for the stock market proposed by the government, the TAIEX went up to 7,700 on December 28, an increase of 8.9 percent as compared to the end of 2011. However, measured on a daily average basis, the TAIEX was 7,481 in 2012, a decline of 8.3 percent as compared to 2011.

Declining Bond Yields Boosted Corporate Bond Issuance

In 2012, the yields on government bonds recorded a moderate downtrend owing to the frail

international financial conditions and the moderation of the domestic economy. The yields on government bonds at each maturity averaged lower than in the previous year. Yield spreads between long-term and short-term bonds were almost the same as those in the previous year, and the yield curve was still flat. The yield on benchmark 10-year government bonds edged down from 1.2856 percent at the end of the previous year to 1.1673 percent at the end of 2012. Regarding corporate bond issuance, because the demand for funds shrank amid the moderating economic growth, the willingness to issue bonds weakened in the first half of the year. However, from the middle of the year onwards, declining interest rates on government bonds, which led the cost of issuing corporate bonds lower, boosted the willingness of companies to tap the corporate bonds market. Compared to the previous year, the issuing amount of corporate bonds increased considerably. The weighted average rates of corporate bonds went down compared to those in the previous year, owing to the ample liquidity in the market.

