



Daily Note: 7 July 2008

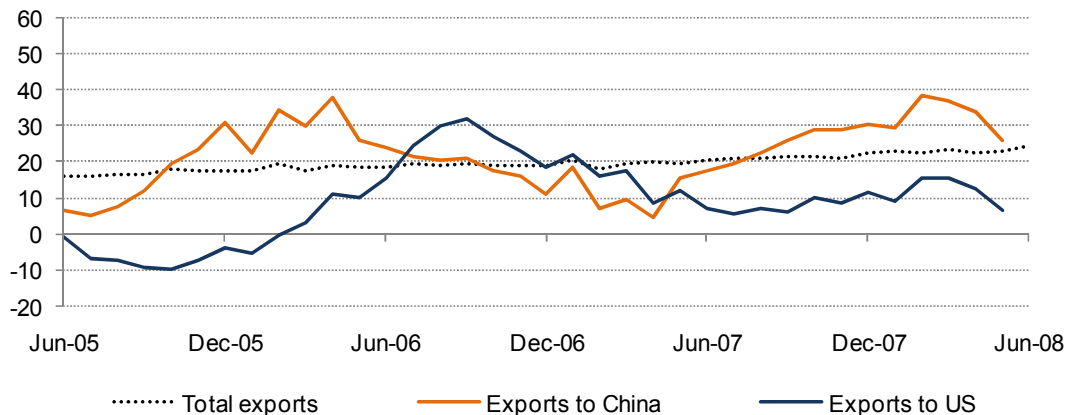
Rising exports, inflation → Taiwanese rates up

WE SUGGEST: Central Bank of China to raise interest rates in September

SUMMARY: Taiwanese exports continued to surge in June. In addition, global inflation is affecting Taiwan as it is everyone else and consumer prices rose at a 17-year high clip of 5.3% in the year to June. The Central Bank of China is likely to intensify its tightening process in the autumn.

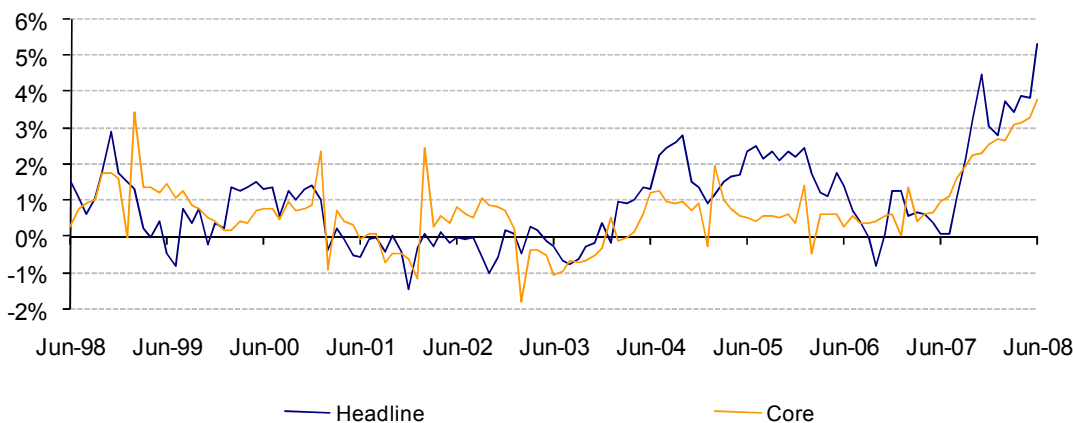
Forecasts of the Taiwanese economy have generally been gloomy over the past year, focusing on the country's large share of the LCD and computer market and its dependence on exports to the United States – directly or indirectly via other countries, eg China. However, the outturn has equally generally surprised on the upside. The changing trade pattern in the Far East makes China a far more important trading partner for Taiwan than 'the West'. By May this year, 28.8% of Taiwanese exports went to China, with another 13.2% to Hong Kong. By contrast, only 11% of Taiwanese exports went directly to the US (down from close to 30% ten years ago), with another 7½% to Euroland and less than 2% to the UK. Obviously, a substantial share of the exports to China – and even more so to Hong Kong – are re-exported. It is impossible to estimate how large this share is or how it is divided by destination. But, crucially, as long as China continues to overheat and suck in goods from Taiwan, this is of less importance. Clearly, as Chinese export growth slows, there will be an impact on Taiwan even if some of the lost Chinese re-exports are replaced by domestic mainland demand for goods from Taiwan. Hence, although Chinese export growth already is slowing, Taiwanese exports to China continue to grow in excess of 20% per annum – as do overall Taiwanese exports. Moreover, the current thaw between Taiwan and the PRC, is likely to boost cross-Straits trade further in the near term.

**Taiwanese exports, 12-month change, %
(exports to China and to US shown as three-month moving averages)**



As the rest of the world is slowing, so too will eventually Taiwanese exports. However, in the meantime, Taiwan is having the same inflation problem as everyone else. Although the Taiwanese economy probably has a small negative output gap, higher food and raw materials prices are feeding through here as well. Headline inflation rose to 5.3% (seasonally adjusted) in the year to June, the highest number in 17 years. Excluding fruit, vegetables, fish, shellfish and energy, the rate is lower, but still at a 12-year high of 3.8%. Moreover, surging import prices (16% in the year to June but a six-month annualised rate of 18.4%) and base effects from 2007 imply that inflation will accelerate in coming months.

Taiwanese inflation, 12-month change, %



The Central Bank of China has already tightened monetary policy steadily since 2003, taking the discount rate from 1.375% to 3.625% in late June this year. However, the pace of tightening has accelerated. In 2005, 2006 and 2007 the discount rate was raised by 62.5bps each. So far this year, the increase is 25bps, with two quarterly meetings of the CBC Board left. However, the accelerated inflation rate implies that at least one, possibly both those meetings will see interest rates rise by 25bps each – particularly as both policy interest rates (the discount rate and the rates for accommodations with and without collateral) and market short-term interest rates are negative in real terms. Moreover, the Bank has also returned to using the reserve requirements ratio. With the exception of foreign currency deposits (as the Bank was concerned about inflows of hot capital speculating in an appreciation of the new Taiwan dollar), the reserve requirements ratio was unchanged from 2001 to 2008. However, last month the ratio was raised by between 75 and 125bps, depending on deposit type. This is also likely to be repeated in the autumn.

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