

## 2. Monetary Management

### Continuing the Gradual Tightening of Monetary Policy

The domestic economy expanded moderately in 2005, although at a slower pace compared with the previous year. The labor market improved for the third year in a row. Capacity utilization rates also remained high. Regarding prices, inflationary pressures heightened. The resurgence of international oil prices and mounting food prices, together with rising medical costs and upward pressure from an increase in the tobacco surcharge all cast clouds over price stability. Nevertheless, both short-term and long-term interest rates continued to remain at low levels. To keep inflation expectations contained and to prevent the real interest rate from dropping, which may hamper fund allocation and long-term financial stability, the Bank continued to adopt a more restrictive monetary policy throughout the year. The discount rate, the interest rate on accommodations with collateral and the interest rate on accommodations without collateral were raised 12.5 basis points, respectively, at each of the Bank's board meetings.

In the recent rate-hiking cycle starting from October 2004 to the end of 2005, the Bank raised its policy rates 6 times for a total rise of 87.5 basis points. At the end of the year, the three policy rates stood at 2.25 percent, 2.625 percent and 4.5 percent, respectively.

### Conducting Open Market Operations

The Bank's certificates of deposit (CDs) remain the primary instrument for the Bank to manage banks' day-to-day reserves. Its interest rates also play an important role in guiding market rates when issued on a fixed-rate basis. In 2005, as net foreign capital inflows were mostly offset by the surge in outward portfolio investments by domestic investors, excess liquidity

### Central Bank Interest Rates

Unit: %

Effective Date	Discount Rate	Accommodation Rate with Collateral	Accommodation Rate without Collateral
2003 / June 27	1.375	1.750	3.625
2004 / Oct. 1	1.625	2.000	3.875
Dec. 31	1.750	2.125	4.000
2005 / Mar. 25	1.875	2.250	4.125
July. 1	2.000	2.375	4.250
Sept. 16	2.125	2.500	4.375
Dec. 23	2.250	2.625	4.500

Source: *Financial Statistics Monthly, Republic of China, the Central Bank of China.*

## Open Market Operations

Unit: NT\$ Billion

Year/ Month	Amount Absorbed			Amount Offered			Outstanding Amount*	
	Total	Maturity of Repurchase Agreements	Issues of CDs	Total	Repurchase Agreements	Redemptions of CDs	Repurchase Agreements	CDs Issued
2003	7,399	1,371	6,028	6,354	1,371	4,983	--	2,992
2004	12,741	618	12,123	12,171	618	11,553	--	3,562
2005	20,007	--	20,007	20,049	--	20,049	--	3,520
2005 / 1	2,312	--	2,312	2,316	--	2,316	--	3,559
2	1,658	--	1,658	1,484	--	1,484	--	3,732
3	2,125	--	2,125	1,980	--	1,980	--	3,877
4	2,511	--	2,511	2,549	--	2,549	--	3,839
5	1,346	--	1,346	1,390	--	1,390	--	3,795
6	1,278	--	1,278	1,451	--	1,451	--	3,622
7	2,422	--	2,422	2,320	--	2,320	--	3,724
8	1,118	--	1,118	1,207	--	1,207	--	3,636
9	882	--	882	1,093	--	1,093	--	3,424
10	1,914	--	1,914	1,797	--	1,797	--	3,542
11	1,098	--	1,098	1,048	--	1,048	--	3,592
12	1,342	--	1,342	1,414	--	1,414	--	3,520

Note: \*End-of-period data.

Source: *Financial Statistics Monthly, Republic of China, the Central Bank of China.*

in the banking system was not accumulated so much as previous years. Owing to the frequent redemptions of CDs, the Bank continued to issue CDs as part of its daily operations to drain excess liquidity and to stabilize market interest rates. At the end of the year, the outstanding amount of CDs issued by the Bank was NT\$3,520 billion, a slight drop from a year earlier.

In addition, foreign exchange swaps with banks were used extensively to absorb excess liquidity. However, the Bank didn't arrange any repos during the year given the ample liquidity in the market.

Since March 2003, the Bank has used only non-competitive bidding by setting a specific interest rate on each CD issuance. Following the Bank's adjustment of the discount rate, the Bank also announced its new CD rates for each maturity term to induce the market interest rate to move towards its target. In 2005, the 30-days CD rate was moved up by 24 basis points to 1.45 percent at the end of the year, leading the overnight call-loan rate to rise from 1.20 percent early in the year to 1.48 percent at the year-end.

### Increasing Redeposits from Financial Institutions

Accepting and releasing redeposits from Chunghwa Post Co. and commercial banks is another instrument of the Bank to influence banks' reserve positions, although it's not used as frequently as open market operations. In view of the ample excess funds in the market resulting in a declining bond yield, the Bank increased its acceptance of redeposits from financial institutions in 2005 to lock in more longer-term funds with the Bank. Outstanding postal savings

### Non-competitive Bidding Rates on CDs Issued by the Central Bank

Unit: %

Effective Date	30 Days	91 Days	182 Days	364 Days	2 Years
2003 / Jan. 03	1.518	--	--	1.615	1.670
Jan. 09	1.518	1.512	1.508	--	--
Jan. 16	1.368	--	--	1.512	1.529
Jan. 23	1.155	1.255	1.280	--	--
Feb. 13	1.155	1.149*	1.193	--	--
Feb. 20	--	--	--	1.381	1.457
July 03	1.050	--	1.075	1.225	--
2004 / Oct. 01	1.150	1.170	1.200	--	--
Oct. 11	1.150	1.170	1.200	1.225	--
Dec. 31	1.210	1.240	1.280	--	--
2005 / Mar. 25	1.270	1.310	1.360	--	--
July 01	1.330	1.380	1.440	--	--
Sept. 16	1.390	1.450	1.520	--	--
Dec. 23	1.450	1.520	1.600	--	--

Note: \*Only competitive bid was conducted on Feb. 13, 2003. The rate refers to the weighted average of bidding rate.

Source: *Press Releases on Open Market Operations, the Central Bank of China.*

redeposits and banks' redeposits were up to NT\$1,417 billion and NT\$428 billion at the end of the year, showing an increase of NT\$66 billion and NT\$45 billion, respectively, from a year before.

In addition, the three domestic farmers' banks, namely the Taiwan Cooperative Bank, the Land Bank of Taiwan and the Farmers Bank of Taiwan, as well as the newly established Agricultural Bank of Taiwan are allowed to receive deposits from community financial institutions and make redeposits with the Bank. At the end of the year, their outstanding redeposits increased to NT \$159 billion, NT\$14 billion higher than in 2004.

#### Continuing to Promote Preferential Loans

To help boost the real estate market and relieve the mortgage burden of home buyers, the Bank, the Ministry of Finance and the Ministry of the Interior jointly initiated a preferential mortgage loan program in August 2000. After expanding the program 6 times since its launch, the upper limit was further raised by NT\$300 billion in May 2005. The total amount of the program was thus increased to NT\$1,800 billion. By the end of 2005, a total of 818,112 households had obtained an amount of NT\$2,508 billion under this program. The amount included NT\$939 billion in parallel lending by banks applying ordinary interest rates.

The Preferential Loans and Credit Guarantees for Traditional Industries was another preferential loan program initiated by the Bank and the Ministry of Finance in October 2000. The program, with an initial upper limit of NT\$450 billion raised from the local banking system, was established to help traditional industries acquire the funds necessary for business operations.

The total amount of the preferential loans was expanded to NT\$1,850 billion at the end of 2004. The program ended in Oct. 2005 with a total amount of NT\$1,839 billion in loans extended by banks to support 229,142 cases under this package.

During the year, the Bank continued to provide subsidies to victims of the earthquake in 1999 for interest payments on mortgage loans. This also applied to banks assuming the mortgage assets of earthquake victims. By the end of 2005, a total of NT\$59.9 billion worth of loans had been approved for 33,574 housing units under this program.

### **Promoting Adjustable Rate Mortgages and Flexible Base Rates**

Since 2002, the Bank has encouraged the adoption of adjustable rate mortgages and flexible base rates pricing system to make banks' loan pricing more market-sensitive and transparent, thereby increasing the effectiveness of monetary policy transmission. The new pricing system was introduced to substitute downwardly rigid prime rates. At the same time, banks were urged to apply this new pricing system to their old loans. As of the end of 2005, loans extended by domestic banks still using the old prime rates accounted for merely 2.1 percent of total loans.

In view of the success of this pricing system, from April 2004, the Bank urged all community financial institutions to adopt the same pricing system not only to improve their competitiveness but also for the benefit of both lenders and borrowers. By June 2005, all community financial institutions had adopted this pricing system.

To ensure that the new system is implemented thoroughly, as requested by the Bank, the Bankers' Association of Taiwan requires its member banks to replace their prime rate pricing with a flexible base rate plus a mark up. From the beginning of 2006, the old prime rate pricing system will no longer be applied to banks' loans.

### **Enhancing the SME Financing Mechanism**

To provide easier access to financing for small- and medium-sized enterprises (SMEs), the Bank participated in SME financing activities, including promoting a two-track guarantee system to help SMEs in obtaining loans. In addition, since June 2003, the Bank has monitored banks' performance on SME financing on a monthly basis to encourage banks to extend loans to SMEs. At the end of 2005, the guarantee balances and loans extended to SMEs by domestic banks were NT\$415 billion and NT\$3,243 billion, showing an increase of NT\$223 billion and NT\$600 billion, respectively, as compared with the end of May 2003.