3. Foreign Exchange Management

The New Taiwan dollar exchange rate regime is a managed float, where in principle the exchange rate is determined by supply and demand in the foreign exchange market. However, if the market is interrupted by seasonal or abnormal factors (e.g. large flows of hot money), causing excessive exchange rate fluctuations not reflecting Taiwan's economic fundamentals, the Bank will step in to maintain an orderly foreign exchange market.

During 2005, the NT$/US$ exchange rate appreciated in the first quarter and depreciated from June to November, finally ending the year at 32.850 against the US dollar, down 2.84 percent from 31.917 at the end of 2004. Nevertheless, the yearly average of the NT dollar against the US dollar, the yen and the euro was up by 3.90, 5.75 and 3.66 percent, respectively, from 2004.

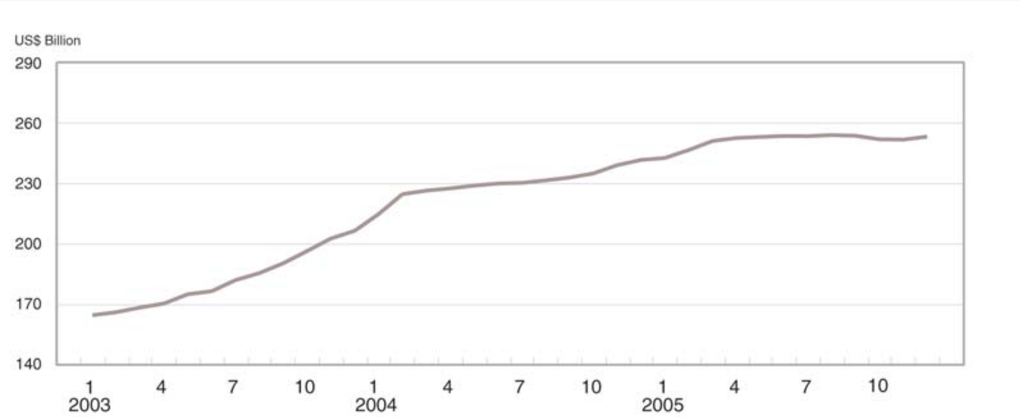
In order to enhance financial discipline and to promote the stable development of the local foreign exchange market, the Bank has implemented a Real-Time Reporting System on Large-Amount Foreign Exchange Transactions to monitor the market. In addition, to ensure that forward transactions are made only upon real demand, the Bank urged banks to enhance foreign exchange rate risk management, and conducted target examinations to effectively eliminate foreign exchange speculation and ensure sound functioning of the foreign exchange market.

Foreign Exchange Market Management

The Bank approved 27 branches of local banks to conduct full-fledged foreign exchange business and another 51 branches to conduct limited business of buying/selling foreign currencies and traveler's checks in 2005.

Simplified application procedures for new financial products were actively promoted in 2005. From January 3 onwards, existing foreign exchange derivatives were allowed to be adopted with only ex post reporting requirements according to a negative list of products requiring ex ante applications. The list included: (1) unapproved products or approved products not up to half a year and linked financial products; (2) financial derivatives involved with or linked to the NTD exchange rate (not including Quanto products and standard cross currency swaps); (3) foreign currency denominated derivatives with underlying assets involving domestic risks (including overseas securities issued by domestic enterprises, such as offshore convertible bonds, global depository receipts, Taiwan stock prices and indexes, MSCI Taiwan stock indices

Foreign Exchange Reserves



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

trading in Singapore, counterparty risk involving domestic risks). Furthermore, to increase domestic firms' hedging instruments, authorized foreign exchange banks were allowed to apply to the Bank to introduce new products such as foreign exchange credit default swaps or options, and NTD or foreign currency deposits linked to foreign currency hedge fund index options or swaps with full or a part of principal protection. For the year 2005, 57 new financial products were adopted by banks.

In order to provide banks with sufficient foreign exchange liquidity to meet corporations' funding needs, the Bank appropriated seed funds of US$20 billion, €1 billion and ¥15 billion 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$937 billion, while foreign exchange-NT dollar swap transactions reached US$266 billion, a 33.65 percent growth over last year.

Foreign Exchange Reserves

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 2005, total foreign exchange reserves amounted to US$253.3 billion, a US$11.6 billion increase from the end of 2004. The main factors contributing to the increase included: (1) net foreign capital inflows; (2) the returns from foreign exchange reserve investments.

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, capital movements can flow freely. As of 2005, restrictions only remained on a few short-term financial transactions involving the conversion of the NTD. For example, each domestic company and a resident could conduct inward and outward remittances up to US$50 million and US$5 million annually, respectively. Nonresidents could remit up to US$100 thousand 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 2005 included:

(1) The Financial Supervisory Commission, after consultation with the Bank, adopted the following measures to loosen restrictions on foreign investments in domestic securities: (i) effective May 13, foreign investors were allowed to conduct securities borrowing and lending business not limited to strategic trading and hedging; and (ii) offshore mortgages were allowed for securities borrowing among foreign investors.

(2) The Financial Supervisory Commission, after consultation with the Bank, adopted the following measures in order to promote the internationalization of the domestic capital market: (i) enterprises were allowed to issue overseas securities for funding purposes. In 2005, 10 corporations issued overseas depository receipts amounting to US$7.11 billion; 14 corporations issued corporate convertible bonds amounting to US$2.36 billion; (ii) a Thai corporation was allowed to issue a Taiwan Depository Receipt (TDR) worth NT$700 million.

(3) The Financial Supervisory Commission, after consultation with the Bank, adopted the following measures in order to loosen the restrictions on overseas securities investment: (i) effective January 13, securities investment trust enterprises with the required documents were allowed to apply for domestic (foreign) private placement to invest in foreign (domestic) funds; (ii) effective February 4, the regulation on financial institutions' earmarked trust fund investment in overseas funds was revised, where the ceiling of the Hong Kong or Macao H stocks and red chip stocks as a proportion of the overseas fund assets was raised from 5% to 10%; (iii) effective May 18, the Bank notified that a US$50 million yearly accumulated remittance ceiling was provided for life insurance companies via specified pecuniary trusts (previously earmarked trust funds) or individual application to the Bank; (iv) effective August 16, the Bank notified that the remittance of offshore funds through institutional representatives or centralized securities depository enterprises were not counted as part of the yearly accumulated remittances for investors, offshore fund institutional representatives or centralized securities depository enterprises; (v) effective September 13, in accordance with the

Regulation Governing Offshore Funds, the Bank revised the scope of specified pecuniary trust investment in offshore funds; and removed the previous prohibition of advertisement, public inducement, or acting as an agent to sell offshore funds, where the securities firms should abide by the Trust Enterprise Law and the *Regulation Governing Offshore Funds*. Additionally, the regulations regarding the credit rating requirements of foreign securities investments and the prohibited investment items were simplified to be eligible to use the regulations regarding the variety and the scope of foreign securities investments recommended by investment consulting companies.

(4) In order to facilitate capital movement, the *Regulation Governing the Declaration of Foreign Exchange Receipts and Disbursement and Transactions* was revised on December 6, 2005 with the following major changes: (i) abolishing the limit on the use of remittance for the minor, who could then remit up to US$500 thousand per transaction; (ii) under the circumstance that securities firms were entrusted as agents to sell or buy foreign securities, futures firms were entrusted as agents to conduct foreign futures trading, and securities firms managing derivative financial products trading businesses, their remittances and the remittances of the ones who entrust them were not included in the respective yearly accumulated remittance amount； (iii) in order to simplify the documentation requirement, the remittances of the securities firms managing discretionary investment in foreign securities and the life insurance companies managing foreign security investments for the insurants did not need to file the remittance book if the transaction amount of the individual beneficiary or insurant did not exceed NT$500 thousand; (iv) the employees of foreign companies' Taiwan branches (subsidiaries) were allowed to remit the amount of the purchase (sale) of their mother companies' stocks, where the remittances were included in the yearly accumulated remittance amount.

(5) In order to promote cross-strait financial business, the following measures were adopted: (i) effective March 7, the remittance items were increased from 12 to 15, which were listed in Table 10 entitled "Matters to be Verified by Banking Enterprises Engaging in Foreign Exchange Settlements Involving Outward Remittances to Mainland China" of the "*Directions for Banking Enterprises on Assisting Customers to Declare Foreign Exchange Receipts and Disbursements or Transactions*"; (ii) effective October 3, in order to satisfy the demand for renminbi and to regulate the renminbi exchange business, banks located in Kinmen and Matsu were allowed to apply for the purchase or sale of renminbi bills. Taiwan Area and China Area residents traveling between Mainland China and Kinmen or Matsu could each

time exchange renminbi up to 20 thousand dollars. Up to the end of 2005, eleven business offices were approved to purchase renminbi 6.06 million dollars and to sell renminbi 49.86 million dollars.

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 derivatives business. To maintain financial discipline, authorized banks violating foreign exchange regulations were rectified and required to improve. By the end of 2005, there were 1,125 units of authorized foreign exchange banks, which included 67 foreign banks, and 42 domestic bank headquarters and their 1,016 branches.

Improvements of Foreign Exchange Business Regulation

Effective December 21, the *Directions Governing Banking Enterprises for Operating Foreign Exchange Business* were revised with the following key points: (i) to comply with the anti-terrorist approaches recommended by the Financial Action Task Force on Money Laundering (FATF), the Bank required banks to show the remitter's name, account number or identification number, and address in the e-mail when making remittances; (ii) foreign currency financing used to be required to be related to foreign trading. However, in accordance with the opening of the domestic capital market, banks' foreign currency demand arising from domestic foreign currency trading could be financed in foreign currency after the Bank's approval; (iii) authorized foreign exchange banks could issue a letter of credit, which guaranteed domestic firms' overseas subsidiaries' borrowing from offshore financial institutions. However, the banks should carefully evaluate the guarantees' financial conditions, business management, and financial resources available for repayment; (iv) based on foreign exchange liberalization, regarding foreign natural persons' applications for credit cards, cash cards and debit cards, banks would not impose extra restrictions on the residence cards and the validation dates.

The Management of US Dollar Counterfeits

On June 9, the Bank notified all banks managing the purchase or sale of foreign currency bills that they were obligated to take foreign currency bills according to quoted rates and could not refuse to take US$100 bills with serial numbers beginning in DF. Once foreign coin or note counterfeits were found, the managing procedure should be abided by the *Regulation Governing the Handling of Counterfeit Foreign Coins and Notes;* and (ii) in order to enhance the detection method used by tellers at authorized foreign exchange banks, the Bank invited US experts on counterfeit discrimination to Taiwan from September 13 to 16 to give eight training courses on this subject.

Offshore Banking Business

Offshore banking units (OBUs) of local banks have been in operation since December 1983 to enhance Taiwan's international financial activities and to establish Taipei as a financial center in Asia. Since June 2001, OBUs have been allowed to conduct cross strait financial business, and their business has been growing rapidly. At the end of 2005, foreign currency deposits from non- financial institutions totaled US$20.71 billion, a US$9.26 billion or 80.93% increase from June 2001, and cross-strait remittances increased to US$ 12.34 billion, a US$11.99 billion or 3,459.84% increase during the same period. This rapid growth of cross-strait remittances helped promote OBUs as the financing center for Taiwanese businesses operating overseas.