

## II. Financial Developments

### 1. Overview



Domestic financial conditions remained accommodative in 2005, although monetary policy was tightened to curb mounting inflationary pressure and reserve money growth slowed. Along with the pace of the Bank's rate rises, bank interest rates and short-term market rates rose gradually. However, yields on longer-term bonds edged down through most of the year.

Loans and investments by major financial institutions expanded at an annual rate of 7.69 percent in 2005, down from 8.64 percent registered in 2004. Within the composition of bank credit, borrowing by non-financial businesses picked up moderately, while unsecured consumer loans, which had been growing strongly since 2003, cooled from the second half of 2005. Government borrowing continued to show negative growth over the year. The moderation of bank credit growth combined with increased holdings of foreign financial assets by residents led the annual growth of the monetary aggregate M2 to decline from 7.45 percent in 2004 to 6.22 percent in 2005. Nevertheless, M2 growth still fell comfortably within the Bank's 3.5 to 7.5 percent target zone.

The NT dollar started the year strong and hit a yearly high of 30.790 against the US dollar on March 10 as foreign capital continuously flowed in. It then depreciated through the end of October and reached a yearly low of 33.770 against the US dollar on October 24, as domestic investors increased their outward portfolio investments on expectations that the Fed would further tighten monetary policy. The NT dollar stood at 32.85 against the US dollar at the end of 2005, showing a depreciation of 2.84 percent compared to the previous year-end. For the year as a whole, the NT dollar, however, appreciated by 3.90 percent against the US dollar.

In the equity market, the TAIEX hovered between 5,800 and 6,200 points over the first five months of 2005. The market modestly resumed momentum from the end of May, as Morgan

Stanley Capital International Inc. (MSCI) raised Taiwan's weighting in its indices and foreign investors sought net long positions in the local equity market. After August, stock prices moved down and reached a yearly nadir of 5,633 points on October 28. From then on, the index bounced back sharply in response to the pickup in economic growth in the fourth quarter. The TAIEX ended the year at 6,548 points, 6.64 percent higher than a year earlier. The daily average turnover for the year, however, dropped by 20.21 percent from the previous year.

Profitability of financial institutions in 2005 retreated significantly from the very high level posted in 2004, but was still higher than 2003. The large decline was mainly attributable to the surge in the writing-off of bad debts and in provisions for consumer loan losses by some banks. The average capital adequacy ratio of domestic banks also dropped to 10.34 percent at the end of the year from 10.67 percent reported at the 2004 year-end. However, the quality of bank assets continued to improve. The non-performing loan ratio of domestic banks declined from 3.82 percent to 2.24 percent during the same period.

