

## II. Financial Developments

### 1. Overview



Domestic financial conditions remained accommodative in 2006, although monetary policy continued to be tightened. Meanwhile, growth of reserve money slowed. Along with the pace of the Bank's policy rate rises, both bank interest rates and short-term market rates rose gradually over the course of the year. Yields on longer-term bonds climbed a bit in the first half of the year, but edged down subsequently towards the end of the year.

Loans and investments by major financial institutions expanded at a slower annual rate of 4.08 percent at the end of 2006, down from 7.77 percent registered at the previous year-end. Among the components of bank credit, unsecured consumer loans, in particular, decreased over the course of the year, mainly reflecting the influx of new NPLs and the cautious attitude adopted by banks after the card debt problem broke out in early 2006. At the same time, the amounts outstanding of commercial paper and corporate bonds were also below the levels seen at the previous year-end. As a result, gross financing extended through the banking system and financial markets showed an annual growth rate of 4.03 percent at the end of 2006, down from 6.96 percent at the end of 2005.

Although foreign capital continued to flow in, its effect on money growth was reduced by a moderation in bank credit growth and an increase in overseas portfolio investment by residents. The M2 annual growth rate was 6.22 percent in 2006, the same level as in 2005. It continued to stay within the 3.5 to 7.5 percent target zone set by the Bank for 2006.

Profitability of financial institutions declined sharply in 2006. The large decline was mainly attributable to a decrease in net interest revenues and a surge in non-performing consumer

loans written off by leading card issuers. The average capital adequacy ratio of domestic banks dropped slightly to 10.11 percent at the end of the year from 10.34 percent reported at the previous year-end. However, the quality of bank assets continued to improve. The non-performing loan ratio of domestic banks declined slightly from 2.24 percent to 2.13 percent during the same period.

The NT dollar exchange rate came under upward pressure during the first five months of this year due to large capital inflows and the appreciation of Asian currencies. It then depreciated gradually toward the end of October, reflecting an increase in outward portfolio investments by domestic investors and a strong US dollar in international markets. The NT dollar closed the year at 32.596 against the US dollar, showing an appreciation of 0.78 percent compared to the previous year-end. On a daily average basis, the NT dollar, however, depreciated by 0.22 percent against the US dollar in 2006 over the previous year.

In the equity market, the Taiwan Stock Exchange weighted stock price index (TAIEX) began the year on a weak note on expectations of continuous rate hikes by the US Federal Reserve and the low season in the electronics sector. The market rebounded in April, but plunged to a yearly low in July as tensions in Middle East pushed up oil prices and foreign capital retreated from Asian markets on concerns that global inflationary pressure accelerated. Since then, however, stock prices trended upwards on a series of upbeat news. The TAIEX closed the year at an annual high of 7,824 points, 19.49 percent higher than a year earlier. The daily average turnover for the year also increased by 26.51 percent from the previous year.