

I. Overview

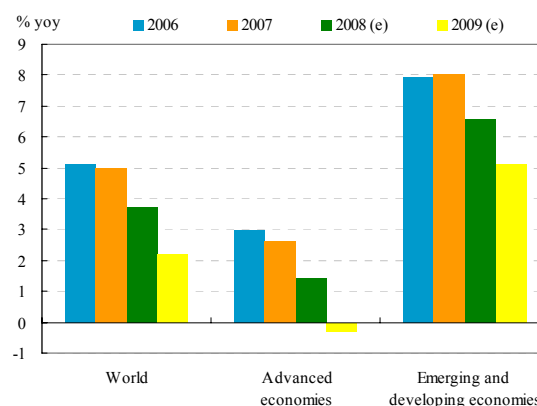
Taiwan's financial system remained stable

Domestic financial markets functioned normally in the first half of 2008. Local financial institutions faced declining profits but generally maintained satisfactory asset quality and adequate capital levels without affecting their role as intermediaries. Payment and settlement systems operated smoothly with improved efficiency. However, the deteriorating global financial crisis began to spill over to the domestic financial sectors in the third quarter of 2008, causing local financial markets to fluctuate substantially and the domestic financial system to assume higher risks. Thanks to the proactive measures taken by the Taiwan government and the soundness of the domestic financial institutions, the impact has been limited so far. Compared to other countries, the financial system in Taiwan is relatively unharmed. Nonetheless, close monitoring for any possible signs of increasing risks is still needed.

World economy faced downside risks and softened inflationary pressures

Buffeted by the growing global financial crisis, large corrections in the housing markets of some advanced economies, and high energy and commodity prices, the world economy faced downside risks. The International Monetary Fund (IMF) projected that the world economy would slow sharply to 3.7% in 2008 from 5.0% in 2007. Advanced economies suffered the most, as many of them were close to recession. Emerging and developing economies also exhibited slower growth. The global economy as a whole was expected to undergo a protracted deleveraging process. As a result, world economic growth was projected to weaken to 2.2% in 2009, considerably down 1.5 percentage points from 2008. Global inflationary pressures gradually eased, driven

Global economic growth rates



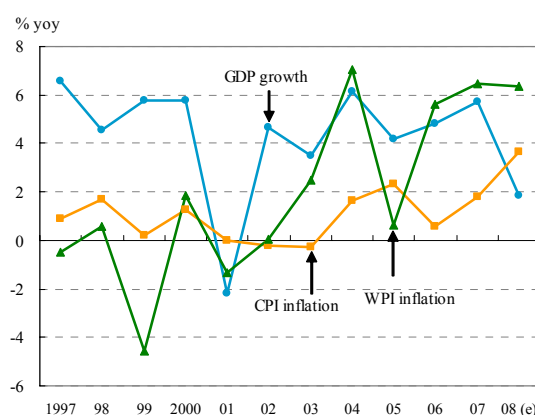
Note: Figures for 2008 and 2009 are IMF estimates.
Source: IMF, "World Economic Outlook Update," November 2008.

mainly by falling international raw material prices and deteriorating economic prospects. The IMF forecasted headline inflation in the advanced economies as well as the emerging and developing economies to be 1.4% and 7.1% in 2009, respectively, considerably lower than the 3.6% and 9.2% registered in the previous year.¹

Taiwan economy expected to slow, while inflationary pressures eased

The robust export growth helped Taiwan's economic growth reach 5.40% in the first half of 2008. However, as the momentum in export growth waned in the face of the global economic downturn, along with sluggish consumer spending and lackluster private investment, preliminary statistics from the Directorate-General of Budget, Accounting and Statistics (DGBAS) indicate that Taiwan's economy turned to a negative growth of -1.02% in 2008 Q3, and would further contract to -1.73% in 2008 Q4, bringing the annual economic growth for the entire year of 2008 down considerably to 1.87% from 5.70% in 2007. Looking ahead into 2009, in spite of the sharp expansion in public fixed capital investment and the mild growth in private consumption, the global economic slowdown and a resulting reduction in external demand may continue to have a negative impact on the performance of exports and private investment. The DGBAS forecast economic growth to rebound to 2.12% in 2009, slightly up by 0.25 percentage points from 2008. With respect to prices, upward pressure on consumer prices receded after reaching a peak in July 2008, primarily due to declining international raw material prices. The DGBAS projected the annual growth rates of WPI and CPI to reach 6.33% and 3.64%, respectively, in 2008. The annual growth rate of CPI is expected to decline to 0.37% in 2009, while that of WPI to markedly contract to -2.18%, largely driven by the ongoing global economic downturn, falling commodity prices, and higher figures for the base year of 2008.²

Economic growth and consumer price inflation rate in Taiwan



Note: Figures for 2008 are DGBAS projections.
Source: DGBAS.

¹ See the IMF "World Economic Outlook Update," November 2008.

² DGBAS press release, 20 November 2008.

Financial markets

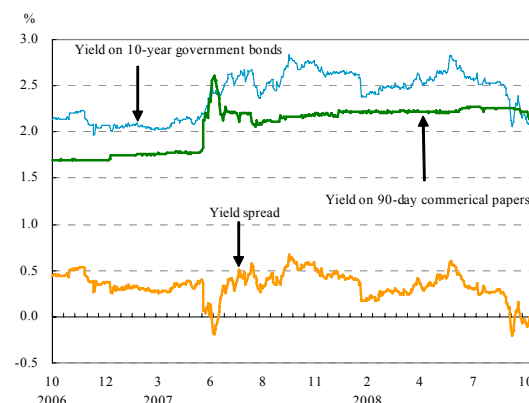
Bond market turnover rate fell steadily, and yield spreads between bond and commercial paper once turned negative

Bond yields began to descend in 2008 Q2 as financial institutions sought to reduce their spare funds through purchases of bonds. This brought down incentives for trading, leading to decreases in the monthly turnover rate. The drop in bond yields resulted in narrowing yield spreads between long-term bonds and short-term commercial papers, which even registered negative in mid-September. The decrease in bond yields is unfavorable to financial institutions that use short-term financing to fund long-term bonds, despite the fact that it generates capital gains for bond holders.

Taiwan's stock indices fell and fluctuated sharply

Motivated by media reports of further improvements in cross-strait economic and trade relations between Taiwan and China, Taiwan's stock markets were buoyant in the first two quarters of 2008. However, beginning in July, due to the slump in major stock markets arising from the persistent expansion of the global financial crisis, Taiwan's stock indices fell sharply amid heightened volatility. The risks of stock investments have thus increased.

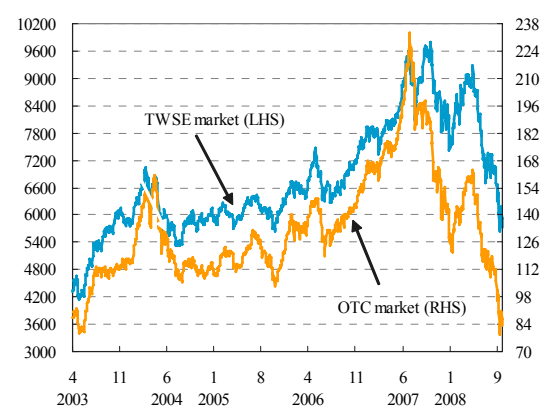
Yield spreads



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

Source: Bloomberg.

Taiwan stock market indices



Sources: TWSE and GTSM.

The NT dollar shifted from appreciation to depreciation with decreased volatility

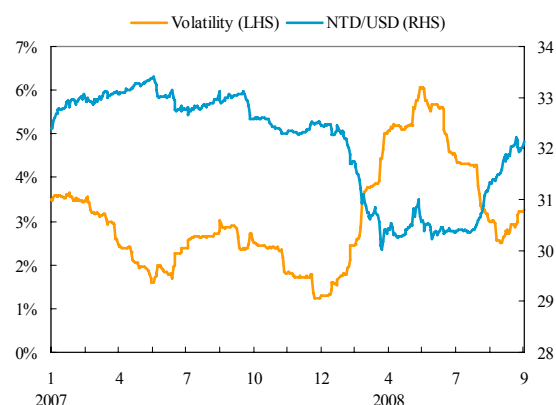
After the dramatic appreciation in 2008 Q1, the New Taiwan dollar (NT dollar) exchange rate against the US dollar generally moved in a narrow range until later depreciated in Q3 due to outward remittances by foreign investors. Volatility in the NT dollar exchange rate once increased to 6%, and then returned to a steady state after July. The depreciation of the NT dollar has not only alleviated the pressure of foreign exchange losses faced by financial institutions, but has also helped to enhance the competitiveness of export industries.

Financial institutions

Domestic banks maintained satisfactory asset quality and adequate capital level

In the first half of 2008, domestic banks still maintained satisfactory asset quality and adequate capital levels despite declining profitability. Given the global economic downturn and financial market turmoil, the future profitability and asset quality of domestic banks may be affected by a number of factors, including further investment losses, eroded profitability due to shrinking interest rate spreads between deposits and loans, depressed wealth management business, as well as uncertainties about the recovery of consumer loans under debt negotiation, cooling real estate markets, and the weakening debt servicing capacity of the corporate and household sectors.

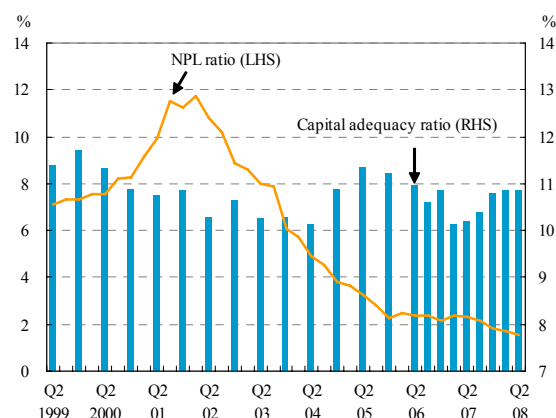
NT\$/US\$ exchange rate and volatility



Note: Volatility refers to the annualized standard deviation of 60-day daily returns.

Source: CBC.

NPL and capital adequacy ratio of domestic banks



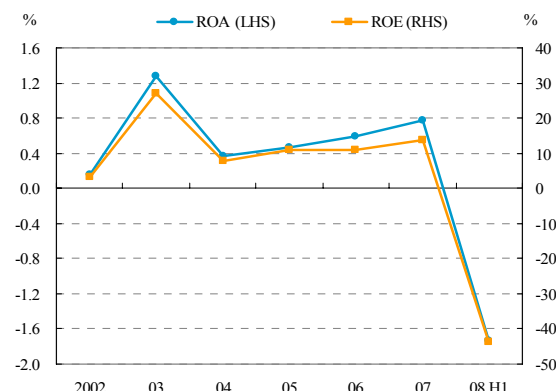
Note: The capital adequacy ratio data are on a semiannual basis before June 2006 and on a quarterly basis after September 2006.

Source: CBC.

Community financial institutions' performance improved

Profitability of community financial institutions continued growing in the first half of 2008. Overall loan quality was improving in the credit departments of farmers' and fishermen's associations, while the capital adequacy ratios of credit cooperatives increased slightly. However, the NPL ratios of some credit departments of farmers' and fishermen's associations were still relatively high and had to be brought down.

ROE & ROA of life insurance companies



Note: ROA = net income before tax / average assets.

ROE = net income before tax / average equity.

Source: FSC.

Life insurance companies suffered huge losses

The asset size of Taiwan's life insurance companies grew slowly in the first half of 2008, while their average risk-based capital (RBC) ratios decreased considerably due to huge losses caused by the appreciation of the NT dollar, and large investment writedowns. Some life insurance companies were even confronted with the pressure of raising capital.

Bills finance companies faced declining profits and higher credit and liquidity risks

In the first half of 2008, the total assets of bills finance companies continued to contract and the profitability declined, while capital adequacy ratios remained above the statutory minimum. Due to sharp volatility in local financial markets, the credit risk of bills finance companies' stock-secured credit increased. Meanwhile, the liquidity risk of some bills finance companies also increased, as confidence in the local financial system was slightly undermined.

A series of policy measures were taken to enhance financial stability and economic growth

To address the adverse effects of the global financial crisis on Taiwan, the government has taken many measures to enhance financial stability and to invigorate the economy. Among them, policy measures designed to deal with financial stabilization, including easy monetary policy, blanket deposit guarantee (from 1 November 2008 to the end of 2009), stock market

stabilization, and providing financing support to enterprises and individuals, have produced positive results that gradually stabilized the financial system. As to other measures intended to promote economic growth, it may take more time for the effects to materialize. In addition, Taiwan's Financial Accounting Standards No. 34 has been amended with reference to the latest revisions of International Accounting Standards. The amendment eases restrictions on reclassification of financial instruments in order to reduce the negative impacts on the financial statements of financial institutions and enterprises that sharp movements in fair value may incur.

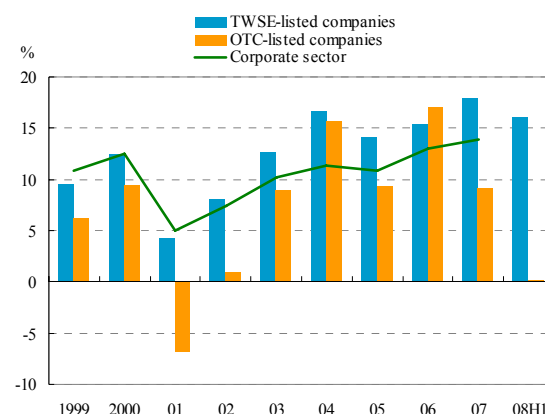
Profits and financial conditions in the corporate sector languished

In the first half of 2008, the impact of skyrocketing international commodity prices, slowing global economic growth, and increasing operation costs of China-based businesses undermined the profitability and financial structure of listed companies. The short-term debt servicing capacity of OTC-listed companies declined markedly, increasing the risk of default.

Household debt burden remained heavy

For the household sector, growth in borrowing moderated while short-term debt servicing capacity strengthened, but debt burdens still remained heavy in the first half of 2008. The tumbling global stock markets, and the subsequent slower economic growth and rising unemployment rate at home, will gradually have adverse impacts on households' assets and

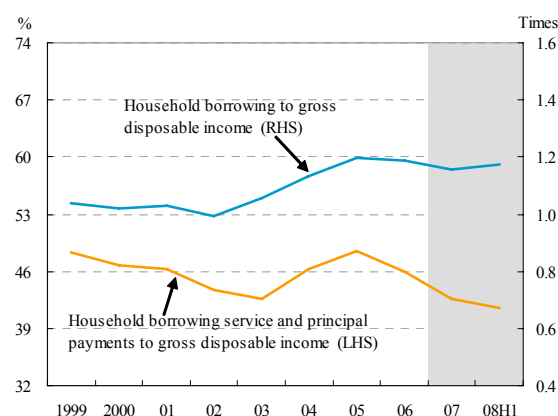
ROE in corporate sector



Notes: 1. Return on equity = net income before interest and tax / average equity.
2. Figures for 2008 H1 have been annualized. The ROE of the OTC-listed companies in 2008 H1 was only 0.12%.

Sources: JCIC and TEJ.

Household debt servicing ratio



Note: Figures for gross disposable income in shaded area are CBC estimates.

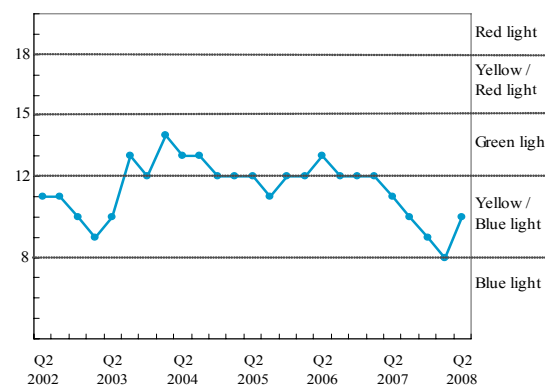
Sources: CBC, JCIC, and DGBAS.

income, reducing their capacity to service their debt.

Real estate market cooled off

Real estate prices continued rising even though market trading activity gradually cooled. Moreover, factors such as rising housing vacancy rates, growing cost burden on home buyers, and decelerating real estate loan growth all contributed to increasing downward pressures on the market.

Real estate cycle indicators



Note: A red light indicates a “heated market,” while a blue light indicates a “sharply declining market.”

Source: “Quarterly Report of Taiwan Real Estate Cycle Indicators,” Architecture and Building Research Institute, MOI.