

2. Monetary Management

In 2006, the Bank's monetary management focused on continuing the gradual pace of policy tightening, reforming bank loan pricing system and enhancing the SME financing mechanism.

Continuing the Gradual Pace of Policy Tightening

Taiwan's economy benefited from the respectable global growth in 2006, although domestic demand moderated. The labor market improved for the fourth year in a row. Capacity utilization rates also remained high. Due to moderate domestic demand and high-base effect on fruit and vegetable prices, CPI inflation was tame at 0.6 percent for the year. Nevertheless, high raw material prices pushed up wholesale prices, which may gradually feed into general price level. At the same time, both short-term and long-term interest rates continued to remain at low levels. Against the backdrop, the Board of the Bank judged that the fine-tuning of the policy rates would safeguard price stability, foster efficient fund allocation, and promote long-term financial stability. The discount rate, the interest rate on accommodations with collateral and the interest rate on accommodations without collateral were raised by 12.5 basis points, respectively, at each of the Bank's board meetings of the year.

In the recent rate-hiking cycle since October 2004, the Bank has raised its policy rates ten times for a total increase of 137.5 basis points. At the end of the year, the three policy rates stood at 2.75 percent, 3.125 percent and 5.0 percent, respectively. The Bank believed that the moderate rate rise would not affect domestic economic activity and would only cause a

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
2006 / Mar. 31	2.375	2.750	4.625
June 30	2.500	2.875	4.750
Sept. 29	2.625	3.000	4.875
Dec. 29	2.750	3.125	5.000

Source: *Financial Statistics Monthly*, CBC.

limited increase in borrowing costs for businesses. The banking sector still has large liquidity to meet the demand for funds.

Liquidity-Absorbing Open Market Operations

The Bank mainly uses open market operations to absorb liquidity. Certificates of deposit (CDs) issued by the Bank remain the primary instrument 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 2006, as net foreign capital inflows were mostly offset by the surge in outward portfolio investments by domestic investors, liquidity in the banking system was not accumulated as rapidly as in previous years. However, the level of excess liquidity remained high due to weak demand for funds in the private sector. In order to lock in more longer-term funds with the Bank, the Bank resumed to issue one-year CDs through an interest rate based auction in February 2006, in addition to the issues of short-term CDs with maturities ranging from 30 days to 182 days. At the end of the year, the total outstanding amount of CDs issued by the Bank was NT\$3,756 billion, higher than a year earlier.

In addition, foreign exchange swaps with banks were also used continuously to reduce excess liquidity. At the end of the year, its outstanding balance decreased from the previous year, mainly because the needs for hedge by insurance companies declined. In regard to

Open Market Operations

Unit: NT\$ Billion

Year/ Month	Amount Absorbed*	Amount Offered*	Outstanding Amounts**	Weighted Average Rates on CDs Issued				
	Issues of CDs	Redemptions of CDs	CDs Issued	1-30 days	31-91 days	92-182 days	274-364 days	2 years
2004	12,741	12,171	3,563	1.08	1.15	1.09	1.23	1.30
2005	20,007	20,049	3,521	1.29	1.34	1.44	—	—
2006	13,525	13,290	3,756	1.55	1.63	1.69	1.84	—
2006 / 1	2,116	2,282	3,355	1.45	1.52	1.60	—	—
2	860	656	3,559	1.45	1.52	1.60	1.70	—
3	982	977	3,564	1.45	1.55	1.64	1.72	—
4	1,730	1,604	3,690	1.52	1.59	1.67	1.77	—
5	604	706	3,588	1.52	1.59	1.67	—	—
6	596	728	3,456	1.54	1.65	1.74	1.89	—
7	1,795	1,692	3,559	1.59	1.66	1.74	1.91	—
8	980	985	3,554	1.59	1.66	1.74	1.88	—
9	714	716	3,552	1.60	1.68	1.74	1.84	—
10	1,715	1,665	3,602	1.66	1.73	1.74	1.85	—
11	793	763	3,632	1.66	1.73	1.81	1.85	—
12	640	516	3,756	1.66	1.74	1.81	1.87	—

Note: * Data in 2004 included NT\$618 billion repurchase agreements traded in open market operations.

** End-of-period data.

Source: *Financial Statistics Monthly*, CBC.

fund-supplying operations, the Bank did not arrange any repos during the year given the large liquidity in the market.

To guide market interest rates upwards, the Bank continued to use non-competitive bidding rate on each CD issuance with maturities ranging from 30 days to 182 days. Following the adjustment of the discount rate, the Bank also announced its non-competitive bidding rates for new CD issuance. In 2006, the 30-day CD rate was moved up by 24 basis points to 1.69 percent at the end of the year, leading the overnight call-loan rate to rise from 1.46 percent early in the year to 1.69 percent at the year-end.

Non-Competitive Bidding Rates on CDs Issued by the Central Bank

Effective Date	Unit: %			
	30 Days	91 Days	182 Days	364* Days
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	–
2006 / Mar. 21	1.520	1.590	1.670	–
June 30	1.590	1.660	1.740	–
Sept. 29	1.660	1.730	1.810	–
Dec. 29	1.690	1.760	1.840	–

Note: * The auction rates on 364-day CDs were not shown on this table.
Source: Press Releases on Open Market Operations, CBC.

Decreasing Redeposits from Financial Institutions

Accepting redeposits from Taiwan Post Co. and commercial banks is another instrument for the Bank to promote financial stability and to influence banks' reserve positions. However, it's not used as frequently as open market operations. At the end of 2006, outstanding postal savings redeposits increased from NT\$1,417 billion at the end of 2005 to NT\$1,487 billion. At the same time, banks' redeposits was down from NT\$428 billion to NT\$ 328 billion as part of the redeposits was shifted to the Bank's CDs.

In addition, the three domestic agricultural banks, namely the Taiwan Cooperative Bank, the Land Bank of Taiwan and the Agricultural Bank of Taiwan are allowed to accept deposits from community financial institutions and make redeposits with the Bank. At the end of the year, their outstanding redeposits decreased to NT\$136 billion, compared to NT\$159 billion in 2005.

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 this program 6 times since its inauguration, the total amount of the mortgage loans was thus increased to NT\$1,800 billion. By the end of 2006, a total of 862,361 households had obtained an amount of NT\$2,645.3 billion under this program. The amount included NT\$994 billion in parallel lending by banks applying ordinary interest rates. Having approved by the Executive Yuan, this program will end until the funds are used up -- as opposed to the original deadline of September 2006.

The Bank also continued to provide subsidies to victims of the earthquake in 1999 for interest payments on their mortgage loans. By the end of 2006, a total of NT\$66.7 billion worth of loans had been approved for 34,619 housing units under this program.

Reforming Bank Loan Pricing System

Since 2002, the Bank has encouraged the adoption of adjustable rate mortgages and flexible base rates pricing system to substitute the downwardly-rigid prime rates for new loans, allowing lending rates more sensitive to market conditions and loan pricing more transparent. At the same time, banks were also urged to apply this new pricing system to their existing loans. As of the end of 2006, loans extended by domestic banks still using the prime rates pricing mechanism accounted for merely 0.96 percent of total loans.

To ensure that the new pricing system is implemented thoroughly, as requested by the Bank, the Banker Association of the Republic of China (Taiwan) requires banks to link prime rates to their base rates. At the same time, the Bank conducted target examination on banks' new pricing practice to carry out the reform.

Enhancing the SME Financing Mechanism

To provide easier access to financing for small- and medium-sized enterprises (SMEs), the Bank continued to promote the 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 2006, the outstanding guarantees and loans extended to SMEs by domestic banks were NT\$381 billion and NT\$2,097 billion, showing an increase of NT\$155 billion and NT\$ 638 billion, respectively, as compared with the end of May 2003.