3. Foreign Exchange Management

In addition to regular foreign exchange market management and reserve management, the Bank continued to approve more banks to conduct foreign exchange business and to allow authorized foreign exchange banks to introduce more financial products to the market, and further deregulated capital movement in 2006.

Foreign Exchange Market Management

The NT 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 may step in to maintain an orderly foreign exchange market.

To monitor the market activities, the Bank continued to implement the Real-Time Reporting System for Large-Amount Foreign Exchange Transactions. In addition, the requirement that forward transactions should be made only upon real transactions, such as trade and financing, was reinforced in order to curb foreign exchange speculation. The Bank also urged banks to enhance their foreign exchange risk management so as to lower individual bank's risk exposure and systemic risk. Moreover, the Bank increased target examinations to maintain an orderly foreign exchange market.

During 2006, various foreign and domestic factors affected the NT$/US$ exchange rate. However, the exchange rate still reflected Taiwan's fundamentals, thus maintained its dynamic stability. It fluctuated between 31.338 and 33.316 during 2006, closing the year at 32.596, up 0.78 percent from 32.850 from 32.850 at the end of 2005.

Enlargement of Foreign Exchange Market

To enlarge the foreign exchange market, the Bank approved another 33 branches of local banks to conduct full-fledged foreign exchange business and another 92 branches to conduct limited business of buying/selling foreign currencies and traveler's checks in 2006. By the end of 2006, there were 1,152 authorized foreign exchange banks, which included 69 foreign banks, and 39 domestic bank headquarters and their 1,050 branches.

The Bank continuously approved new financial products in 2006. The newly approved financial products were as follows: (1) NTD time deposits linked to the hedge-fund index dbX-Harmony II using the CPPI (Constant Proportion Portfolio Insurance) strategy; (2) new and structured foreign exchange credit derivative financial products, such as basket default swaps, first-to-default swaps, n-to-default swaps, and structured basket default swaps; (3) new business such as NTD denominated ABN AMRO CQII fund index swap business and NTD time deposit linked to NTD denominated ABN AMRO CQII fund index. The introduction of these new derivative products provides local firms with more hedging instruments. For the year 2006, banks introduced 38 new financial products upon the approval of the Bank.

Due to the increases in market participants and diversity of financial products, the daily average transaction amount of the Taipei foreign exchange market further increased to US $15.655 billion in 2006, 29.66% higher than US$12.074 billion of the previous year.

In order to provide banks with sufficient foreign exchange liquidity to meet corporate funding needs, the Bank continued to carry out foreign currency swap transactions with banks and extend foreign currency call loans to banks. During 2006, foreign currency call loan transactions reached US$1,240 billion, while foreign currency-NT dollar swap transactions reached US$242 billion. The year-end balance for swap transactions was US$44 billion.

Steady Growth of Foreign Exchange Reserves

In 2006, the Bank's foreign exchange receipts amounted to US$712.4 billion, while foreign exchange expenditure was US$699.5 billion. At the end of 2006, total foreign exchange reserves

Foreign Exchange Reserves

Source: Department of Foreign Exchange, the CBC.

amounted to US$266.1 billion, a US$12.9 billion increase from the end of 2005. The increase in foreign exchange reserves was mainly attributed to a current account surplus, foreign capital inflows and the return on investment of foreign exchange reserves.

Deregulation on Capital Flow Management

With the progress of financial liberalization and internationalization, the Bank continued to deregulate capital movements. In general, capital can flow freely in and out Taiwan. As of 2006, restrictions only remained on a few short-term financial transactions involving the conversion of the NT dollar. 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 upon the approval from the Bank.

Key deregulation measures with regard to the management of capital flows in 2006 included:

(1) In November, the Bank and the Financial Supervisory Commission (FSC) approved the guidelines proposed by Bankers Association of the Republic of China to allow non-resident foreigners to take up NTD loans from local banks.

(2) In order to loosen the restrictions on foreign investments in domestic securities, the Bank agreed with the following measures: (i) effective February 24, foreign investors were allowed to invest in warrants underwritten before an Initial Public Offering; (ii) effective March 27, foreign investors were allowed to engage in non-hedging futures trading and to introduce USD-denominated futures products; (iii) effective March 27, transaction amount of foreigners' trading on futures and options was no longer limited by 30% of total inward remittances; (iv) effective May 16, foreign investors were allowed to invest in securities investment trust funds privately placed by securities investment trust enterprises; (v) effective August 16, foreign investors were allowed to invest in foreign currency-denominated international bonds; (vi) effective August 18, foreign investors were allowed to borrow securities from domestic security firms.

(3) In order to promote the internationalization of the domestic capital market, the Bank agreed with the following measures: (i) enterprises were allowed to issue overseas securities for fund raising. In 2006, 7 corporations issued overseas depository receipts amounting to US$3.15 billion; 16 corporations issued convertible bonds amounting to

USD$4.98 billion; (ii) Deutsch Bank and Bank of Paris were allowed to issue USD-denominated international bond worth 0.2 billion and Australian dollar-denominated international bond worth 0.5 billion, respectively.

(4) The Bank agreed with the following applications on overseas securities investment: (i) securities investment trust enterprises were allowed to issue 87 securities investment trust funds to invest in foreign securities amounting to NT$610 billion; (ii) 13 insurance companies were allowed to invest in foreign securities through direct remittances, swaps or cross currency swaps amounting to US$6.9 billion ; (iii) 5 insurance companies were allowed to invest in foreign securities through specified pecuniary trusts amounting to US$1.4 billion; (iv) 10 commercial banks were allowed to invest in foreign securities through managed accounts amounting to US$0.7 billion.

(5) In order to facilitate capital movement, the Bank revised the Regulation Governing the Declaration of Foreign Exchange Receipts and Disbursement and Transactions with the following changes: (i) to develop the domestic foreign currency-denominated futures market, and to allow foreign investors to engage in non-hedging futures transactions, the above regulation was revised on March 27. Several agencies were allowed to conduct remittance business: (a) the Futures Exchange may handle exchange settlement for their members; (b) Futures enterprises may handle exchange settlement for local residents when fulfilling the margin requirement for futures trading; (c) Futures enterprises for foreigners may engage in foreign currency-denominated futures trading; and (d) Managed Futures Enterprises can discretionarily engage in futures trading or foreign currency-denominated margin transactions for trustors; (ii) to relax remittance restrictions, the above regulation was again revised on July 7 with the following measures: (a) the margin for foreign currency-denominated futures was not counted toward the accumulated remittance amount of the futures merchant or the trustor for the current year; (b) remittance made by the domestic charity or public welfare public body for international humanity assistance was not counted toward the yearly accumulated remittance amount ; (c) juridical person or public body were allowed to remit to China for tourist purpose.

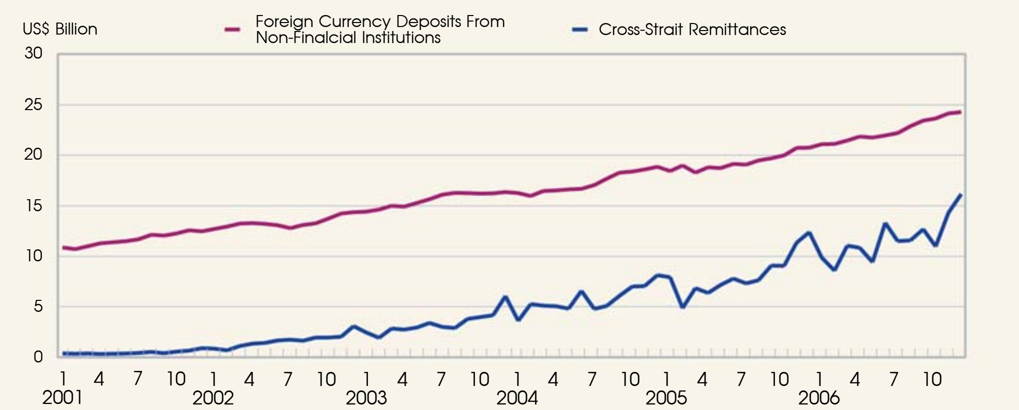
(6) In order to simplify the Renminbi exchange business of banks located in Kinmen and Matsu and to monitor the relevant information, on May 15 the Bank revised the Regulation Governing the Purchase or Sale of Renminbi Bills Managed by Banks Located in Kinmen

and Matsu, including the permission for banks to establish new exchange offices and to entrust other organizations to manage renminbi exchange business, the permission for travel agencies to remit for customers, the requirement for filing the trading information, and the rule for reporting the trading information during weekends and holidays. Up to the end of 2006, banks in Kinmen and Matsu in total purchased Renminbi 30.16 million dollars and sold Renminbi 197.95 million dollars.

Development of Offshore Banking Business

Offshore banking units (OBUs) of local banks have been in operation since December 1983 to stimulate Taiwan's international financial activities and to establish Taiwan as a financial center in Asia. Since June 2001, OBUs have been allowed to conduct cross Taiwan-strait financial business, and their business has been growing rapidly. At the end of 2006, foreign currency deposits from non-financial institutions totaled US$24.23 billion, a US$12.78 billion or 11.63% increase from June 2001, while cross Taiwan-strait remittances increased to US$16.11 billion, a US$15.76 billion or 4547.52% increase during the same period. This rapid growth of cross-strait remittances helped promote OBUs as the funding center for Taiwanese business operating overseas.

Non-Financial Institution Deposts and Cross-Strait Remittance through OBU



Source: Department of Foreign Exchange, CBC