

5. Foreign Exchange Market

Slight Depreciation of the NT Dollar

Although Taiwan's trade surplus continued to increase and foreign capital flowed in, the enormous portfolio investment abroad by Taiwan's residents kept the NT dollar relatively weak. The trade-weighted average nominal effective exchange rate index of the NT dollar slightly declined by 0.22 percent for the year of 2006. The movements of the NT dollar against other currencies, including the US dollar, the euro, the Japanese yen, the Chinese renminbi (RMB) and the Korean won, in 2006 are analysed as follows.

Regarding the movements of NT\$/US\$ exchange rates, the NT dollar fluctuated between 31.338 and 33.316. From the beginning of 2006 to January 12, due to large foreign capital inflows and the foreign exchange sale by domestic firms, the NT\$/US\$ appreciated from 32.818 to 31.880. Subsequently, since the market expected that the Fed's stance towards rate hikes would turn conservative, and the economy of the Euro Area continued to recover, the US dollar depreciated in the international market. However, the effect of these international factors was offset by the outward remittances of oil payments and the enormous demand for foreign exchange from insurance companies to invest abroad, the NT\$/US\$ depreciated to 32.669 on March 24.

**Percentage Changes of NT Dollar against Major Currencies
(compared with End 2005)**



Source: Department of Economic Research, CBC.

Afterwards, the G7 summit urged China and other Asian countries to adopt more flexible exchange rate regimes, the market expected the Fed to halt rate hikes, and Japan's economy boomed remarkably. These factors caused the US dollar to continue depreciating in the international market. On top of these, the continuous inflows of foreign capital and the sale of foreign exchange by domestic banks caused the NT\$/US\$ to appreciate to a yearly high of 31.338 on May 10.

Later, the US economy showed sign of weakness and the Fed suspended rate hikes. Nevertheless, heightened geopolitical risk, including the missile test of North Korea and the Middle East tension, prompted the market to hold more US dollars. On the domestic front, outward remittances of foreign capital and insurance companies, and demand for foreign exchange by banks and importers reinforced the downward trend in the NT dollar. The NT\$/US\$ depreciated to a yearly low of 33.316 on October 25.

In November 2006, as the US economy slowed down and rate hikes by the European Central Bank (ECB) narrowed the interest rate spread with the US, the US dollar turned weak. Meanwhile, the Asian currencies also strengthened against the US dollar and foreign capital inflows continued. These factors reversed the depreciation trend of the NT dollar, which stood at 32.596 against the US dollar at the end of 2006. Compared with the previous year-end, the NT dollar slightly appreciated by 0.78 percent against the US dollar at the end of 2006. However, on a daily average basis, the NT\$/US\$ exchange rate depreciated by 1.05 percent in 2006 from the previous year.

With respect to the NT dollar exchange rate against the euro, as the economy of the Euro Area grew strongly in 2006, the ECB raised interest rates six times in a row since December 2005, narrowing the interest rate spread between the US and the Euro Area. Consequently, the euro appreciated against the US dollar significantly, and also against the NT dollar, in 2006. The NT dollar depreciated by 9.82 percent against the euro between the end of 2005 and 2006, and by 2.24 percent on a daily average basis in 2006 over the previous year.

Regarding the NT dollar against the Japanese yen, since Japan's economy continued to recover, the Bank of Japan (BOJ) ended the quantitative monetary easing policy in early March 2006. Moreover, the market expected that the Japanese yen to appreciate along with the RMB after the G7 summit. As a result, the yen appreciated remarkably against the US dollar after the middle of April 2006. In July, the BOJ indicated a slowdown in the pace of policy rate rises, leading the market to expect limited rate rises by the BOJ for the rest of 2006.

Moreover, missile and nuclear tests conducted by North Korea triggered concerns over geopolitical risk in East Asia. Furthermore, the interest rate spread between the Euro Area and Japan expanded as a result of continuous rate rises in the Euro Area. The above-mentioned factors caused the yen to depreciate against the US dollar. Since the yen depreciated by a greater extent than the NT dollar against the US dollar, the NT dollar appreciated against the Japanese yen by 1.44 percent between the end of 2005 and 2006, and by 4.40 percent on a daily average basis in 2006 over the previous year.

Although China implemented macro-tightening policy to curb an overheating economy, its economy continued to grow rapidly and large trade surplus built up. As a result, the RMB appreciated gradually against the US dollar and also against the NT dollar. Compared with the end of 2005, the NT dollar depreciated by 2.63 percent against the RMB at the end of 2006. On a daily average basis, the NT dollar depreciated by 3.77 percent against the RMB in 2006 over the previous year.

Despite North Korea's missile and nuclear tests, South Korea's economic growth accelerated to 5.0 percent in 2006, mainly due to a slide in crude oil prices, an increase in private investment, as well as an expansion in exports. With fast economic growth and large capital inflows, the Korean won significantly appreciated against the US dollar and also against the NT dollar in the year. The NT dollar depreciated by 7.11 percent against the Korean won between the end of 2005 and 2006 and by 7.8 percent on a daily average basis in 2006 compared with the previous year.

Significant Increase in Foreign Exchange Trading

Trading in the Taipei foreign exchange market increased significantly in 2006. Total net trading volume for the year increased by 30.0 percent from the previous year to US\$3,910.84

Turnover of Major Products in the Taipei Foreign Exchange Market

Unit: US\$ Million

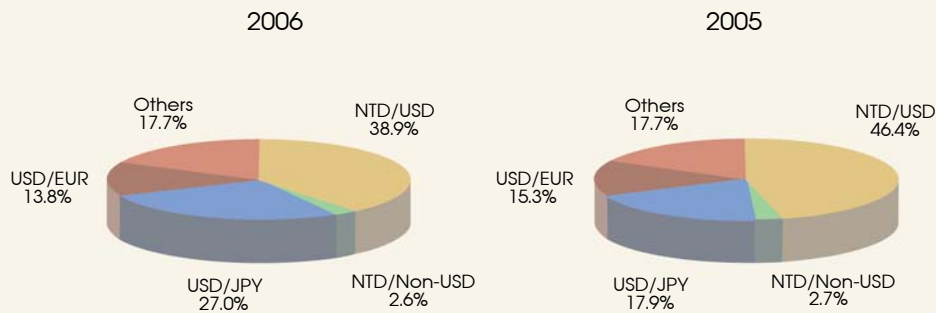
Year	Spots	Forwards	Forex Swaps	Margin Trading	Options	Cross Currency Swaps	Total
2002	872,844	114,341	238,807	25,869	149,630	8,875	1,410,366
2003	1,058,850	156,323	361,490	33,907	213,198	13,930	1,837,698
2004	1,289,872	273,931	617,577	30,299	350,514	17,764	2,579,955
2005	1,550,731	274,370	823,483	24,378	295,908	39,788	3,008,657
2006	1,910,270	411,182	1,107,646	37,809	396,578	47,353	3,910,838
2005-2006 Growth Rate (%)	23.2	49.9	34.5	55.1	34.0	19.0	30.0

Source: Department of Foreign Exchange, CBC.

billion. The daily average turnover stood at US\$15.64 billion, representing an increase of 29.5 percent over the previous year. The increase in turnover mainly reflected increases in external trade, capital movements, and third currency transactions. The marked appreciation of the euro against the US dollar, and the slowdown in the BOJ's rate rises, which caused the interest rate spread between Japan and the US and Europe to remain significant, both contributed to the increase in third currency transactions.

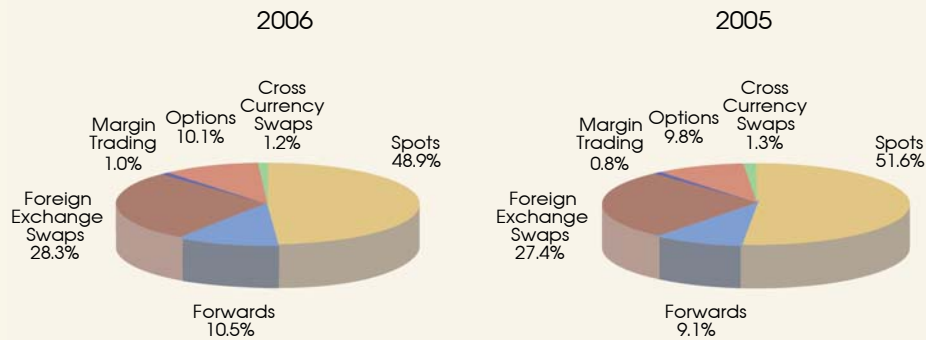
In terms of trading partners, transactions between banks and non-bank customers accounted for 33.6 percent of total net turnover. Interbank transactions made up a 66.4 percent share, including 17 percent for transactions among local banks and 49.4 percent for those between local banks and overseas banks.

Composition of Foreign Exchange Transactions by Traded Currency



Source: Department of Foreign Exchange, CBC.

Composition of Foreign Exchange Transactions by Product



Source: Department of Foreign Exchange, CBC.

Turnover of Other Products in the Taipei Foreign Exchange Market

Unit: US\$ Million

Year	Interest rate-related Products				Commodity-related Products		Stock Index Options	Credit Derivatives	Total
	Forward Rate Agreements	Interest Rate Swaps	Interest Rate Options	Foreign Currency	Commodity Options	Commodity Price Swaps			
2002	30,518	22,488	4,479	2,458	1,826	305	556	–	62,630
2003	20,121	41,855	10,066	12,036	3,313	175	663	–	88,229
2004	20,020	77,664	45,635	12,500	6,733	–	1,012	168	163,823
2005	25,089	78,528	23,668	29,385	4,594	–	389	581	162,235
2006	24,796	69,219	11,970	40,992	1,827	–	1,005	964	150,772
2005-2006 Growth Rate (%)	-1.2	-11.9	-49.4	39.5	-60.2	0.0	158.3	65.8	-7.1

Source: Department of Foreign Exchange, CBC.

As far as traded currencies are concerned, NT dollar trading against foreign currencies accounted for 41.5 percent of total trading volume, with the NT dollars trading against the US dollars accounting for a major share of 38.9 percent. Transactions in third currencies accounted for 58.5 percent of total trading volume, with trading mainly in currency pairs of US dollar-Japanese yen and US dollar-euro, which accounted for 27.0 percent and 13.8 percent of total trading, respectively. In particular, the trading volume of the NT dollar against other currencies only increased by 9.9 percent, while that of third currencies grew significantly by 49.4 percent.

With respect to types of transactions, spot transactions accounted for the highest share with 48.9 percent of total turnover, followed by foreign exchange swaps with 28.3 percent, forwards with 10.5 percent, options with 10.1 percent, cross currency swaps with 1.2 percent, and margin trading with 1.0 percent. Compared with those in 2005, the trading volumes of all the types increased.

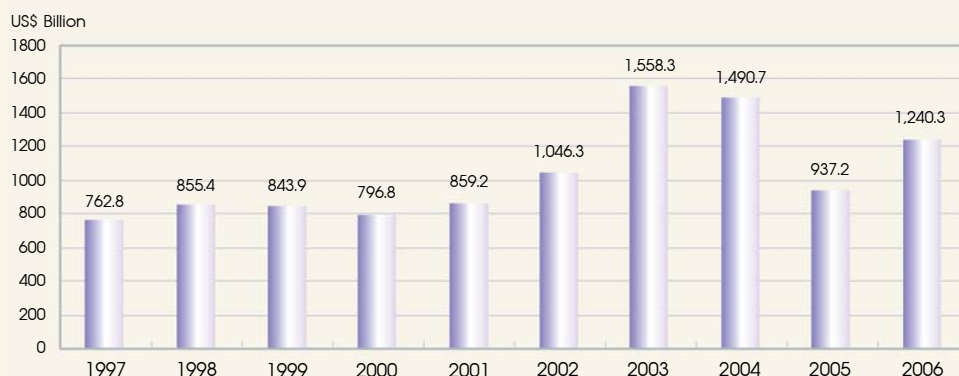
In addition, the turnover of forwards, swaps and options based on foreign currency interest rates, stock price indices, commodity prices, and credit in the bank-customer market amounted to US\$150.77 billion in 2006. Of this amount, interest rate-related derivatives accounted for the lion's share of US\$146.98 billion or 97.5 percent, representing a year-on-year decrease of 6.2 percent.

Expansion in the Foreign Currency Call-Loan Market

The transaction volume in the foreign currency call-loan market in 2006 was US\$1,240.25 billion, an increase of 32.3 percent over the previous year. Of this amount, US dollar transactions accounted for US\$1,238.79 billion. The increase was mainly because banks increased their overnight call-loan transactions for efficient fund utilization. In addition, Japanese yen transactions totaled ¥72.77 billion in 2006, representing a large increase of 3 times the figure recorded in

2005. As the BOJ slowed down its pace of policy rate rises, the interest rate spread between the US and Japan remained conducive to carry trade. Therefore, the amount of Japanese yen call loans increased largely, but the share was still small at only 0.05 percent. Finally, the amount of euro transactions totaled only €530 million, increasing by 4.8 percent from 2005.

Transactions in the Taipei Foreign Currency Call-Loan Market



Source: Department of Foreign Exchange, CBC.

Considerable Increase in the Assets of Offshore Banking Units

At the end of 2006, there were 66 offshore banking units (OBUs) in operation. Domestic banks operated 39 of the OBUs, while foreign banks ran the other 27. The assets of all OBUs totaled US\$76.69 billion at the end of the year, representing a remarkable increase of US\$6.53 billion or 9.3 percent from the previous year-end, mainly because claims on nonresidents and financial institutions increased. Of the total assets, domestic bank OBUs accounted for US\$57.71 billion or 75 percent, and foreign bank OBUs accounted for US\$18.98 billion, or 25 percent.

The OBUs' main sources of funds were due to their affiliated branches and deposits by financial institutions, together accounting for 60.9 percent of total liabilities. These were followed by deposits of non-financial institutions, which accounted for 31.6 percent of total liabilities, with an increase of 17 percent from the 2005 level. OBUs have been gradually developing into funding centers for overseas Taiwanese firms. Moreover, the OBUs' main uses of funds were due from affiliated branches and deposits with financial institutions. These accounted for 52.6 percent of total assets, followed by loans extended abroad and locally with a share of 26.8 percent. In terms of geographical origin, 71 percent of funds came from Asia, and 23 percent from the Americas. In terms of fund destination, 61 percent of funds went to Asia, and 25 percent to the Americas.

The forex-trading turnover of all OBUs in 2006 was US\$114.86 billion, a decrease of 14.1 percent over the previous year, primarily as a result of the impact of mergers and acquisitions among some local banks. Of the total turnover, US\$72.51 billion was for spot transactions and US\$15.89 billion for forward transactions, decreasing by 24.2 percent and 8.0 percent, respectively, compared with the previous year. In contrast, the turnover of swap transactions amounted to US\$26.46 billion, a significant growth of 27.1 percent over the previous year, primarily because the interest rate spread between the US and Japan fueled carry trade activities. Moreover, the total turnover of other derivative products, including interest rate swaps, margin trading, forward rate agreements, financial futures, options, cross currency swaps, commodity price swaps, commodity forward contracts, stock index swaps and credit derivatives, amounted to US\$145.88 billion, representing a significant increase of 61.0 percent over the previous year.

Consolidated Balance Sheet of Offshore Banking Units in Banking System

Unit: US\$ Million

Year / Month	Loans to Non-financial Institutions	Portfolio Investment	Claims on Financial Institutions	Other Assets	Total Assets= Total Liabilities	Deposits of Non-financial Institutions	Due to Financial Institutions	Other Liabilities
2004/12	18,066	6,734	37,105	7,314	69,219	18,810	42,688	7,721
2005/12	18,697	8,718	38,432	4,311	70,158	20,712	44,305	5,141
2006/12	19,473	10,805	40,352	6,056	76,686	24,227	46,664	5,312
2006/ 1	18,889	8,896	35,137	4,149	67,071	21,034	41,370	4,667
2	18,643	9,165	35,533	4,975	68,316	21,076	41,666	5,574
3	18,773	9,397	35,535	4,689	68,394	21,417	41,746	5,231
4	18,729	9,572	37,369	4,675	70,345	21,794	43,202	5,349
5	18,955	9,752	37,760	4,739	71,206	21,701	44,046	5,459
6	19,231	9,937	36,350	4,550	70,068	21,903	43,218	4,947
7	19,205	10,151	34,702	5,361	69,419	22,140	41,488	5,791
8	18,491	10,093	36,875	5,677	71,136	22,824	43,267	4,558
9	19,032	10,173	40,402	5,354	74,961	23,379	46,603	4,494
10	19,279	10,255	34,888	5,389	69,811	23,589	41,001	4,739
11	19,622	10,218	35,629	5,829	71,298	24,083	41,251	5,476
12	19,473	10,805	40,352	6,056	76,686	24,227	46,664	5,312

Source: Financial Statistics Monthly, CBC.