

Taiwan

| Taiwan | 2008 | 2009 | 2010F | 2011F |
|----------------------------|-------|-------|-------|-------|
| GDP | 0.7 | -1.9 | 7.5 | 4.6 |
| CPI (average, y/y) | 3.5 | -0.9 | 1.5 | 2.0 |
| Unemployment Rate (sa, %) | 5.0 | 5.7 | 5.0 | 4.2 |
| Current account (% of GDP) | 6.0% | 10.7% | 6.1% | 6.8% |
| Fiscal balance (% of GDP) | -0.9% | -4.1% | -2.6% | -1.9% |

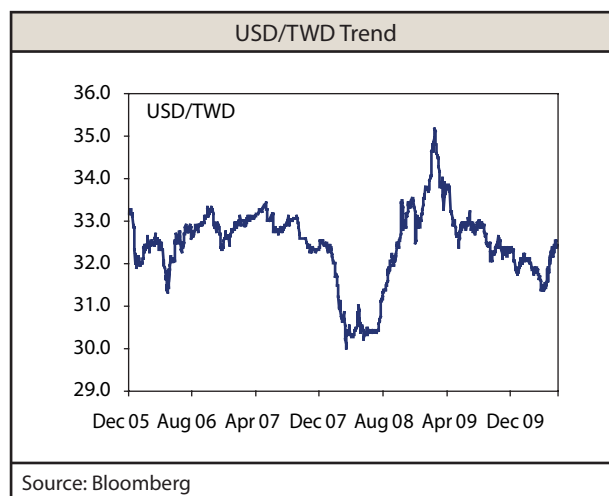
Summary

- TWD has returned to losses against the USD since European debt crisis in May. With the authorities concerned about potential fallout from Europe as well as impact on export competitiveness, upside is limited for the TWD. While China's unpeg announcement on 19 Jun should be generally positive for Asian currencies, we do not expect the RMB to appreciate significantly over the next 6 months. Taken together, we have adjusted marginally our end-2010 USD/TWD forecast to 31.80, from 31.40 previously.
- With TWD likely to be kept on tight leash going forward, the central bank would have to offset with tighter interest rate policy. It hiked its official rediscount rate unexpectedly at its 24 Jun meeting by 0.125% to 1.375%. With the stated aim of keeping real interest rate positive, we expect CBC to continue its modest rate hike quarterly into 2011. We look for the official rediscount rate rising to 1.75% by end-2010 and 2.75% by end-2011.
- While recent reports are also generally pointing to data moving in the right direction, there are some signs of moderation in the quarters ahead, in particular import growth and peaking of the leading index. Post the stronger than expected 1Q10 GDP figures, we are revising up Taiwan's GDP growth higher to 7.5% for 2010 vs. our earlier forecast of 6.0%.

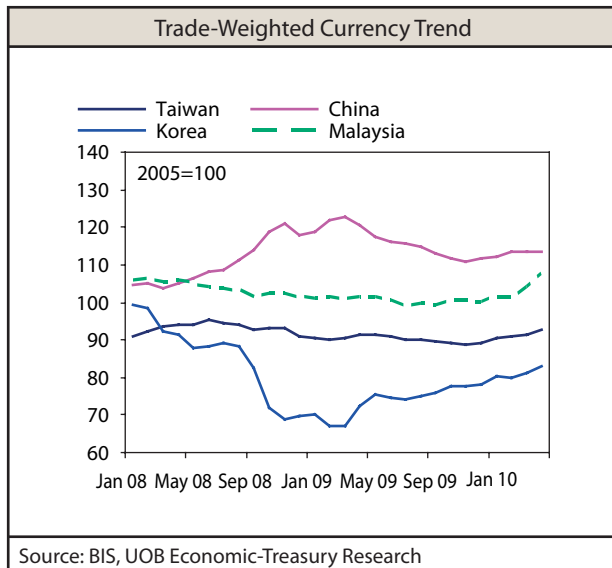
TWD To Stay on Weak Footing

Since the Greek (and European) sovereign debt crisis broke out in early May, the TWD has been on a weak footing against the USD. While TWD appreciated about 2.0% to 31.42/USD by end-Apr, it has reversed to a 2.6% loss since then as the environment turned towards risk aversion. Another development is that TWD has turned more volatile as well on an intraday basis, with frequent weakness seen at the last hour of trade. This suggests that the authorities are still wary of potential fallout from the European debt crisis as well as the local currency's impact on export competitiveness. This is reflected on the trade-weighted TWD, which gained 4% YTD compared to 6-7% gain for the trade-weighted KRW and MYR, and about 1% for the trade-weighted S\$. While China's announcement of a shift in FX policy shift on 19 Jun should be positive for Asian currencies (i.e. USD negative), we do not anticipate an aggressive RMB appreciation at least over the next 6 months (please see our section on China for more details). This means that Asian currencies should largely maintain a moderate pace going

into 2011. With European debt concerns still playing out in the months ahead, we see relatively little room for TWD strength, and adjusted marginally our end-2010 USD/TWD forecast to 31.80, from 31.40 previously.



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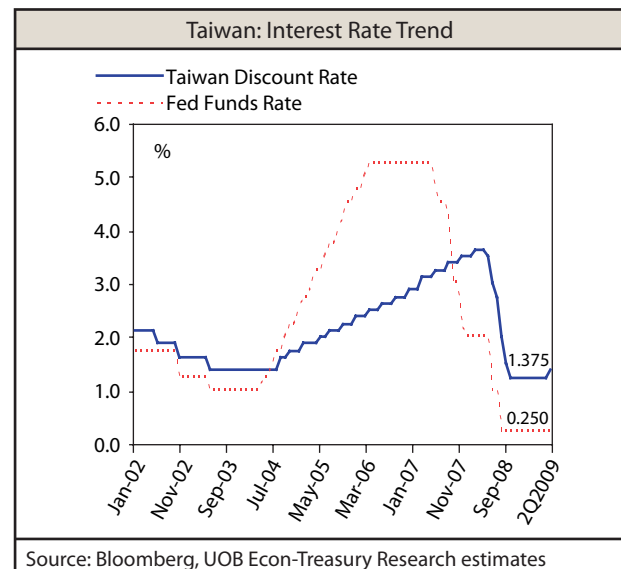
Monetary Policy Normalization On Track With Surprise Rate Hike

Inflation backdrop has been surprisingly moderate in Taiwan, with consumer prices in May at 0.7%/y, down from 1.34% in Apr. For the January-May period, headline CPI edged up 1.2%/y, despite the low base last year (full year 2009 inflation was -0.9%). The drivers for weaker-than-expected prices have been food category, which went into negative in May after months of hovering in and out of deflation. The lack of pricing pressures is also apparent in other goods and services categories, suggesting that inflation would not be a major concern for policymakers.

At the same time, M2 growth has slowed for the ninth consecutive month to Apr at 4%/y, about half the pace since peaking in Jul 2009 at 8.4%/y and average growth of 7.2% for M2 in 2009. The CBC has been active in its policy normalization process via the liquidity tightening route especially since 3Q of 2009, with increased issuance of certificate of deposits. CBC's issuance of 1Y CDs since Apr 2010 rose by TWD300bn, which is equivalent to a hike in requirement ratio by 1.2 percentage points, according to the CBC's statement after the June interest rate meeting. At the same time, excess reserves in the banking system fell to TWD23.5bn by end-May from a peak of TWD154.1bn in Apr 2009.

In a surprise move at the Jun 2010 quarterly interest rate meeting, the CBC hiked its official rediscount rate by 0.125% to 1.375%, 3 months ahead of our expectation. CBC cited the global recovery process and heightened

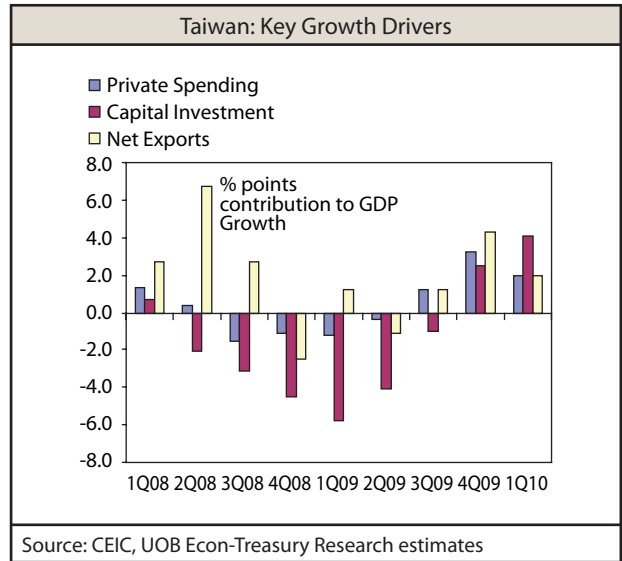
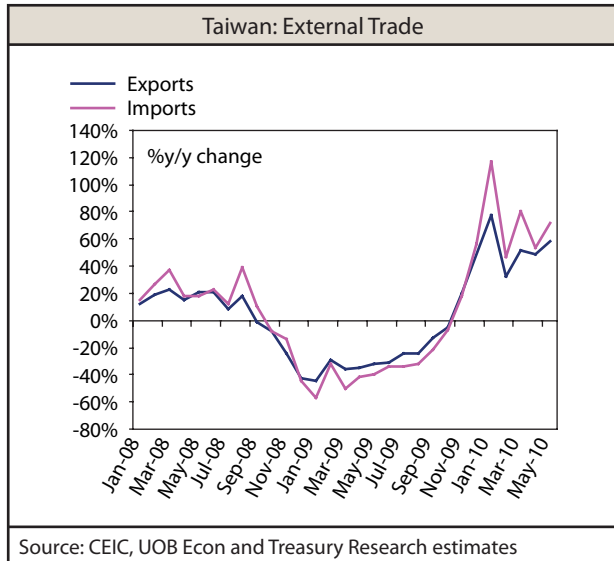
domestic activities as the main factors in its decision. At the same time, CBC also took actions to prevent property price bubbles from gaining traction, imposing new LTV caps, tighter housing regulations, and moral suasion. At the same time, we believe CBC is adopting a weak currency/firm interest rate strategy to strike a balance between export competitiveness and managing inflationary pressures/capital flows. With the stated aim of keeping real interest rate positive, we expect CBC to continue its modest rate hike at its quarterly meetings well into 2011. Given our forecasts of Taiwan's inflation rate to hover around 1.5% in 2010 and 2.0% in 2011, we expect the official rediscount rate would be raised further in the second half, to 1.75% by end-2010 and 2.75% by end-2011, a level that was last seen at the post-Lehman days at end-2008.



Growth Pace to Moderate in Second Half

Taiwan's economy grew 13.27%/y in 1Q10, the fastest since 3Q1978, on the back of strong exports and increased domestic consumption. The 1Q headline figure topped a previous estimate by over 4%pt, according to the govt. Real exports jumped by 42.2% while domestic consumption rose 12.9% during the quarter. The 1Q registered its first back-to-back growth since the financial crisis triggered a 5-quarter decline, with 4Q09 growth at 9.06%. Recent reports are also generally pointing to data moving in the right direction, with exports in May expanding nearly 60%/y, compared to the 30-50% range in the prior three months.

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Post the strong 1Q10 GDP report, we expect Taiwan's GDP growth is likely to bias higher to 7.5% for 2010 vs. our earlier forecast of 6.0%, with the pace of expansion expected to moderate towards the second half as exports likely to stagnate given the headwinds from Eurozone debt crisis. One indication is that there are signs that Taiwan's imports growth appears to be decelerating in recent months, especially for the key electronics components (YTD gain of 66%/y/y in May vs. 82% at end-1Q despite a substantially depressed base in 2009). Meanwhile, PMI indexes from China, Europe and US are also showing signs of moderation in recent months after peaking in early 2010. Taiwan's statistics bureau raised its 2010 GDP growth projection to 6.14% from earlier forecast of 4.72% after the 1Q report.

