

Modern Mercantilism, Central Bank Bankruptcy and Policy Dilemma: The Case of Taiwan

Background

In the Pacific Basin, the economic performance of Taiwan has been one of the postwar wonders of developing countries. After the complete separation from mainland China in 1949, Taiwan followed the export-oriented development strategies in contrast to mainland China's autarkic and centrally planned economy. There were many factors which were attributed to the phenomenal Taiwanese economic growth, but the major ones are:

- 1) the basic infrastructures (especially the elementary school system and the transportation network) provided during 50 years (1895-1945) of Japanese colonization;
- 2) one of the highest per capita foreign aid packages ever provided by the United States before and during the "take off" stage of development;
- 3) a successful land-to-tiller policy;
- 4) the influx of tens of thousands of engineers, school teachers and other highly educated Chinese during 1945-1949; and
- 5) a successful monetary policy which stopped the inflation in conjunction with a taxation policy which stabilized the prices of basic staples.

By 1964, when the US economic aid formally ended and Taiwan's economy was supposed to have passed the take-off stage, the gross national product (GNP) in real terms had increased by more than two and half times compared to 1952. After 1964, the booming export created by the Vietnam War and the ability to follow Japanese export markets to North America enabled the Taiwanese economy to double its real GNP every seven to eight years and to weather both

oil crises, even though Taiwan is heavily dependent upon imported energy resources.

By the end of 1988, the GNP in current price stood at NT (New Taiwan) \$ 3,423 billion (or US \$ 130 billion). The per capita GNP was greater than US \$ 6,500. No wonder Taiwan has been considered one of the leading Asian NICs (newly industrialized countries).

Distorted economic growth

However, the rosy growth figures conceal a fundamental flaw in the composition of the GNP. The year 1980 may be considered the turning point of the great economic distortion in Taiwan. As one of the thriftiest countries in the world, Taiwan's gross capital formation steadily increased from 22.8 percent of the gross domestic product (GDP) in 1965 to 34.3 percent in 1980. This rapid industrialization was made possible by the explosive export-import sector which leap-frogged from approximately 20 percent of the GDP to well over 50 percent. However, the trade was more or less balanced over this period (1965-80).

In view of the recognition of the People's Republic of China by the United States in 1978, entrepreneurs in Taiwan suddenly lost the incentive to invest in long-run projects. The gross capital formation nosedived steadily to merely 16.2 percent of the GDP by 1986. Even though it has recovered somewhat since then, it is still less than 20 percent of the GDP. In terms of real national income, however, Taiwan has still maintained a real growth rate of well over 6 percent during 1980-88. This was made possible by Taiwan's mercantilistic fervor in sustaining the export surplus.

The current account surplus since 1983 is tabulated in Table 1 to show the magnitude of this phenomenon. The total of trade surpluses in six and half years was nearly \$ 85 billion and the total of current account surpluses was nearly \$ 70 billion. On a per capita basis, in six and half years, each Taiwanese (including every baby and every retiree) has transferred nearly \$ 4,200 to foreign countries, mainly the US. While Taiwan has maintained a trade surplus against American markets, it has maintained a perennial trade deficit against Japan, Taiwan's second largest trade partner.

TABLE 1

TRADE BALANCE AND CURRENT ACCOUNT BALANCE OF TAIWAN, 1983-88
(million US \$)

Year	Export	Import	Trade Balance	Current Account Balance
1983	25,028	18,760	6,268	4,412
1984	30,185	20,952	9,233	6,976
1985	30,466	19,296	11,170	9,195
1986	39,492	22,635	16,859	16,217
1987	53,224	33,012	20,212	17,925
1988	60,316	46,511	13,805	10,167
1989 I e II	31,959	24,632	7,327	4,892
Total:			84,874	69,784

Source: *Financial Statistic*, September 1989, THE CENTRAL BANK OF CHINA (in fact, Taiwan).

Impact of the trade surplus

Since Taiwan still exercises foreign exchange control, the central bank in Taiwan (alias The Central Bank of China) has been accumulating a behemoth of a current account surplus continuously since 1981. The total international reserve net of gold and gold holdings has ballooned to over \$ 76 billion at one time (1987), and it was still well over \$ 74 billion even after a tremendous effort was made to digest the US dollar holdings by importing an amazing 350 metric tons of gold during 1987-88. The change in international reserve holdings is illustrated in Table 2.

TABLE 2

INTERNATIONAL RESERVES AND GOLD HOLDING
(million US dollar)

	1983	1984	1985	1986	1987	1988	1989 II
Foreign Exchanges	11,859	15,664	22,556	46,310	76,748	73,897	74,248
Gold	682	816	964	1,313	2,698	5,395	5,886
Total	12,541	16,480	23,520	47,623	79,446	79,292	80,134

Source: Compiled from *Financial Statistic*, September 1989, THE CENTRAL BANK OF CHINA

The \$ 80 billion worth of international reserve is, as of now, the second largest official reserve in the world; it is second only to Japan's nearly \$ 100 billion. However, Taiwan has only 20 million in population compared to Japan's 120 million, and Taiwan's per capita GPN is no more than one third of Japan's. Any rational economic policy maker in Taiwan must be aware of the potential economic problems that this large international reserve could create. In order to demonstrate the enormity of this accumulation, the following illustrations are provided: it would be enough to purchase almost two years' worth of total import at current rate, and it is nearly two hundred times more than mainland China's international reserve on a per capita basis (\$ 4,000 vs. \$ 20). It is difficult to justify on any economic rationality the size of accumulated reserves.

Bankruptcy of the central bank

In a modern nation, the central bank is an important agency in carrying out the monetary policy and in regulating the financial institutions. In its daily business as a trustee of legal reserve deposits for commercial banks and as the issuer of currency in circulation, the central bank in general enjoys tremendous profit from the "seignorage", the right to issue money. The central bank in Taiwan is no exception. Even after paying the Finance Ministry billions of dollars of profit, the Central Bank's net worth increased from nearly NT \$ 11 billion in 1978 to NT \$ 179 billion in 1985 (*i.e.*, from US \$ 250 million to US \$ 4,475 million). The Central Bank, on the one hand, earned a relatively high interest income in the United States and elsewhere from its accumulation of foreign exchange reserve, and on the other hand, issued reserve money or monetary base on which no interest was paid. Indeed, the Central Bank in Taiwan had become the greatest profit maker of all institutions, public or private, in Taiwan by 1985.

This excessively large accumulation of reserves finally brought disastrous consequences, one of which was the "bankruptcy" of the Central Bank. As mentioned earlier, Taiwan's trade surplus had been accumulated through its trade with the US (about 50% of the total export). The pressure from the US government to correct this chronic

trade surplus has been mounting. Taiwan was especially vulnerable to this pressure because as an orphan in international politics with only three major countries (South Korea, Saudi Arabia, and South Africa) recognizing its status, support from the US is vitally important for Taiwan's survival.

The currency appreciation against the US dollar started to take place in 1985-86. The Taiwan government tried to slow down the appreciation by a general reduction in tariffs and quotas, by allowing easier capital outflow of up to US \$ 5 million per year per person; and by encouraging enormous tourist expenditures abroad. However, these measures alone could not slow down the accumulation of trade surplus because of the declining domestic investment and consumer spending. The appreciation of the NT dollar against the US dollar created a tremendous loss for the Central Bank since its major liabilities were all in terms of NT dollars while its greatest assets, foreign exchange reserve, were in US dollars. The Central Bank tried to intervene in the foreign exchange market but was not effective because smart "hot" money correctly assessed the situation and kept pouring into Taiwan. It was reported that more than US \$ 10 billion got into Taiwan to reap the windfall profit from the certain appreciation of the NT dollar. Table 3 shows the total assets, foreign assets, net worth of the Central Bank, and the changes in the exchange rate against the US dollar.

Even as late as 1980, foreign assets were only 27 percent of the Central Bank's total assets, but they soared to 83 percent in 1984, and to 96 percent at the end of the third quarter of 1989. There has been a small degree of diversification, but the fear of confiscation by the diplomatic pressure of the People's Republic of China has kept 80 percent of the foreign exchanges in US dollars. Holding all assets in foreign exchange, and especially in US currency, contradicts the common sense of risk aversion through portfolio diversification. Any appreciation of NT dollars means a huge loss for the Central Bank. This problem is evidenced by the decrease in the Central Bank's net worth from approximately US \$ 1.1 billion in 1980 to a *negative* US \$ 13 billion in 1989. The loss continued to mount as the exchange rate appreciated to below NT \$ 26 to one US dollar in June 1989.

TABLE 3

TOTAL ASSETS, FOREIGN ASSETS, NET WORTH
OF THE CENTRAL BANK AND EXCHANGE RATES, 1980-1981
(million NT dollars)

Year	Total Assets	Foreign Assets	Net Worth	Exchange Rate NT \$: US \$	
1980	427,342	115,484	38,666	35.96	} depreciation of NT \$
1981	523,199	302,398	78,648	37.79	
1982	618,405	361,243	128,042	39.86	
1983	701,190	504,425	141,047	40.22	
1984	782,497	649,645	147,444	39.42	} appreciation of NT \$
1985	1,006,296	936,097	179,493	39.80	
1986	1,749,414	1,688,253	79,637	35.45	
1987	2,326,097	2,257,520	-203,444	28.50	
1988	2,248,707	2,233,670	-280,815	28.17	
1989 III	2,133,263	2,041,023	-464,533	25.60	

Source: Compiled from *Financial Statistics Monthly*, Economic Research Department; THE CENTRAL BANK OF CHINA, October 1989 and TAIWAN STATISTICAL DATA BANK, 1989; Council for Economic Planning and Development, ROC.

Economic consequences

A bankruptcy of a central bank is merely a loss on the balance sheet, but the economic consequences of foreign exchange accumulation are something the government cannot take lightly. As the Central Bank purchased foreign exchange by issuing domestic currency, *i.e.*, NT dollar, the reserve money increased correspondingly, and the money supply M_{1B} (defined as the sum of currency in circulation, checking accounts, passbook deposits and passbook savings deposits) grew rapidly. The growth rate of M_{1B} in 1986, 1987 and 1988 were 51.4, 37.8 and 24.4 percent, respectively. In absolute value, the increase in M_{1B} in 1985 was only NT \$ 81.8 billion, but exploded to NT \$ 386 billion, 430 billion and 382 billion during the last three years. As of September 1989, the size of M_{1B} exceeded NT \$ 1,905 billion compared to NT \$ 669 billion in 1984.

Rapid money supply increases should eventually produce inflation. Surprisingly, the consumer price index (CPI) has shown very little increase, and the wholesale price index (WPI) has even shown declines in the last four or five years (see Table 4). What explains this

phenomenon? As an import-dependent country, especially in energy, grain and other industrial materials, Taiwan enjoyed a fantastic decline in energy prices and low and stable food prices in the eighties. More importantly, the exchange rate appreciation from 39.85 to nearly 26 (which is a 35% appreciation) has itself contributed immensely to the dampening effect on WPI and CPI. One wonders why those billions of newly created NT dollars do not affect the economy. Certainly, they do produce unpredictable distortions in the economy.

TABLE 4

MONEY SUPPLY, CPI AND WPI, 1983-88
(base 1980=100)

Year	M_{1B} (billion NT \$)	M_{1B}	WPI	CPI
1983	612.9	154.4	106.2	121.4
1984	669.6	168.7	106.7	121.4
1985	751.5	189.4	103.9	121.2
1986	1137.9	286.7	100.4	122.0
1987	1568.2	395.2	97.2	122.7
1988	1950.5	491.4	95.6	124.2
1989 III	1905.6	na	na	na

Source: Compiled from *Taiwan Statistical Data Book*, 1988; Council for Economic Planning and Development, ROC.

In the last four years, a very small scale stock exchange in Taiwan (which trades in less than two hundred stocks) has been the focus of phenomenal speculative activities. Stock transactions and prices exploded exponentially and billions of dollars were made by a few rich manipulators in the stock market. Daily transactions often exceeded NT \$ 100 billion (or nearly US \$ 4 billion), and it is said to be the world's fourth most active stock market.

In addition, the speculation in urban land is no less fervent than the activities in the stock market. Land and housing prices in the capital city, Taipei, have at least tripled. Any decent western style apartment costs over a quarter million US dollars, equivalent to nearly 30 years of gross income of an average college graduate.

The results of these speculative activities are:

- 1) a maldistribution of income and wealth;
- 2) a demoralizing effect on normal business and production activities; and

3) a distortion of social and moral values to such an extent that millions of people spend their time, energy and limited resources in the pursuit of financial gain rather than productive developments.

The speculative nature of the stock market is demonstrated by the figures in Table 5. Since 1983, the stock index jumped more than fifteenfold. As of this writing, the D-J of Taipei is over 10,000.

TABLE 5

STOCK MARKET IN TAIWAN
(NT \$ million)

Year	Number of Stocks	Total Par Value	Total Market Value	Total Trading Volume	Stock Index 1966=100
1983	123	167.2	306.0	363.8	654.3
1984	127	190.4	390.3	324.5	872.5
1985	130	213.4	415.7	195.2	745.6
1986	133	240.8	548.4	675.7	944.7
1987	145	287.3	1,386.1	2,668.6	2,135.0
1988	168	343.6	3,383.3	7,868.0	5,202.2
1989/Sept.	172	379.5	6,216.1	na	10,402.8

Source: Compiled from *Taiwan Statistical Data Book*, 1989; Council for Economic Planning and Development, ROC.

Policy dilemma

As the Taiwan dollar appreciated over the last four years, the competitiveness in the international market of thousands of small and medium exporters deteriorated. Some of them found alternative locations of production by taking advantage of the new capital transfer stipulation of the Central Bank. Many entrepreneurs now invest in Thailand, Malaysia, Philippines, Indonesia and even in mainland China to take advantage of cheap labor in those countries. Some invest in the US because of the availability of cheaper land.

(The richest man in Taiwan, the plastic king, recently announced a direct investment of over US \$ 1 billion in petro-chemical plants in Texas, citing the reason that similar land would cost one hundred times more in Taiwan). Exports have stagnated during the last six months and the US is still pressing for NT dollar appreciation. The CPI has finally shown an upward movement which may explode on account of the two-trillion-dollar M_{1B} floating in Taiwan. Stocks and land prices appear unaccountably high with respect to fundamental values.

The Central Bank finally took some drastic measures to curb the voluminous credit availability. The discount rate was raised from 4.5 percent to 6.5 percent, and the legal reserve requirement for checking deposits was raised from 25 to 29 percent. This last measure created a drastic shortage in the required reserves of major commercial banks. This shortage was exacerbated by Central Bank's refusal to extend temporary loans, thus forcing the banks to curtail their lending activities. The stated objective of the Central Bank was to reduce the growth rate of M_{1B} to less than 20 percent. These drastic measures may not be effective because Taiwan still expects to have about US \$ 10 billion trade surplus in 1989 which will provide enough reserve money (monetary base) to offset all the tightening produced by higher reserve requirements. Meanwhile, many small and medium enterprises have been hit hard by the tightening credit.

Why was the most common monetary policy instrument, the open market operation, not used to smooth out the credit tightening? The Central Bank simply does not possess a significant amount of government securities or any other securities to sell since more than 96 percent of its total assets are in foreign exchange! If the Central Bank tries to sell foreign exchange to tighten the money supply, the Taiwan dollar will appreciate sharply. Thus, the open market operation is completely out of the question for fear of attracting more speculative foreign "hot" money which in turn will accelerate the NT dollar appreciation process. It seems that the Central Bank is incapable of getting out this dilemma unless a stimulative fiscal policy is adopted. Fiscal stimulation can be accomplished by investing heavily in social overhead capital, waste treatment and environmental restoration. In the past, the need in these areas has been neglected by both

the government and industries alike. The government can borrow from the public where savings are abundant, can also import technology and capital equipment to digest the huge trade surplus.

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