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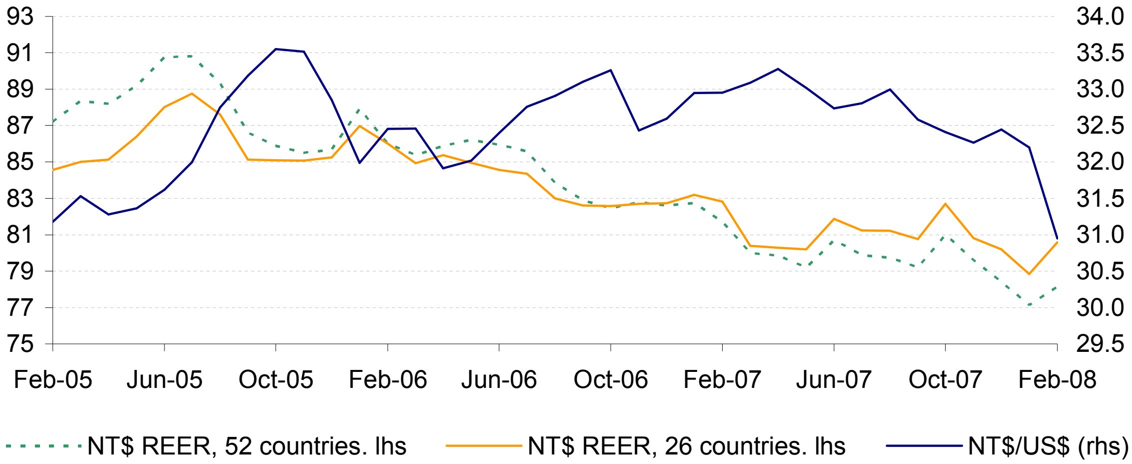
Confused of Taipei

WE SUGGEST: New Taiwan dollar likely to rise further in the short term

SUMMARY: The New Taiwan dollar (NT$) has reached a 10.5-year high against the greenback, causing significant concern in Taipei. But it is difficult to see a way out of the Taiwanese dilemma. Inflation is picking up, necessitating higher interest rates. This combines with dollar weakness to make the NT$ more attractive. A stronger currency helps dampen imported inflation – but also erodes competitiveness in an export-dependent economy. All points to weaker growth.

In the last day or so, the New Taiwan dollar (NT$) has reached a 10½-year high against the US currency. The Taiwanese monetary authorities worry that one reason for NT$ strength is speculative inflows. Hence, Governor Perng took the opportunity to remind foreign funds and their local custodian banks that foreign funds ostensibly intended for portfolio investment must be used for that purpose and not left in bank accounts waiting for currency appreciation. However, there also seems to be a certain amount of confusion going on in Taipei, and at different levels at that. First, because once foreign money has become part of Taiwanese money supply (ie, been deposited in local banks) it doesn't matter if the funds are used for equity purchases or not. Buying shares simply transfers the funds from one account to another, with no change in money supply. Unless, of course, what the authorities are worried about is that the foreign capital will flee Taiwan again once the currency has appreciated. But, in that case, the NT$ will weaken – which apparently would be welcome.

New Taiwan dollar, exchange rate

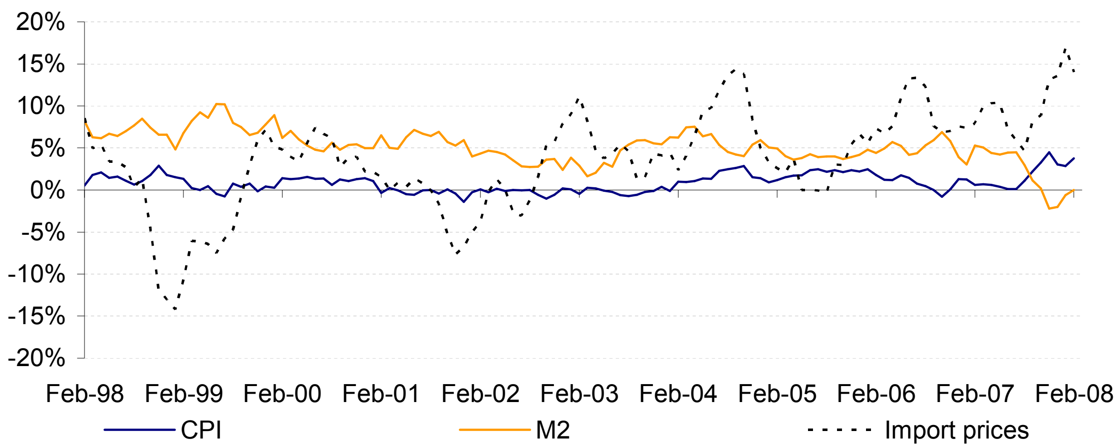


Next, the strength of the NT$ is more apparent than real. Yes, the currency is at a long-time peak against the greenback. But this is a consequence of US dollar weakness, rather than necessarily of NT$ strength. On a trade-weighted effective exchange rate index (real and nominal) the currency has continued to weaken until the very latest month. Until early January, the NT$ was still weakening against the yuan, the currency of its most important trading partner (just under 30% of Taiwanese exports go to the mainland, close to 40% if Hong Kong-bound exports are included, versus less than 12% to the United States).

While the NT$ has appreciated against the yuan by about 5% since then is worrying, the continued strong growth of export orders from the mainland (up 18.8% in the year to February) implies that this is so far not hurting Taiwan's foreign trade. This could of course change; and the latest FGDP data from Taiwan is not encouraging. Output grew by 0.5% in Q4 – but net exports contributed 1.3% to growth, as domestic demand fell.

However, to some extent, NT$ appreciation is also caused by the monetary authorities. As noted in a previous *Daily Note* (Taiwan's inflation problem, 25th February 2008), Taiwan does have an inflation issue. Consumer prices rose by 3.8% in the year to February, a 13-year high, with the underlying rate (excluding fresh fruit, vegetables, shellfish, fish and energy) at 2.7%, also the highest rate since 1994. As a result, the CBC has been raising interest rates since 2004 and is likely to raise them again this month. At a time when US interest rates are falling and it is complicated to go long on the yuan, any proxy for the Chinese currency – the Hong Kong dollar, the won, the yen or even the NT$ - become more attractive. Moreover, much of Taiwanese inflation is imported. Import prices have risen by double-digit annual rates since last November. With imports slightly in excess of 50% of GDP, this is a powerful inflationary stimulus.

Taiwanese broad money and inflation, 12-month change, %



It is difficult to see a way out from the Taiwanese dilemma. Higher inflation requires higher interest rates. A stronger currency helps dampen external inflationary impulses. But it also erodes the competitiveness of an economy where exports constitute 70% of GDP and net exports recently have been the only contributor to output growth. The most likely outlook for 2008 is one where as long as the mainland economy powers ahead, the rising NT$ should be of less concern. But if (when?) the mainland economy slows down, Taiwan is badly positioned to continue to grow on domestic demand alone. Significantly, broad money and credit numbers are already weak, with real M2 contracting by 2.2% in the year to February, the fourth consecutive month it has fallen.

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