Economics

# Taiwan: Central bank turning hawkish

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## Interest rates, TWD and TAIEX are all rising

- The Central Bank of China (CBC) delivered a bigger-than-expected 25bps rate hike last Thursday, taking the benchmark rediscount rate to 3.125%. This came after a series of currency-supporting measures in May, such as restarting the issuance of 364-day NCD; selling USD and requiring market makers to report FX trades exceeding USD 1mn; urging financial institutions to develop and market more domestic investment products.
- The market is interpreting the CBC's moves as targeting capital outflow and defending the TWD which have followed from the use of the TWD as a funding currency for carry trades. On the day of the CBC meeting, the TWD appreciated by 0.6% (against USD) to close at 32.795, the strongest level over five months. Meanwhile, the net purchase of Taiwanese stocks by domestic investors returned to positive territory as at end-May. This was followed by foreign investors, whose record-breaking purchases reached TWD20-40 bn per day since mid of June. As a result, the TAIEX rose by 3.2% last week alone, compared to 4.1% in the first five months this year.

## The show's not over

- Besides capital outflow/TWD depreciation per se, the CBC may need to worry more about the risk it presents to higher (imported) inflation. The CBC statement last week highlighted that "increases in the CPI are projected to accelerate in 2H07", rather than only mentioned "potential inflation risk" in March statement. It cited the gradual feed-through from rising wholesale prices, scheduled increase in labour costs (minimum wage will be raised by 9.09% starting from July1), on top of low base-effects for CPI statistics in 2H07.
- TWD depreciation raises the local price of imported goods. Import prices (in TWD terms) accelerated to 10.3% YoY in May07 from 7.5% in Dec06, even while USD-denominated import prices eased. Wholesale prices accelerated as well, to 7.6% YoY in May07 from 6.4% in Dec06 (***Chart 1***).
- CPI inflation has been well-behaved at 0.7% YoY over Jan07-May07. However, concerns are rising that producers will eventually pass costs onto end consumers. Inflation expectations have started to rise. According to the consumer confidence survey in May, expectations about commodity prices in the next six months worsened sharply by 6.85 points, reaching a new historical low.
- Given that the statistics department places 2007 inflation forecast at 1.5% (DBSf: 1.3%), another 25bps rate hike seems likely in September. This would lift the rediscount rate to 3.375% and leave real rates at around 2% (***Chart 2***). Note, however, that deposit rates are below the rediscount rate. The averaged 1-year deposit rate among five leading domestic banks was raised to 2.35% from 2.26% after the 25bps hike in rediscount rate last Thursday. Even the 3-year deposit rate was a mere 2.43% after adjustment. Real deposit rates are less than one percent based on inflation forecast.

**Chart 1: Import inflation rising**

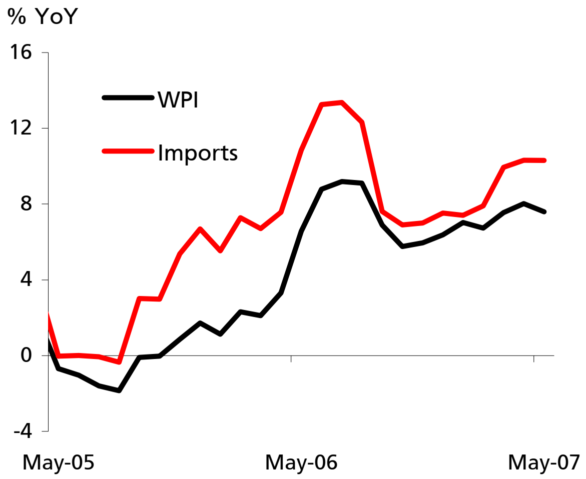
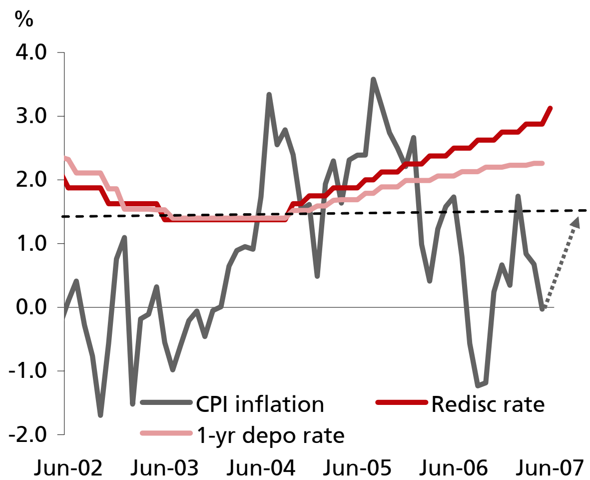



**Chart 2: Rate hike needed to prevent inflation**

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## Further rate hikes will depend on growth outcomes

- Growth has been driven by external demand for the past two years. Over the past four quarters (ending 1Q07) , net exports accounted for more than 100% of GDP growth (some domestic demand sectors contracted). The weak growth is the reason why the CBC used a milder 12.5bps (rather than 25bps) hikes during its rate normalization cycle from 4Q04-1Q07, and tolerated 13% depreciation in real effective exchange rate during 2H05-1H07.
- The acceleration of the CBC's tightening last week should reflect its expectation of a better economic outlook going forward. To justify further rises in interest rates (and also TWD and TAIEX), two things will be needed. One is a recovery of global demand/global electronics cycle and its spillover into domestic sector. While the worst of US slowdown has passed, we do not expect an especially strong rebound. Electronics demand, key for Taiwan, remains lacklustre. The Semiconductor Industry Association recently downgraded sales growth forecast to 1.8% for 2007 from 10%, citing price declines as the main reason. This means that Taiwan's electronics recovery may take some time, as almost 90% of Taiwan's electronics exports are electronics components nowadays, after the manufacturing of information and communication products was largely shifted to Mainland China. In short, a quick and strong rebound in exports is unlikely in 2H07.
- Another thing needed for stronger fundamental growth is a government focused on economic development over political bickering. Two key areas are important, in our view. First, are the upgrading Taiwan's industry structure and a breaking in cross-strait restrictions on transportation and investment. Any significant change is likely only after the new President takes office in 2Q08 (elections are slated for Mar08).

Sources for charts are CEIC and DBS Research (forecasts and data transformations)

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