3. Foreign Exchange Management

Foreign Exchange Market Management

The NT dollar exchange rate regime is a managed float, where in principle the exchange rate is determined by supply and demand in the foreign exchange market. If the market is disrupted by seasonal or irregular factors (e.g. large flows of hot money), causing the exchange rate to become excessively volatile, the Bank may step in to maintain an orderly foreign exchange market.

In the beginning of 2008, Taiwan faced imported inflation pressure. Fortunately, the NT dollar appreciation effectively offset the pressure on domestic inflation. On March 26, the NT $/US$ exchange rate appreciated up to a high of 30.010, and then turned to a process of slow depreciation. Later, however, the US subprime mortgage crisis caused a worldwide economic downturn, which resulted in consecutive months of negative export growth for Taiwan and thus a large depreciation of the NT dollar. At the end of the year, the NT$/US$ exchange rate was 32.860, which fell by 1.27 percent from last yearend. However, the NT$/US$ exchange rate was relatively stable as compared to major international currencies.

To monitor the market activities, the Bank continued to implement the Real-Time Reporting System for Large-Amount Foreign Exchange Transactions. In addition, the requirement that forward transactions should be made only upon real transactions, such as trade and financing, was reinforced in order to curb foreign exchange speculation. The Bank also urged authorized banks to enhance their exchange rate risk management so as to lower their risk exposures and systemic risks. Moreover, the Bank strengthened target examinations to maintain an orderly foreign exchange market.

Enlargement of Foreign Exchange Market

To enlarge the scale of the foreign exchange market, the Bank authorized another 123 branches of local banks to conduct foreign exchange business in 2008. By the end of 2008, there were in total of 1,333 authorized foreign exchange banks. In addition, another 74 non-authorized foreign exchange banks were approved to buy/sell foreign currency banknotes and traveler's checks during the year.

The Bank continued to approve new financial products and promote foreign exchange derivatives business by expanding the permissible scope via the negative list approach. For the year 2008, banks introduced 26 new financial products, which effectively promoted bank services and diversified foreign exchange trades.

Due to an increase in the number of market participants and product diversity, the daily average transaction amount of the Taipei foreign exchange market further increased to US $20 billion in 2008, 6.4 percent higher than the US$18.6 billion of the previous year.

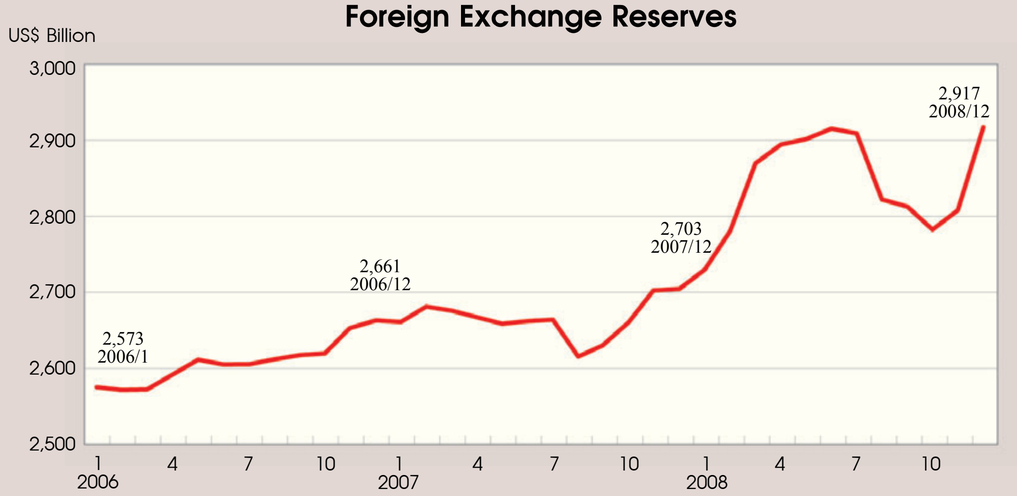
In order to provide the financial system with sufficient foreign currency liquidity to meet the funding needs, including corporate needs to venture into overseas markets, the Bank provided US$20 billion, 1 billion and ¥80 billion as seed funds for the Taipei foreign currency call loan market.

In order to provide banks with sufficient foreign currency liquidity to meet corporate funding needs, the Bank continued to carry out foreign currency swap transactions with banks and extend foreign currency call loans to banks. During 2008, foreign exchange call loan transactions reached US$1,983 billion, while foreign currency-NT dollar swap transactions reached US$472 billion.

Foreign Currency Deposit Reserve System

In line with monetary policy and to ensure adequate liquidity for banks' foreign exchange deposits, the Bank has implemented the foreign currency deposit reserve system since December 8, 2000. The system required authorized foreign exchange banks to set aside reserves for newly added foreign currency demand deposits and time deposits with a 5 percent required reserve ratio. Afterwards, the ratio has been adjusted several times to reflect the domestic economic situation, and the basis for reserve provision was changed to actual foreign currency deposit balances. In order to reduce bank funding costs and to narrow the interest rate spread between

Foreign Exchange Reserves



Source: Department of Foreign Exchange, CBC.

NT dollar deposits and foreign currency deposits, the Bank lowered the foreign currency deposit reserve ratio from 5 percent to 0.125 percent on April 1, 2008.

Foreign Exchange Reserve Management

In 2008, the Bank's foreign exchange revenues amounted to US$1,095.9 billion, while foreign exchange expenditure was US$1,074.5 billion. At the end of 2008, total foreign exchange reserves stood at US$291.7 billion, a US$21.4 billion increase from the end of 2007. The increase was mainly attributed to a higher return on investment of foreign exchange reserves.

Capital Flow Management

With the progress of financial liberalization and internationalization, the Bank has largely deregulated capital movement restrictions. In general, capital can flow freely in and out of Taiwan. As of 2008, restrictions only remained on a few short-term financial transactions involving the conversion of the NT dollar. For example, a domestic company or a resident could each conduct inward and outward remittances up to US$50 million and US$5 million within one year, respectively. Non-residents could remit up to US$100 thousand per transaction. For remittances exceeding the respective ceilings, transactions could be made with the approval from the Bank.

Key measures with regard to the management of foreign exchange in 2008 included:

(1) Having consulted with the Financial Supervisory Commission about broader scope for foreign securities investment, the Bank agreed to the following measures: (i) Agreed March 4, foreign investors would be allowed to engage in trades of structured products with domestic securities firms and banks, including products linked to domestic or foreign equities and interest rates and denominated in NT dollar or foreign currencies. However, the amount of investment in government bonds, time deposits, money market instruments and money market funds, plus the net amount paid on NT dollar premiums for trading of over-the-counter equities and NT dollar interest rate derivatives, structured products and option-side transactions on convertible bond asset swaps and net payment of the swap settlement difference should not exceed 30 percent of each foreign investor's inward remittances. Nonetheless, this limit does not apply to investments in outright trading of government bonds with more than one year to maturity. (ii) Agreed March 6, foreign investors would be allowed to trade with domestic securities firms and banks in NT dollar- or foreign currency-denominated Taiwan or foreign equities options or swap derivatives.

(2) In order to encourage overseas enterprises to list on Taiwan's stock market, the Bank took the following measures: (i) Agreed October 20, the cap of US$5 million on domestic

securities investment by an overseas Chinese or a foreign individual investor (FIDI) would be removed. (ii) Agreed October 30, the original stockholders of overseas enterprises listed on the Taiwan stock market may, as a foreign institutional investor (FINI) or a FIDI in pursuant to the Regulations Governing Investment in Securities by Overseas Chinese and Foreign Nationals, take the funds which they obtain from selling their shares in Taiwan's market and place in settlement accounts for subsequent investments so as to save time and fees of foreign exchange transactions.

(3) Agreed August 6, with the permission of the competent authorities, overseas Chinese and foreigners were allowed to get NT dollar loans from financial institutions as foreign direct investors. If collateral is needed, domestic securities purchased by them as FINIs could be used as collateral.

(4) Along with the recent overseas branching of domestic enterprises, there were increasing cases where foreign employees received stock dividends. Agreed August 13, in order to relieve these foreign employees from the inconvenience of selling their holdings through new or borrowed accounts, overseas subsidiaries or branches of listed and emerging stock companies were allowed to use the investment accounts in the name of offshore FINIs, originally used for handling overseas employees' warrants, to manage stock dividends for overseas employees and new stock issuance.

(5) In order to promote the internationalization of the capital market, the Bank agreed to the following measures: (i) Domestic enterprises may issue overseas marketable securities to raise funds. In 2008, 3 corporations issued overseas depository receipts with a total of US$0.46 billion; 7 corporations issued European Convertible Bonds with a total of US $1.85 billion. (ii) On August 20, the Bank agreed the issuance of NT dollar-denominated bonds by the Central American Bank for Economic Integration (CABEI) with an NT$7 billion upper limit for the total balance. (iii) Two foreign companies were allowed to issue Taiwan Depository Receipts (TDRS) with the total amount reaching NT$5.5 billion.

(6) The Bank loosened the following regulations regarding foreign exchange remittances: (i) On May 21, the Bank notified banks that the remittances of the following types of donations for Szechuan earthquake in China would not be counted toward the reporting obligator's yearly remittance balance, including donations through the Straits Exchange Foundation, local governments, R.O.C. Red Cross, etc. (ii) On September 5, the Bank relaxed the restrictions on outward remittances of investment in China. A remittance for the aforesaid purpose in the amount of no more than US$1 million would be allowed without prior approval of the Ministry of Economic Affairs.

Management of the Foreign Exchange Business of Financial Institutions

(1) At the end of 2008, there were 1,327 authorized foreign exchange banks in total, which included 36 head offices and 1,198 branches of domestic banks, 93 branches of 32 foreign banks, and 2,631 authorized money exchanger and financial institutions authorized to engage in basic foreign exchange business.

(2) Up to the end of 2008, 13 insurance companies were allowed to engage in investment-oriented insurance business; 7 insurance companies were allowed to conduct business in relation to foreign currency conventional insurance certificates; 2 securities firms were allowed to conduct overseas warrant business.

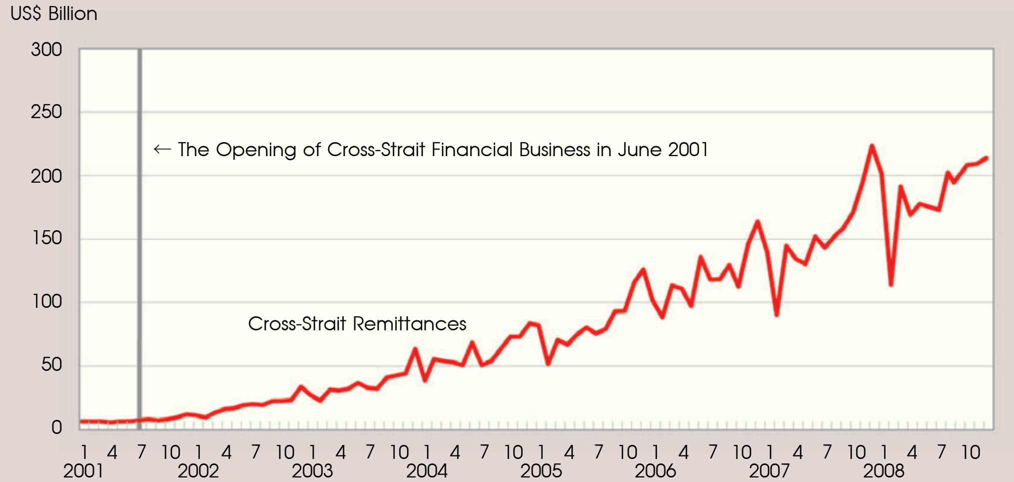
(3) On April 11, the Bank allowed futures trust enterprises to apply to the Bank for business regarding "raising domestic foreign currency-denominated futures trust funds".

(4) As the government agreed to open Taiwan to mainland China tourists and to expand the three mini Cross-Strait communication links, the Bank promulgated the Regulations Governing the Administration and Settlement of Renminbi in the Taiwan Area on June 27, and approved 14 financial institutions to conduct Renminbi cash exchange business. Up to the end of 2008, the total amount of purchase was 1.63 billion Renminbi, while the total sale was 1.98 billion Renminbi.

Development of Offshore Banking Business

Since June 2001 with official approval, OBUs have conducted cross Taiwan-Strait financial business, which has shown rapid growth. At the end of 2008, foreign currency deposits from

Non-Financial Institution Deposits and Cross-Strait Remittances through OBUs



Source: Department of Foreign Exchange, CBC.

non-financial institutions totaled US$31.13 billion, or a 14.2 percent increase from the end of 2007, while cross Taiwan-Strait remittances grew to US$219.1 billion, a US$39.65 billion or 22.09 percent increase from the previous year. This rapid growth of cross-Strait remittances helped promote OBUs as the funding center for Taiwanese businesses operating overseas.[1]

[1] The overall OBU development is analyzed in the Foreign Exchange Market segment in Section II of this Annual Report.