UNITED OVERSEAS BANK

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Flash Notes

Taiwan's Central Bank Hikes Rate As Expected

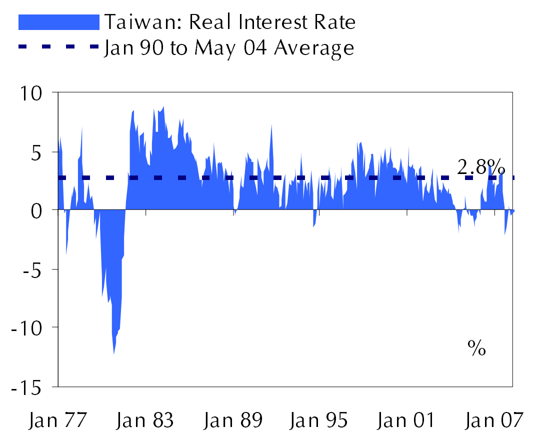
As widely expected, Taiwan's central bank CBC at its scheduled quarterly meeting today (Thursday 26 Jun) moved to hike the official discount rate by 12.5bps to 3.625%. This is the 16th quarterly interest rate increase for CBC in the current tightening cycle, for a total of 225bps. In the post-meeting statement, CBC continued to reiterate its tight monetary policy stance in view of inflationary pressures, especially after the move to raise fuel prices in late May.

On the inflation front, Taiwan's consumer prices gained an average of 3.7%y/y in the first 5 months of 2008, ahead of the official target of 3.3%. We note that food prices, which were responsible for the spike in consumer prices earlier this year, have begun to moderate somewhat. However, non-food prices are expected to keep the overall headline CPI firm in the months ahead, due to passthrough from higher fuel prices. Recall that the Taiwanese govt had announced in late May 12-16% rise in gasoline and diesel prices, as well as plans to raise domestic electricity prices in July and October. Within the consumer price index basket, gas, electricity, and oil account for about 6.5% of total weight. With these factors in place, Taiwan's inflation is not expected to peak until 4th quarter of 2008. We expect average inflation in Taiwan to come in around 3.5% for 2008, fully 1%pt higher compared to our previous full-year forecast of 2.5%, which did not anticipate increases in fuel and electricity prices.

Against a backdrop of higher consumer prices and concerns of entrenched inflationary expectations, we believe the CBC is likely to maintain its tight policy stance for the remainder of 2008. Real interest rate has been hovering in the negative territory since Feb this year, compared to the long term average of 2.8% (between 1990-May 2004) which is likely to be considered the neutral interest rate level by the central bank. The CBC acknowledged in its statement that that real interest rates are "low" and it is necessary to raise the nominal rates. We continue to see CBC hiking in a predictable fashion by raising at least twice in the remaining two quarterly meetings in 2008. The risk of a 25bps move is considerable, instead of the usual 12.5bp hikes, considering the negative real interest rate environment.

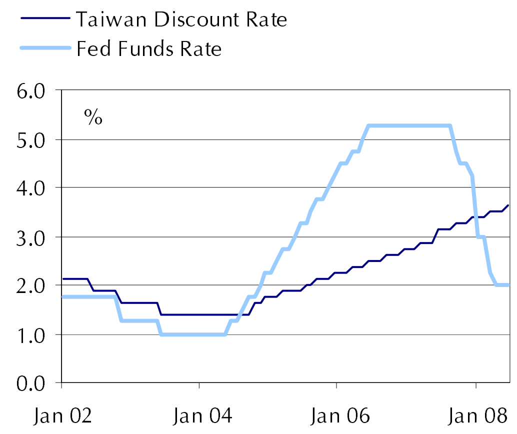
On the currency front, the TWD appears to face strong resistance near the 30.00/USD level. With the TWD having already gained nearly 7.0% in the first half of 2008, the CBC may resist having the local unit making further gains in view of external demand weakness and the bottoming of the USD. We are trimming down our TWD forecast to 30.20/USD by year-end, from earlier projection of 29.00.

Taiwan: Real Interest Rate



Source: CEIC, UOB

Taiwan Discount Rate vs. US Fed Funds Rate



Source: Bloomberg, UOB