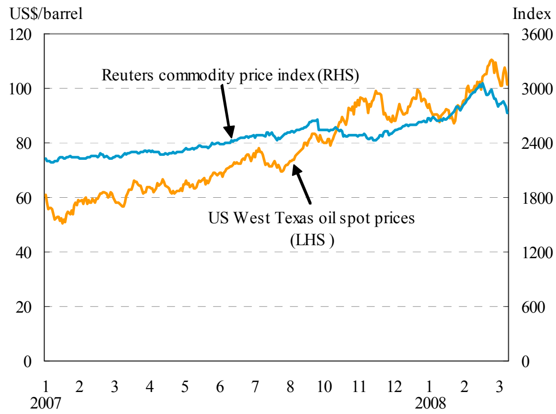
record high (Chart 1.4). Soaring international oil and commodity prices have exacerbated global inflationary pressures, while downturn pressure has emerged in the global economy as a result of the US subprime mortgage crisis. This will be a dilemma for central bankers in the implementation of monetary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

Global current accounts remained imbalanced

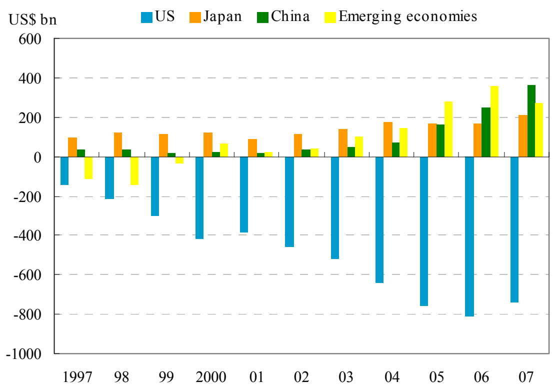
In 2007, the US current account deficit declined to US$735.6 billion after reaching a record US$811.5 billion in the previous year. This was mainly brought about by rising export growth due to the depreciation of the US dollar in the latter half of 2007. Contrary to the US, the sizable current account 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.

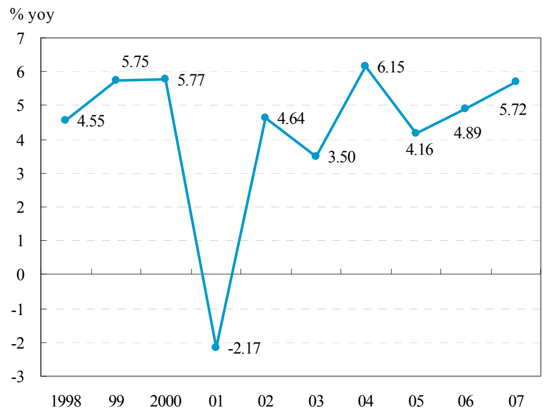
2. Domestic economic and financial conditions

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.

Economy sustained solid growth in 2007

Economic growth remained solid in 2007, underpinned mainly by stable export growth against the backdrop of continued global economic expansion, and a rebound in growth in private consumption expenditure and private investment. Statistics from the DGBAS indicate economic growth of 5.72% for 2007, up from 4.89% in 2006 (Chart 2.1). Although the global economic slowdown is expected to moderate Taiwan's export growth, domestic demand is projected to remain stable. The DGBAS predicts economic growth will decline to 4.78% in 2008.[6]

Chart 2.1 Economic growth in Taiwan

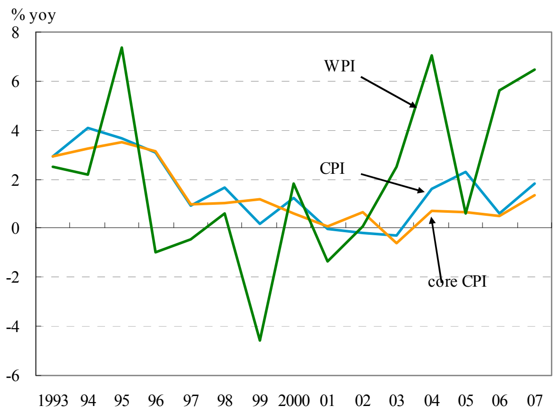


Note: Figure of 2007 is preliminary statistics.
Source: DGBAS.

Inflationary pressures increased

International raw material and commodity prices stayed elevated in 2007, driving an upsurge in wholesale prices. The Wholesale Price Index (WPI) accelerated 6.47% year on year, compared to a rise of 5.63% in the previous year. On the Consumer Price Index (CPI) side, a series of typhoons and a rapid increase in international prices for crude oil, grains and other commodities exerted upward pressure on consumer prices in the latter half of 2007. The annual CPI and core CPI[7] inflation rates stood at 1.8% and 1.35%, respectively, in 2007, both higher than the previous year (Chart 2.2). Inflationary pressures have increased further since the beginning of 2008, due to rising prices for imported raw materials and food. The average CPI and core CPI inflation rate continued to increase from January through May of 2008, averaging 3.66% and 2.97% year on year, respectively. The DGBAS

Chart 2.2 Consumer and wholesale price inflation rates



Source: DGBAS.

[6] DGBAS press release, 29 May 2008.

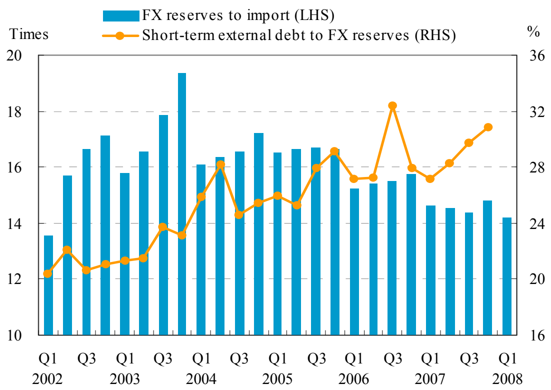
[7] The term "core CPI" in this report refers to a consumer prices index excluding perishable fresh fruits and vegetables, fish and shellfish, and energy.

projects the CPI inflation rate to reach 3.29%[8] year on year in 2008 in view of unabated inflationary pressures.

Current account remained in surplus and foreign exchange reserves stayed sufficient

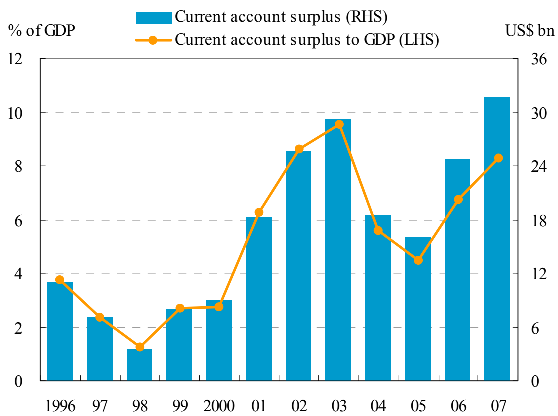
In Taiwan, growth in foreign exchange reserves slowed since 2006, but the outstanding amount still stood at US$286.9 billion as of the end of March 2008, enough to cover 14.19 months of imports.[9] Foreign exchange reserves remained in ample supply,[10] while the ratio of short-term external debt to foreign exchange reserves was 30.81%[11] at the end of 2007, indicating that Taiwan has strong capacity to meet its payment obligations for imports and service its short-term external debt (Chart 2.3). In addition, the current account has remained in surplus for several years, due mainly to a merchandise trade surplus. The 2007 current account surplus reached a record high of US$31.7 billion, equivalent to 8.27%[12] of GDP (Chart 2.4).

Chart 2.3 Short-term external debt servicing capacity



Notes: 1. FX reserves and external debts are end of period figures.
2. Imports are quarterly average of monthly imports.
Sources: CBC, DGBAS and MOF.

Chart 2.4 Current account surplus



Sources: CBC and DGBAS.

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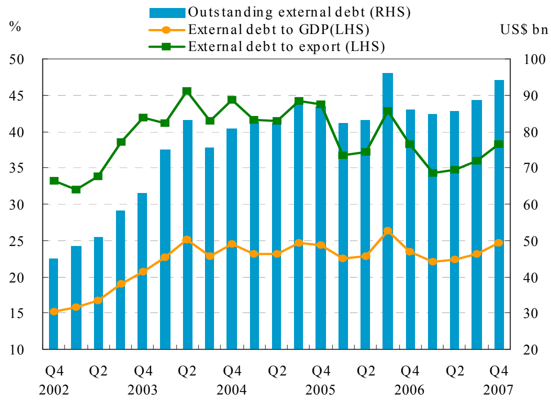
[8] Same as Note 6.
[9] Figures for imports refer to the Ministry of Finance statistics for total amount of annual imports on customs basis.
[10] See "Damocles: Testing Times Ahead," Lehman Brothers, July 22, 2004. For import cover of foreign exchange reserves, the cutoff point for risk is three months. A country with an import cover of less than three months is considered to be at relatively high risk.
[11] See WU Yih-Jiuan, " *Taiwan's financial crisis early warning system* [in Chinese]" (April 2003), quoting country risk scoring system of JP Morgan and similar scoring system benchmarks from American Express Bank. The general international consensus is that a reading of less than 50% indicates relatively low risk.
[12] See Note 10. For the ratio of current account deficit to GDP, the cutoff point for risk is 3%. A country where the reading is greater than 3% and has risen by at least 5 percentage points from the previous year is considered to be at relatively high risk.

External debt trended upward, but servicing capacity remained strong

External debt[13] has trended generally upward for the past five years, reaching a peak of US$96.0 billion at the end of September 2006 and shrinking slightly to US$94.3 billion, or 24.52% of GDP, at the end of 2007. The ratio nevertheless was still below the internationally recognized warning level [14] of 50%. Meanwhile, external debt as of the end of 2007 was equivalent to 38.22% of annual exports[15], indicating that export revenues were sufficient to cover external debt[16] (Chart 2.5) and there was no clear sign of pressure on external debt servicing capacity.

Chart 2.5 External debt servicing capacity



Notes: 1. External debts are end of period figures.
2. GDP and exports data are annual figures.
Sources: CBC and DGBAS.

Continued improvement in fiscal positions, and government debts came under control

In order to spur an increase in private investment, thereby boosting overall economic growth, the government has aggressively promoted major infrastructure projects. As a result, substantially increased public spending since 2000 caused fiscal deficits to sharply escalate at all levels of government. The deficits reached a peak of NT$374.9 billion in 2001 and subsequently declined since 2002 on the strength of rising tax revenues and controlled spending growth. In 2007, the deficit contracted further to NT$70.1 billion[17] and the fiscal deficit to GDP ratio also fell to 0.56%[18] from 3.80% in 2001, reflecting a steady improvement in the state of fiscal revenues versus expenditures (Chart 2.6).

[13] The CBC Foreign Exchange Department defines "external debt" as the combined amount owed to foreign parties by Taiwan's public and private sectors, including long-term debts with a maturity of greater than one year and short-term debts with a maturity of one year or less. The term "public external debt" refers to debts that the public sector is either obligated to repay directly or has guaranteed (starting from December 2004, figures for public external debt include outstanding foreign debts arising from repo transactions between the CBC and international financial institutions). The term "private external debt" refers to private-sector foreign debts that are not guaranteed by the public sector.

[14] See Note 10. For the ratio of external debt to GDP, the cutoff point for risk is 50%. A country with a ratio of 50% or higher is deemed to be at relatively high risk.

[15] Figures for exports refer to Ministry of Finance statistics for the total amount of annual exports on customs basis.

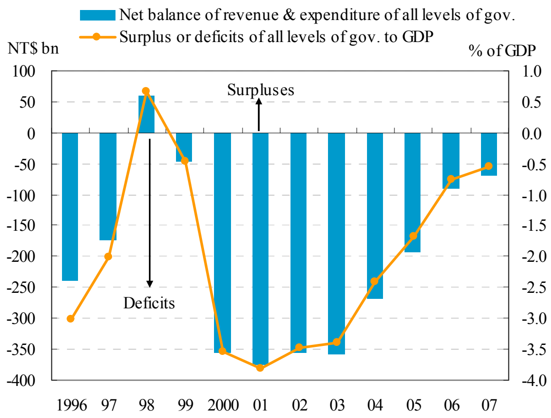
[16] See Note 11. The ratio of external debt to exports less than 100% indicates relatively low risk.

[17] The figure is based on the DGBAS estimate for 2007 fiscal revenues and expenditures, issued on 28 March 2008.

[18] See Note 11. Under the 1992 European Union Maastricht Treaty and the subsequent Stability and Growth Pacts, fiscal deficits in EU member nations are not allowed to exceed 3% of GDP.

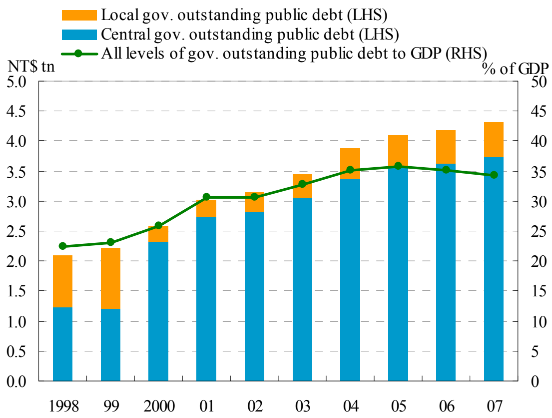
As fiscal deficits rose and governments relied on the issuance of debt to finance their debt servicing expenditures, outstanding public debt at all levels of government[19] has increased steadily over the past decade. However, the expansion began to moderate in 2006 and the outstanding debt stood at NT$4.3 trillion[20] in 2007, up slightly from NT$4.2 trillion[21] as of the end of 2006. Meanwhile, the ratio of outstanding debt to annual GDP fell back to 34.49%[22] in 2007 after peaking in 2005. The growth of public debt is gradually coming under control (Chart 2.7).

Chart 2.6 Fiscal positions in Taiwan



Notes: 1. Data of fiscal surpluses (deficits) are end of period figures.
2. The figures herein include central and local governments.
Sources: MOF and DGBAS.

Chart 2.7 Public debts



Notes: 1. Data of 2007 are final accounts for central government and budgeted figures for local government.
2. The sharp rise of central government debt in 2000 was caused by the transfer of the debts from local to central government due to the simplification of administrative organizations.
Sources: MOF and DGBAS.

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[19] The term "outstanding debt at all levels of government" as used by this report refers to outstanding non-self-liquidating debt with a maturity of one year or longer. Final audited figures for outstanding one-year-or-longer non-self-liquidating public debt (NT$4.2 trillion) issued by all levels of government during FY 2006 within their general budgets and extraordinary budgets is equivalent to 37.0% of the average GNP for the preceding three fiscal years (NT$11.3 trillion). This figure is below the ceiling of 48% set out in the Public Debt Act.

[20] The 2007 data for central government debt are from the Executive Yuan's final accounts. Data for local government debt are based on statutory budgeted figures because the Ministry of Finance has not yet announced the final accounts.

[21] This figure indicates the amount of non-self-liquidating debt with a maturity of one year or more issued by all levels of government. If adding in the debt with a maturity of less than one year and self-liquidating debt, outstanding government debt as of 31 December 2006 stood at NT$5.1 trillion.

[22] See Note 11. Under the Maastricht Treaty and the subsequent Stability and Growth Pacts, outstanding debt in EU member nations is not allowed to exceed 60% of GDP.