

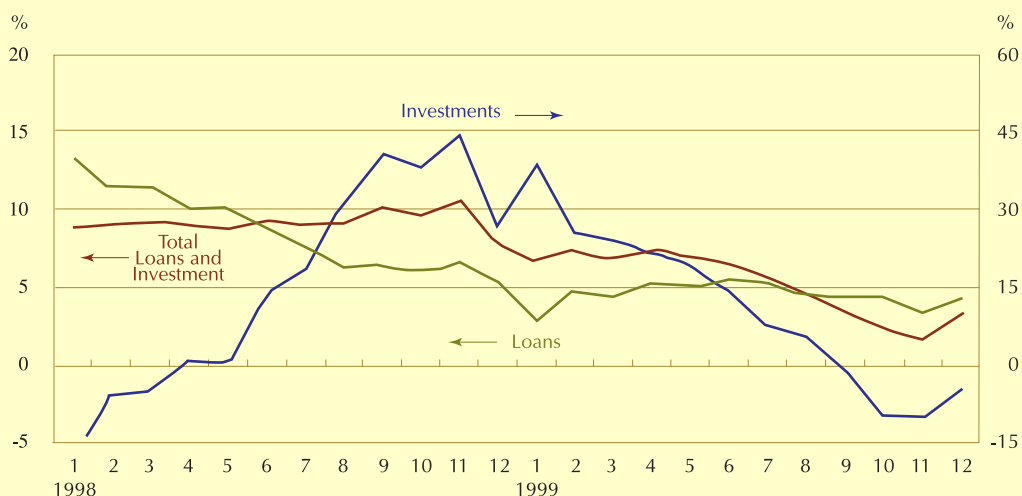
IV. ANNEX

1. The Slowdown in Bank Loans and Investments Growth

Introduction

Loans and investments by major financial institutions in Taiwan have exhibited a noticeably declining trend since 1998. By the second quarter of 1999, although economic recovery had been on track, the momentum of growth had mainly been driven by an increase in exports while domestic demand in general remained slack, resulting in dampened loan demand. Furthermore, during the second half of 1999, banks actively dealt with non-performing loans and wrote off bad debts. The annual growth rate of bank loans and investments dropped from 8.53 percent at the end of 1997 to 3.40 percent at the end of 1999. Of the composition, the annual growth rate of loans dropped to 4.50 percent, and investments registered a negative growth rate of 3.63 percent mainly due to banks decreasing purchases of short-term bills in order to expand lending business. This annex presents some major factors contributing to the declining trend in bank loans and investments growth from the following three aspects : (1) the supply side, (2) the demand side, and (3) the accounting reason.

Annual Growth Rate of Loans and Investments



Factors contributing to the slowdown in the growth of bank loans and investments

(1) The supply side

1. Banks' attitude toward lending turned conservative.

Several corporate defaults at the end of 1998 incurred heavy losses for banks. To reduce lending risk, banks adopted conservative lending policies and cut back on lending to highly leveraged corporations, while increasing the holdings of risk-free government bond and the Central Bank-issued certificates of deposit.

2. The stagnant real estate market and lackluster stock prices affected the value of collateral.

In the wake of the Asian financial crisis, the share prices of some traditional businesses dropped below their par value, mainly due to the sluggish domestic economy and the crowding-out effect of funds invested in high-tech shares. In addition, the housing market remained in the doldrums, causing housing prices to drop further. As bank loans were backed mainly by real estate and partly by listed shares, the decline in their prices caused bank loans secured by these assets to shrink.

3. The Ministry of Finance imposed restrictions on extending loans by some problem community financial institutions.

In recent years, bank runs on several community financial institutions have seriously impaired banking soundness. To ensure financial stability and safeguard the rights of depositors, the Ministry of Finance imposed restrictions on extending loans by some problem community financial institutions.

(2) The demand side

1. Indirect finance was gradually substituted by direct finance.

Since 1995, funding conditions have been relatively easy, market rates have been on the decline, and the stock market trading has been active in general. All these factors have contributed to lower cost of funds for companies to raise funds directly from the financial market. In terms of flow data, the ratio of funds raised directly from the financial market to total financing increased from 35.21 percent in 1998 to 43.27 percent in 1999, while the ratio of funds borrowed from financial institutions decreased from 64.79 percent to 56.73 percent during the same period.

2. Changes in the industrial structure affected demand for loans.

Taiwan's industrial structure has undergone profound changes in recent years. Traditional industries, which have heavily relied on bank loans as their main source of funds, have weakened their demand for funds due to a decline in production. On the other hand, high-technology firms, equipped with abundant funds of their own relative to other firms, can easily raise funds from the markets. Therefore, the robust production of the high-tech sector has contributed little to the growth in bank loans and investments.

3. Rich earnings arising from robust exports and stock transactions reduced domestic firms' demand for bank loans.

During 1999, improved prospects for the Taiwan economy backed up by solid fundamentals led foreign investors to increase their investment in Taiwan's stock market. Local individuals and firms increased their NT dollar funds by selling holdings of shares to foreign investors. In addition, robust exports caused exporters to accumulate their funds by converting foreign exchange income into NT dollars. The two sources of funds from abroad thus reduced the local firms' demand for bank loans.

4. The lackluster construction sector weakened demand for housing loans.

The real estate market has been in the doldrums in recent years. In the first half of 1999, the construction sector appeared to have hit the bottom with signs of economic recovery. However, it deteriorated further during the second half of the year due to the September 21 earthquake. The financing needs of construction firms decreased, as there were few new construction projects. Loans extended by domestic banks to individuals for purchasing houses increased by NT\$99.6 billion in 1999, significantly lower than an increase of NT\$180.5 billion in 1998, reflecting less willingness by individuals to buy houses.

5. Sluggish growth of private consumption weakened demand for consumer loans.

During 1999, the contagion effect of the Asian financial crisis triggered a slump in the share prices of brick-and-mortar firms. Many individual investors suffered severe losses, which led to a decrease in their consumption ability. Moreover, affected by the September 21 earthquake, domestic private consumption weakened further. Nominal private consumption went up only 6.16 percent in the year, the lowest since 1986. Both consumer loans and revolving credit card loans slowed down their growth, reflecting weak

funding needs for consumer spending.

(3) The accounting reason

1. Banks actively dealt with non-performing loans.

Financial difficulties suffered by several corporations at the end of 1998 led to a surge in banks' non-performing loans. To restore sound banking, the Bank lowered required reserve ratios, while raising the remunerated rate on required reserves. In addition, the Ministry of Finance reduced business tax rates for financial institutions. The bank profits derived from these measures were required to be used exclusively for writing off bad debts. As banks actively dealt with non-performing loans, loans were successively reclassified as nonaccrual loans or written off as bad loans. Consequently, loans on banks' books decreased. In 1999, loans reclassified as nonaccrual loans and bad loans written off by financial institutions added up to NT\$335.5 billion, deducting 2.20 percentage points from the annual growth rate of loans and investments.

2. The NT dollar appreciated, causing foreign currency loans to shrink when converted into NT dollar terms.

Since October 1998, the NT dollar exchange rate has exhibited an appreciating trend, causing foreign currency loans in NT dollar terms to shrink. At the end of 1999, the NT dollar appreciated by 2.62 percent over the previous year, causing a reduction of 0.08 percentage point in the annual growth rate of loans and investments.

Conclusion

The slowdown in bank loans and investments growth over the recent years have mainly resulted from the weak demand for funds from the business sector and the conservative lending policies of banks. In addition, the structural transformation of domestic industries has led to a decline in production on the part of traditional industries, and hence has decreased their demand for loans. High-tech firms, on the other hand, have been less dependent on bank loans. Their robust production has contributed little to expanding bank lending. Banks actively dealing with non-performing loans in the second half of 1999 is also one of the major factors contributing to the slowdown in the growth of bank loans. However, this is necessary because banks' reclassifying nonaccrual loans and writing-off bad loans are helpful to mobilize funds and recover their losses while improving the overall soundness of the banking sector.