

SEACEN Country Report: Recent Economic and Monetary Developments and Outlook in the Republic of China*

Fa-Chin Liang**

I. Economic Performance

1. Economic Growth

Marred by the sluggish global economy and the terrorist attacks in the US, Taiwan experienced an economic slowdown in 2001. Exports of goods and services declined by 8.17%, which in turn dampened private investment. The staggered stock market and the rising unemployment rate curbed household consumption as well. For the year, the Taiwan economy contracted by 1.91%.

Since the first quarter of this year, the global economy has turned around. As a result, our exports gathered momentum as foreign demand increased. Imports gradually picked up because of the derived demand from exports. Domestic private investment and consumption improved as well. As a result, the economy registered a growth rate of 0.89% in the first quarter of this year. As high-tech industries revived, industrial

production grew 10.11% in May. For the year as a whole, the economic growth rate is expected to reach 2.55%.

2. Prices

Prices were stable throughout 2001. Despite a slight increase in services prices, sluggish domestic demand, increasing competition in the domestic goods market, and an excess supply in foods led to a decrease in goods prices. Overall, the CPI inflation declined to -0.01%. The core CPI (the CPI excluding the categories of fresh fruits and vegetables, fish and shellfish, and energy) increased a mere 0.08%.

Prices remained stable during the first five months of this year. Although the economy moved toward recovery, housing rent, the prices of petroleum, vegetables and fruits were declining, which led to a drop in the CPI

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**Deputy Governor, the Central Bank of China.

inflation to -0.07%. In the mean time, the core inflation slightly increased to 0.55%. For the year as a whole, the CPI inflation is projected to be 0.64%.

3. Unemployment Rate

The unemployment rate surged to 4.57% last year. The economic slowdown and the increased outward relocation of local industries were the main reasons behind the growing unemployment rate. However, since last October, the labor market conditions have gradually improved as general economic activities continued to recover. The rate went down from the historic high 5.33% of last October to 5.02% of this May.

4. New Taiwan Dollar Exchange Rate

The yearly average NT dollar exchange rate was 33.8 against the US dollar for 2001. From mid-July onwards, the NT dollar appreciated as the US dollar was weak and the subsequent September 11 terrorist attacks in the US further drove down the US dollar in the international markets. In the second half of December, the NT dollar went down again as a result of the depreciation of the Japanese yen.

Since the beginning of this year, the NT dollar exhibited a mild trend of appreciation due to a weakening US dollar, a widening trade surplus, and the increasing foreign portfolio investment in Taiwan. Consequently, the NT

dollar appreciated 3.38% from the end of last year to June 21 this year.

5. Balance of Payments

Balance of payments remained in good shape in 2001. The current account surplus increased to US\$18.86 billion, showing the highest figure on record, while the financial account registered a mild outflow of US\$0.72 billion. For the first quarter of this year, both exports and imports showed signs of improvement. The current account continued to register a surplus of US\$7.15 billion. And the financial account showed an outflow of US\$1.09 billion. Foreign exchange reserves amounted to US\$139.8 billion at the end of this May, representing an increase of US\$17.6 billion over the end of 2001.

6. Interest Rates

Throughout last year, money market interest rates moved downwards, which were led by the Central Bank of China's (CBC) easy monetary policy to stimulate the economy. The downward trend continued this year. The call-loan rate dropped from 4.66% in January last year to 2.22% this May. The yearly weighted average lending rate on new loans of the five leading domestic banks also decreased from 6.82% in January last year to 4.58% this May.

7. M2 Growth

The growth rate of monetary aggregate M2 averaged 5.79% for the year 2001. The figure, while 1.25 percentage points lower than the previous year, was within the target range set by the CBC. The decrease in M2 growth last year reflected the weakening demand for money resulting from the economic slowdown, sluggish stock market, and a shift of funds from bank deposits to bond funds.

Since the beginning of this year, although general economic activities gradually picked up, funds continued to shift from bank deposits to bond funds and firms' funding demands were not strong. As a result, the M2 grew at a lower 4.33% in the first five months year on year, but still stayed within the 3.5% to 8.5% target range set for this year.

8. Stock Market Conditions

At the beginning of last year, the Taiwan Stock Exchange Index (TAIEX) rose as the US equity markets rebounded, which was fueled by the Fed's aggressive interest rate cuts. It also gained strong momentum from the domestic side, as foreign investors built up huge net buying positions in the local market and merger

deals among local banks started to surface. These factors helped push the TAIEX upwards to reach its yearly high of 6,104 points on February 15. However, the TAIEX soon reversed its upward trend due to the disappointing earnings reports of listed companies and the downward revisions of financial forecasts by major local hi-tech companies. Compounded by the September 11 terrorist attacks in the US, the TAIEX continued to move down and fell to its annual low of 3,446 points on October 3, 2001. Afterwards, the downward trend was reversed as a combination of booming US high-tech stock prices and better economic outlook boosted confidence in the stock market. At the end of last year, the TAIEX closed at 5,551 points.

From the beginning of this year to mid-April, the TAIEX continued to advance as optimism on the global and domestic economy prevailed. Recently, buyers' profit-taking activities and the slumping US NASDAQ index affected TAIEX's performance and the market declined. The TAIEX closed at 5,460 points on June 21, 2002.

II. The Policy of the Central Bank of China

1. Monetary Policy

Given that prices remained stable, the CBC

adopted an easy monetary policy to stimulate the economy last year. The CBC has cut the

discount rate 12 times since December 2000 by a total of 262.5 basis points. At the end of the year, the discount rate was at its record low of 2.125%.

The CBC also adjusted the structure of required reserve ratios last October with an aim to reduce banks' costs of fund and to help improve their operations. The required reserve ratios of checking deposits, passbook deposits, passbook savings deposits, time deposits, and time savings deposits decreased to 10.75%, 9.775%, 5.50%, 5.00%, and 4.00%, respectively. As a result, the weighted average required reserve ratio declined to 5.00% from 6.22%. The required reserve ratio of foreign currency deposits was also cut from 10% to 5%. In November 8, this ratio was further cut to 2.50% to help reduce banks' costs of holding foreign currency deposits.

2. Liberalizing Capital Movements

With regard to liberalizing capital movements, major policy measures taken last year include the followings:

a. The timeframe for inward remittances of approved equity funds by qualified foreign institutional investors (QFIIs) was extended from 1 year to 2 years.

b. The ceiling on the amount of investment in domestic securities by each QFII was raised from US\$2 billion to US\$3 billion.

c. The foreign exchange settlements relating to the borrowings of domestic companies from their overseas subsidiaries and the repayments thereof were excluded from the US\$50 million general remittance quota. This measure is to encourage the flow-back of outbound capital.

3. Financial Reforms

The CBC and the Ministry of Finance (MOF) have worked together to carry out a series of financial reforms. In July last year, the government set up the *Financial Restructuring Fund* to restructure problem financial institutions. The *Financial Institution Merger Law* lays down a legal framework for asset management companies and introduces the market mechanism to speed up the disposal of financial institutions' non-performing assets. The *Law* also provides incentives for financial institutions to merge. The problem of overbanking will be alleviated gradually through mergers and acquisitions. The *Financial Holding Company Law*, which took effect in July last year, provides the foundation for financial institutions to achieve synergy and to provide one-stop services to the public through business integration and professional marketing. The *Financial Supervision Agency Act*, currently under review by the Congress, will further integrate the existing system to promote sound financial development in the future.

III. Conclusion

Although the Taiwan economy suffered a setback last year, it made substantial adjustments during the process. In addition to the major overhaul in the financial sector in recent years, the government and the private sector also speed up to develop Taiwan into a knowledge-based economy with environmental sustainability. The ongoing structural change and financial reform are testimony of such adjustments to upgrade the economy. Furthermore, the government recently proclaimed the *Challenge 2008 National Development Plan* with an expected total investment of NT\$2.6 trillion as the blueprint to guide national development in the next six years. Together with the solid foundations built in the past decades, the Taiwan economy is heading toward a bright prospect.

