3. Foreign Exchange Management

Foreign Exchange Market Operations

The Bank kept on pursuing dynamic stability of the NTD exchange rate under a managed floating regime in 2004. During the year, the US dollar depreciated due to factors such as the deteriorating twin deficits in the US and the possible appreciation of the Chinese Renminbi. Meanwhile the NTD exchange rate against the USD appreciated due to factors such as the Asian currency appreciation, the raising of the weight of Taiwan in the basket of benchmark world stock market index compiled by the Morgan Stanley Capital International Co. (MSCI), and exporter's early sale of forward exchanges. At the end of the year, the NTD exchange rate was 33.978 per US dollar, an appreciation of 6.46 percent compared to the end of 2003. Over the same period, the euro appreciated by 8.07 percent, while the Korean won appreciated by 15.22 percent against the USD.

In order to enhance financial discipline and to promote the stable development of the local foreign exchange market, the Bank has implemented a real-time reporting system on large-amount foreign exchange transactions to monitor the market and facilitate the balance of demand and supply. In addition, the Bank ensured that forward transactions were made only upon real demand, conducted on-site examination and audit of abnormal transactions, and urged banks to enhance exchange rate risk management to effectively eliminate foreign exchange speculation and ensure sound functioning of the foreign exchange market.

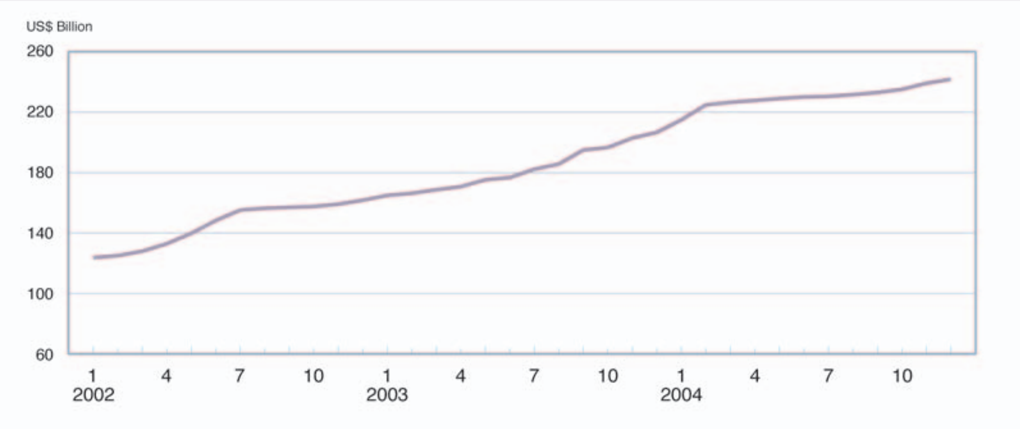
Foreign Exchange Market Management

The Bank approved 32 branches of local banks to do full-fledged foreign exchange business and another 51 branches to do limited business of buying/selling foreign currencies and traveler's checks in 2004.

New financial products were aggressively promoted in 2004. On May 26, 33 foreign exchange derivative products were allowed to be adopted with only ex post reporting requirements. On October 20, Regulations Governing the Discretionary Foreign Currency Margin Trading Business Conducted by Authorized Banks was promulgated to open discretionary margin trading business. For the year 2004, there were 180 new financial products adopted by banks.

In order to provide banks with sufficient foreign exchange liquidity to meet corporates' funding needs, the Bank appropriated seed funds of US$20 billion, 1 billion euros and 15 billion

Foreign Exchange Reserves



Source: Department of Foreign Exchange, Central Bank of China.

yens for the foreign exchange call-loan market. Moreover, the Bank actively carried out foreign currency swap transactions. During the year, foreign exchange call loan transactions reached US$1,491 billion, while foreign exchange-NT dollar swap transactions reached US$199 billion, an 82.2 percent growth over last year.

Foreign Exchange Reserve Management

In addition to maintaining liquidity, security and profitability, the Bank's objectives of foreign reserve management also included promoting economic development and upgrading industries. At the end of 2004, total foreign exchange reserves amounted to US$241.7 billion, a US$35.1 billion increase from the end of 2003. The main factors contributing to the increase included: (1) net foreign capital inflow; (2) exporters' earlier sale of forward exchange contracts; (3) the return from foreign exchange reserve investment; and (4) the increase of the US dollar value of euro- and yen-denominated reserve assets due to the appreciation of euro and yen against the US dollar.

Capital Flow Management

With the progress of financial liberalization and internationalization, the Bank manages the foreign exchange market according to the market mechanism. In general, bilateral capital movements can flow freely. As of 2004, restrictions only remained on a few short-term financial transactions involving the conversion of NTD. For example, overseas Taiwanese and foreign natural persons could invest in Taiwan securities up to US$5 million; a foreign legal entity and a non-company fund could invest in Taiwan securities up to US$50 million. Each domestic company and resident could conduct inward or outward remittances up to US$50 million and

US$5 million, respectively. Nonresidents could remit up to US$0.1 million per transaction. For remittances exceeding the respective ceilings, applications could be made through authorized foreign exchange banks.

Key measures with regard to capital flows in 2004 included:

(1) The Ministry of Finance (the competent authority has become the Financial Supervisory Commission of the Executive Yuan since July 2004), after consultation with the Bank, adopted the following measures in order to loosen restrictions on foreign investments in domestic securities: (i) effective February 3, foreign investors were authorized to invest in money market funds. This investment amount, plus the investment amount of repos, other money market instruments, margins on futures and time deposits, could not exceed 30 percent of total remittances; (ii) effective May 21, foreign investors were authorized to participate in the Bank's daylight overdraft facility; (iii) effective June 17, the Bank no longer reviewed foreigners' securities investment applications; and (iv) foreign investors were authorized to broaden the scope of securities borrowing and lending for strategic trading, including stock index securities investment trust funds (effective September 22), domestic and overseas exchangeable corporate bonds, the arbitrage/hedging of government exchangeable bonds, stock index securities investment trust funds, and borrowing securities during the transition period from convertible bonds to stocks (effective December 21).

(2) The MOF, after consultation with the Bank, adopted the following measures in order to promote the internationalization of the domestic capital market and to improve relations with international financial organizations: (i) enterprises are allowed to issue overseas securities for funding purposes. In 2004, 11 corporations issued overseas depository receipts amounting to US$3.26 billion; 59 corporations issued overseas corporate convertible bonds amounting to US$7.01 billion; (ii) a Malaysian corporation was allowed to issue a Taiwan Depository Receipt (TDR) worth NT$0.6 billion; and (iii) to reinforce Taiwan's relations with international financial organizations, the Council of Europe Development Bank (CEDB) was allowed to issue bonds with a ceiling of NT$ 15 billion.

(3) The MOF, after consultation with the Bank, adopted the following measures in order to loosen the restrictions on overseas securities investment: (i) 27 securities investment trust enterprises were allowed to invest a total of NT$ 202 billion in foreign securities; (ii) 14 life insurance companies were allowed to invest a total of US$6.9 billion in foreign securities with direct remittances, forex swaps or cross currency swaps; (iii) 7 life insurance companies

were allowed to invest a total of US$0.58 billion in foreign securities through earmarked trust funds managed by financial institutions; (iv) 5 commercial banks are allowed to invest a total of US$0.22 billion in foreign securities through assembled management accounts; and (v) the variety and scope of foreign securities allowed to be invested in by earmarked trust funds were revised to include offshore funds whose investments in the mainland China securities do not exceed 0.4 percent of the fund's net worth, and investments in mainland-China related securities not exceeding 5 percent of the fund's net worth. The minimum rating grade requirement for investible foreign bonds was lowered from A to BBB.

(4) In order to facilitate capital movements, certain related remittance regulations were revised as follows: (i) the Regulation Governing the Declaration of Foreign Exchange Receipts and Disbursements or Transactions was revised on April 7, 2004 with the following major changes: (a) the regulations regarding the remittance documents to be certified by banks were revised to meet the requirement of the Financial Supervisory Commission on new international business such as allowing securities firms to conduct structured product transactions linked to foreign financial products; (b) forex declaration is required for investments in mainland China with an amount below US$ 0.2 million; and (c) the declarant may apply for changing the content of the original declaration of foreign exchange receipts and disbursements or transactions with the submission of an accountant's opinion letter indicating no intentionally untruthful information; (ii) effective June 17, the Bank no longer reviews the remittance of investment principle and returns on domestic securities of foreign institutional investors; and (iii) effective October 20, banks can directly remit to mainland China with a ceiling of US $0.1 million per transaction. However, if the remittance is made from mainland China, it should be subject to the Regulation Governing the Financial Business between the Taiwan Area and the Mainland Area.

Management of Authorized Foreign Exchange Banks

The Bank continued to approve banks' applications for becoming authorized foreign exchange banks and to approve authorized banks' applications for conducting derivative business. To maintain financial discipline, authorized banks that violate foreign exchange regulations were rectified and required to improve. By the end of 2004, there were 1,104 authorized foreign exchange banks, which included 43 domestic bank headquarters and 995 branches, and 66 foreign branches.

The Management of US Dollar Counterfeits

In July 2004, some banks incurred losses due to US dollar counterfeits and thus refused to accept US dollar bills. The Bank adopted the following measures to minimize counterfeit losses: (i) Notification letters were sent to banks purchasing/selling foreign currencies to remind them of the obligation to accept foreign currencies based on the listed prices, and requesting the reinforcement of counterfeit discriminating capabilities of bank employees and the purchase of new US dollar examination machines; and (ii) in order to enhance the detection method used by tellers at authorized foreign exchange banks, the Bank invited foreign experts on counterfeit discrimination to Taiwan twice in 2004 to give training courses on this subject.

Offshore Banking Business

Offshore banking units (OBUs) of local banks have been set up since December 1983 to enhance Taiwan's international financial activities and to establish Taipei as an Asian financial center. During 2004, the Bank promoted the Offshore Booking Center and cooperated with the Financial Supervisory Commission to promote financial business between the two sides of the Taiwan Strait, which stimulated the rapid growth of OBU business. Effective October 13, domestic banking units (DBUs) were allowed to act as agents on behalf of OBUs to conduct offshore forex deposit and inward remittance business.