



**ESCAPING THE FLAMES**

**TAIWAN STRATEGY**

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16 APRIL 1999

# Taiwan and the Asian crisis: Escaping the flames

- Taiwan is reviving from a financial crisis of confidence and an export slump. It has suffered least from the Asian crisis and is reviving first.
- We expect real GDP growth of 5.1% this year, higher than the government's forecast of 4.7% and much higher than the consensus forecast of 4.4%.
- Huge foreign reserves, absence of foreign debt, and minimal hot money immunise Taiwan from the Asian currency crisis. But Taiwan has had a significant asset bubble.
- The government has so far failed to reform the troubled financial system, which continues to be a drag on the economy and creates a severe risk of eventual crisis.
- The two major political parties have moved toward a consensus on the status quo in relations with China, so Taiwan policies toward China are likely to moderate after President Lee Teng-hui, whose more aggressive policies are outside the consensus, leaves office in the year 2000.
- Taiwan's policies toward Beijing, and Beijing's policies toward Taipei, are both moderate. But the issue of Theatre Missile Defence, raised by Washington, could cause a political explosion.
- The principal investment themes in our opinion will be electronics revival, new outsourcing based on Japanese restructuring, and telecommunications reform.

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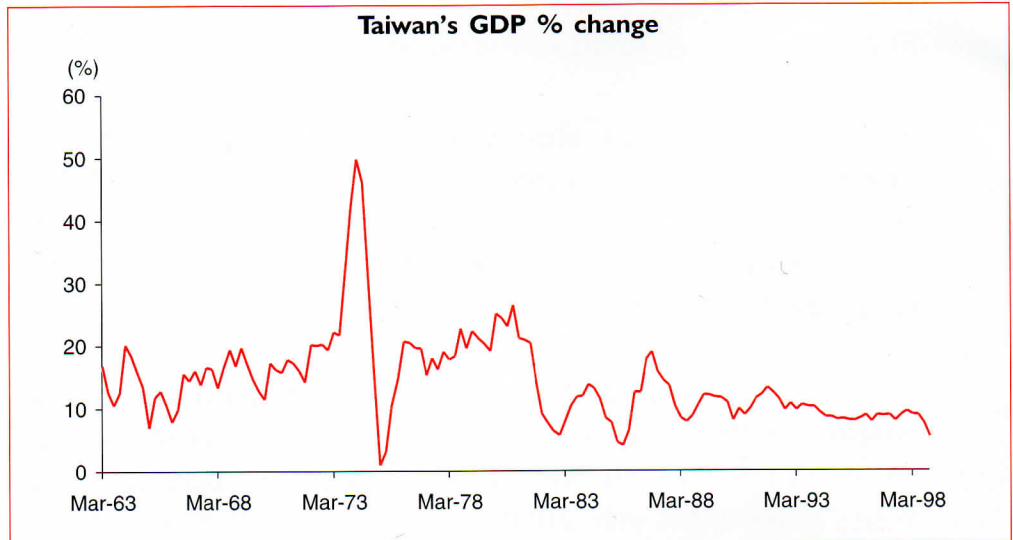
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# Escaping the flames

*Taiwan has economic fundamentals so strong that the crunch was surprising*

Taiwan was slow to be affected by the Asian financial crisis, and appears to have emerged from it more quickly than any other Asia Pacific economy. Indeed, Taiwan's economic fundamentals are so strong that it was surprising for it to have had a crunch at all. But its Third World-style financial system risked meltdown even when the economy was growing at a rate of just under 5%.

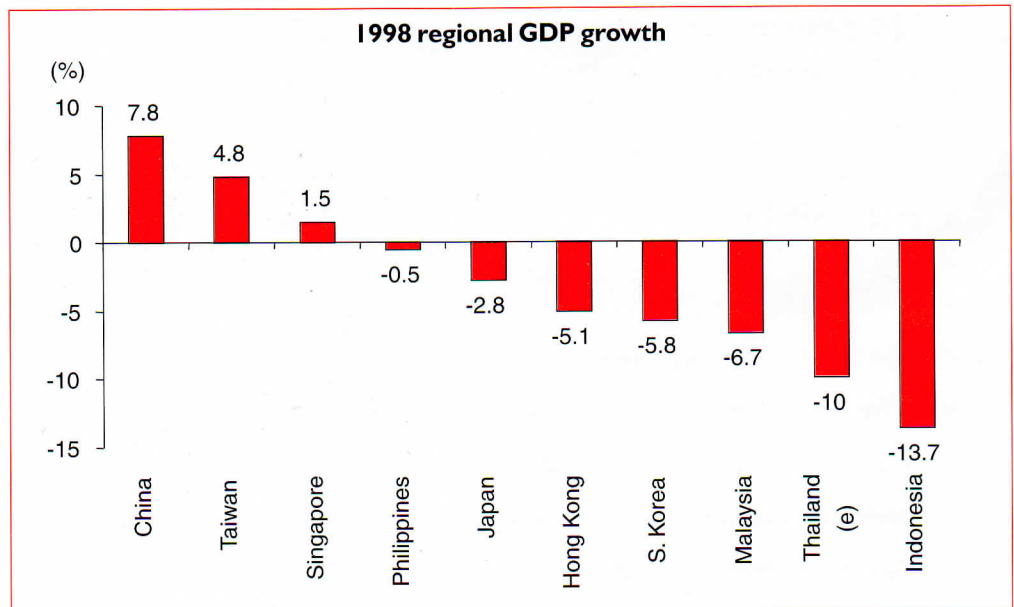
Taiwan's long-term economic growth has, of course, been among the world's highest. In modern times, it has never suffered negative growth.



Source: CEIC

*Even in the crunch, Taiwan held up impressively...*

Its performance during the recent Asian unpleasantness, particularly, has been impressive compared with its Asian neighbours. (China's superior growth rate in 1998 is almost all Keynesian stimulus, and masks very deep problems that Taiwan mostly does not share, in our view.)

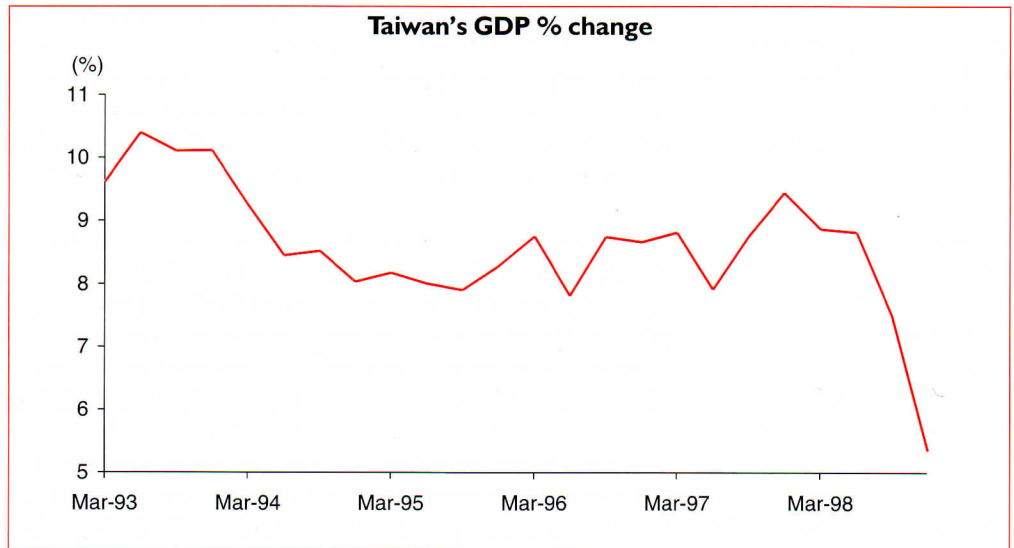


Source: CEIC, NIHK

... although Taiwan's Third World-style financial system had begged for a crisis

Prior to the turmoil, Taiwan's financial system had permitted companies and banks to leverage themselves on the implausible assumption that growth would continue forever at 6% or more.

However, from up close, the 1998 decline of growth was precipitous, and this was how 1998 looked to Taiwan financial institutions and big companies that had leveraged themselves on the assumption of continued rapid growth.



Source: CEIC

## The power of entrepreneurship

*Taiwan's success and failure both lie in its peculiar economic structure*

The reasons for Taiwan's relative success, and for its near-meltdown, lie in the peculiar structure of an economy that is a weird amalgam of Silicon Valley, Hong Kong, and Tokyo. The dynamic half of the real economy is dominated by relatively small, focused, family-controlled firms. Whereas in South Korea the centre of gravity and dynamism is the huge conglomerates like Hyundai, in Taiwan the core of the economy is dynamic smaller firms like Acer, the upstart computer manufacturer.

Amazingly, with a population of under 22m people, Taiwan in 1997 had 1,020,435 small and medium-size enterprises employing 7.2m workers, or 78.4% of Taiwan's workforce. They produce roughly half of all Taiwan's exports. Some 40-50,000 small and medium-sized enterprises start up each year.

The hi-tech segment of these firms predominantly supports the global computer industry. This segment specialises in breaking down the production of computer parts (including customised hi-tech chips) into small pieces and creating and managing production processes so as to minimise costs. In this way, the small economy of Taiwan has managed to capture dominant positions in many aspects of the global computer business and other high technology businesses.

This little island produces 60% of the world's personal computer (PC) hardware, 40% of the world's integrated circuit foundry services, and 25% of the world's independent integrated circuit packaging. It also provides an increasing variety of custom-designed chips for specialised purposes. Taiwan produced over 13m PCs in 1997. Two-thirds of the world's PC motherboards and 19 out of 20 of the world's scanners are produced in Taiwan.

Most of these global market shares are growing because Taiwan's hi-tech companies are way ahead of Singapore and Malaysia technologically, adjust faster and make cheaper products than US competitors, and lack the huge debt burden of Korean companies.<sup>1</sup> Taiwan's market share in computer parts is increasing, its strength in semiconductors is gaining on South Korea, and it is preparing a major surge in telecommunications.

*A little bit Silicon Valley, a little bit Hong Kong...*

The analogy to Silicon Valley is imperfect. Most Taiwan companies are not successful primarily through inventing new software or new scientific breakthroughs; their genius is predominantly process management and process innovation. But the spirit of fast-moving entrepreneurship is quite similar.

The second aspect of Taiwan's dynamic, small-firm economy is like a piece of Hong Kong. Taiwan companies produce a high proportion of the world's shoes, clothing, and much else. Originally, physical production was based in Taiwan, but as in Hong Kong, as local costs rose they have transferred their factories to China while retaining the ownership and most of the profits in Taiwan. Like their hi-tech counterparts, their competitive advantage has come from expertise in managing the physical production process, managing the costs, and managing in a mainland Chinese setting better than anybody else in the world. (Taiwan and Hong Kong have both been successful in China, but the Taiwan business culture is much more similar to China's than Hong Kong's business culture is. As such, Taiwan management teams seem to adapt much more rapidly to business conditions in China.)

<sup>1</sup> A Taiwan banker heavily involved in the electronics sector estimates that principal Korean producers are paying US\$2.50 per computer chip for bank interest costs.

Parenthetically, Taiwan has so far failed to compete with Hong Kong and Singapore as a major regional services and regional headquarters centre, despite much effort. Potential investors eventually discover that Taiwan's restrictions on doing business with China, together with its restrictive and backward financial system, would in all likelihood defeat the purposes of a regional headquarters. Among other things, such purposes usually include maintaining close relations with the biggest regional market (ordinarily China) and dealing with the most delicate and complex financial issues.

*...and lots of dynamic firms with clear market niches*

Those two kinds of dynamic firms have given Taiwan clear market niches, sustained by a highly educated population and particularly by an educational pinnacle that includes large numbers of the world's most highly trained scientists and engineers. Unlike Thailand, Malaysia, and Indonesia, Taiwan does not just produce me-too products using me-too technologies and processes.

An economy based on small firms possesses fundamental advantages in hard times. These small firms can sense market changes instantly and adapt quickly. This is the opposite of South Korea's structure, where a few giant conglomerates dominate the whole economy. (In South Korea, the top five conglomerates control close to half of the economy, whereas 140 conglomerates in Taiwan control that share.) Those huge conglomerates have advantages of scale when a market is booming or when a project, for instance building a Saudi Arabian port, requires huge scale, but they are relatively clumsy and slow to adapt when markets change or decline.

The economy of small firms is hyper-competitive, and the rapid changes of technology in the hi-tech sector, as well as quickly evolving changes of fashion in the low tech sector, inhibit the onset of oligopolies and cartels. Even compared with Hong Kong, where cartels are rampant, Taiwan has exceptionally competitive hi-tech and low-tech sectors.

Taiwan is probably best positioned to take advantage of the restructuring of Japanese companies. More and more of the Japanese giants are beginning to restructure in a desperate effort to get costs down, regain competitiveness, and become profitable in an era where the lack of the old easy money makes profits far more important than they ever were before. As these Japanese companies do so, they are likely to engage in a massive new wave of outsourcing. Taiwan's superior process engineering should be a major attraction. We believe crucial investment theme of Taiwan in the next several years will be who will capture the biggest outsourcing contracts.

*But the entrepreneurial structure has its risks*

The flip side of this entrepreneurial processing strength is that Taiwan's companies absorb much of the risk of technological or fashion change. When big US computer makers or shoe companies suddenly have to shift to radically new designs, they can do it more easily because they do not have to restructure internally. Instead, they can just stop ordering one kind of thing from their Taiwan suppliers and order something else from the same supplier or a different one. So far, this ability to absorb the risk has worked in favour of Taiwan firms, but one can imagine circumstances in which a massive technological change could put a strain on the technology sector.

Taiwan has a collection of politically connected industries and conglomerates that is a drag on development in the same way as their counterparts elsewhere in Asia. Taiwan has an advantage because these companies have typically been smaller, and collectively taken up a smaller share of the economy, than their peers elsewhere. However, Taiwan has in key areas been slower to liberalise than other Asian economies.

*Taiwan would be more dynamic if monopolies and protected companies are forced to compete*

For instance, the two terrestrial television stations, China Television Company and Chinese Television System, are owned by the ruling Kuomintang (KMT) and the armed forces respectively. Prior to July 1996, the regulator of telephones and the telephone monopoly was one and the same entity. The result was poor service, high costs, waiting lists, and low penetration rates. In 1996, Taiwan separated the regulator from the monopoly, and in 1998 the government issued cellular telephone licences to six consortia. (Taiwan was two years ahead of mainland China in separating regulation from operation, but far behind almost every other Asian country.) In just a few months, cellular penetration tripled from a derisory 6% to 18%.<sup>2</sup> (Hong Kong, with a similar demographic profile, has a 34% penetration rate.) To the extent that monopolies and protected companies are broken up or forced to compete, Taiwan's economy should become more dynamic.

As elsewhere, the break-up of monopolies and political connections carries both a short-term political price in lost income for powerful supporters as well as a development premium for the whole economy. Increasingly, however, there is also a political price for not liberalising, because the population is becoming conscious of the price of supporting favoured industries and the opposition Democratic Progressive Party (DPP) is making this a critical issue. Telecommunications could become one of the most reliable sources of economic growth and stock market performance in the next few years, and there are similar opportunities in other areas if the government adopts a reformist posture. This will likely be a major investment theme. On the other hand, there has been a recent trend to prop up favoured companies, and we see this as weakening Taiwan's long-run resilience.

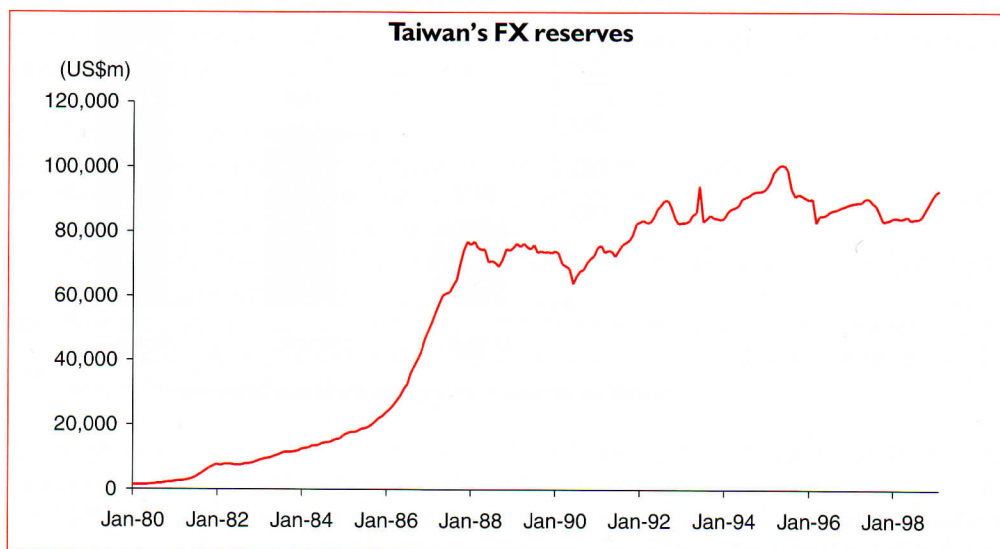
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<sup>2</sup> Information on Taiwan telecommunications has been drawn from a paper by our Greater China Telecom analyst Richard Ferguson.

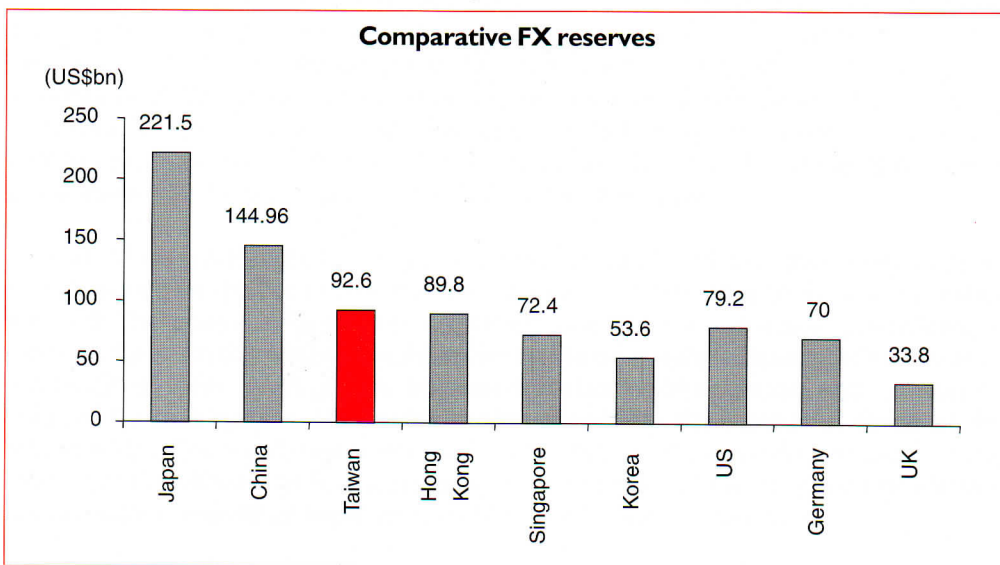
# A foundation of strong balance sheets

Taiwan also has a major financial advantage in its sovereign and corporate balance sheets

Aside from its economic structure, Taiwan has a major financial advantage compared with most other Asian countries. It has huge foreign exchange reserves (US\$92.6bn in February 1999) and negligible foreign debt (US\$50m — not billion — at the end of 1998; South Korea's was US\$151.5bn). In fact, Taiwan's foreign exchange reserves are the third largest in the world. Thus, the foreign debt crises of 1997-98 that hobbled Thailand, South Korea, and Indonesia simply cannot happen to Taiwan.



Source: CEIC

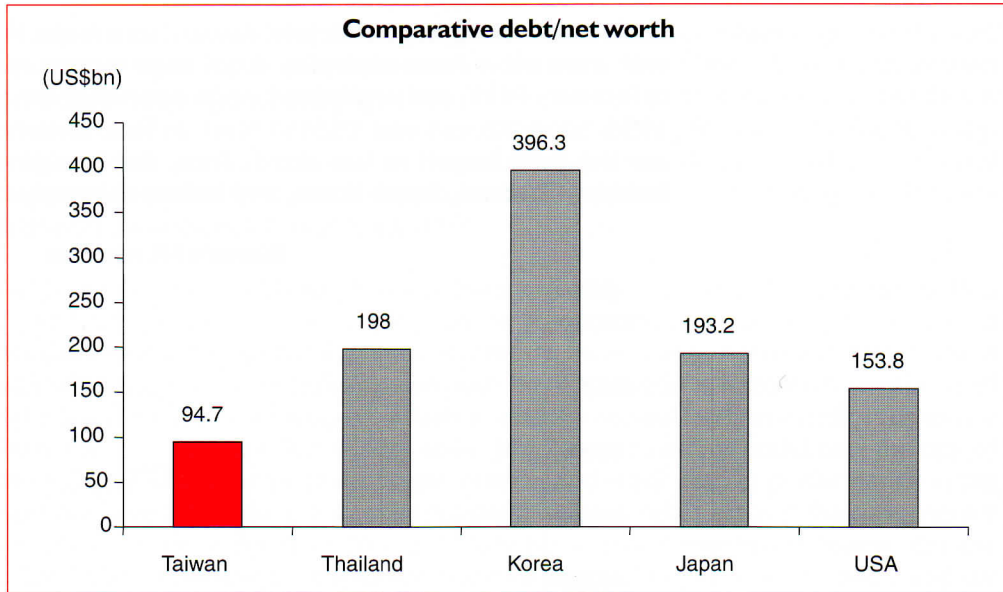


Source: CEIC, IMF - latest data



*Most dynamic small firms have minimal debts compared to their regional counterparts*

Moreover, this is not just true of the sovereign accounts. Most of the dynamic small firms have limited debt, very little of which is foreign; a typical smaller Taiwan company is 50% geared, and the average for all manufacturing firms was 94.7%. Pre-crisis Korean chaebol were usually 400% geared.



Source: Taiwan Council for Economic Planning & Development

# A victim of financial backwardness

Anthony LOK and William H. OVERHOLT

*Together with a politically coddled group of big firms, even an economy with enviable strengths like Taiwan can get into trouble*

How then can an economy with such enviable strengths get into trouble? Easily: by having a backward, politicised, financial system, together with a politically coddled group of big firms, which together work more like Tokyo than like Silicon Valley.

Taiwan's banking system started off as a pure socialist system. All the banks were owned and controlled by the government. This has changed gradually, but seven big banks, including the biggest three, are still owned by the government. The governing KMT owns 42% of the largest foreign exchange bank. The financial system now includes:

- Government-owned banks.
- Partially privatised (60%) but government-controlled banks.
- New (1991) private banks, of which some are in trouble and others controlled by construction and property groups.
- Community cooperatives of various kinds, most of which appear badly run and politically manipulated.
- A spreading network of venture capital firms that are financing smaller hi-tech companies in the manner of Silicon Valley — often as an offshoot of similar processes in Silicon Valley itself.

The venture capital network, although it comprises very small funds, is the part of Taiwan's financial system that is efficient and a competitive advantage for the economy. This part has no counterparts elsewhere in Asia. Singapore's financial structure is totally dominated by the government, and the local private sector is just too small to sustain a venture capital industry. Japan appears over-regulated. Hong Kong has a venture capital industry, but it is small by comparison because Hong Kong lacks a hi-tech sector and its regulatory system is structured to sustain the family-controlled firm. According to Taiwan's Council for Economic Planning and development, Taiwan had 111 venture capital companies with a cumulative US\$2bn in capital in October 1998. At the end of 1997, they had invested in 1,839 companies. In February 1999, a difficult month in a bad year for Taiwan's economy, there were 121 new venture capital-supported enterprises.

*Too many levers over the banks*

A maze of intricate regulations gives the government and the governing party so many levers over the banks that by all accounts the banks have to do whatever they are told. The power of government officials, and even of individual politicians, to force banks to do things they would prefer not to do parallels Japan's "administrative guidance" system, with all the bureaucratisation, politicisation and corruption entailed by that system. (A current controversy gives the flavour of some of the relationships. The legislature is demanding the details of the banks' non-performing loans, but the Ministry of Finance refuses, reportedly out of fear that such revelations would enable individual legislators to blackmail bank executives.)

In 1991, the government permitted 16 new banks to be established. This laudable effort to create more competition and a relatively more private system has, however, fostered other problems. Most of these banks are linked to major industrial groups, a link that fosters abuses everywhere. (Taiwan's bankers indicate that related-party lending is less severe than in many other Asian countries, but that it does occur, and that in southern Taiwan it is quite common for banks to make agreements of the form "I will lend to your companies if your bank will lend to mine.") The sudden influx of new banks that desperately needed customers led to a flood of cheap money for the bigger firms and, hence, to some of the kinds of excessive expansion and leverage that caused so much trouble elsewhere in Asia.

*Too many banks, in fact!*

Taiwan is overbanked with 40 local banks, 46 foreign banks and over 300 rural credit cooperatives, among others. This means low returns for the banks (average 1998 ROA of 0.6% and ROE of 7.9%), lack of economies of scale, lack of professionalism, and excessive complexity for supervisory authorities. In general, the banks lack adequate risk management systems and credit analysis. This weakness is exacerbated by a problem of the banks' biggest customers: although most of Taiwan's companies have very limited foreign exchange liabilities, many of the bigger companies (which are the banks' favoured customers) do have substantial foreign exchange exposure.

A combination of overbanking, political interference, and stock market speculation made Taiwan's larger companies financially vulnerable. These companies had loaded up on loans provided on very easy terms for a variety of reasons. Many are politically favoured. Many have connections to the owners of some of the private banks. And the private banks formed since 1991 have been desperate for customers, so they have competed to offer loans on generous terms to the bigger companies. The result of all this was a mini-version of the Asian bubble crisis, in which the availability of cheap loans bloated up certain sectors of Asian economies and made the companies exceptionally vulnerable to any downturn of economic growth or upturn of interest rates.

Like most Asian countries, Taiwan also has a real estate bubble, although it is much smaller than those in Thailand and Malaysia. Some of the real estate hangover dates all the way back to 1990, when the stock market collapsed from around 13,000 to around 2,000. (One of the reasons Taiwan has had a milder crunch in 1998 is that its big bubble had burst in 1990). Government easy money policies encouraged developers to overbuild. Many developers rushed to build so they could create a "performance record" to impress stock market investors. The Chung-Hua Institution for Economic Research estimates that about 100,000 housing units remain vacant, even though housing prices in Taipei have already dropped 40% and prices outside Taipei substantially more. (One of the greatest successes of the regime in Taipei, and a source of social stability is that 80% of Taiwan families own their housing, but this is a negative for real estate developers.)

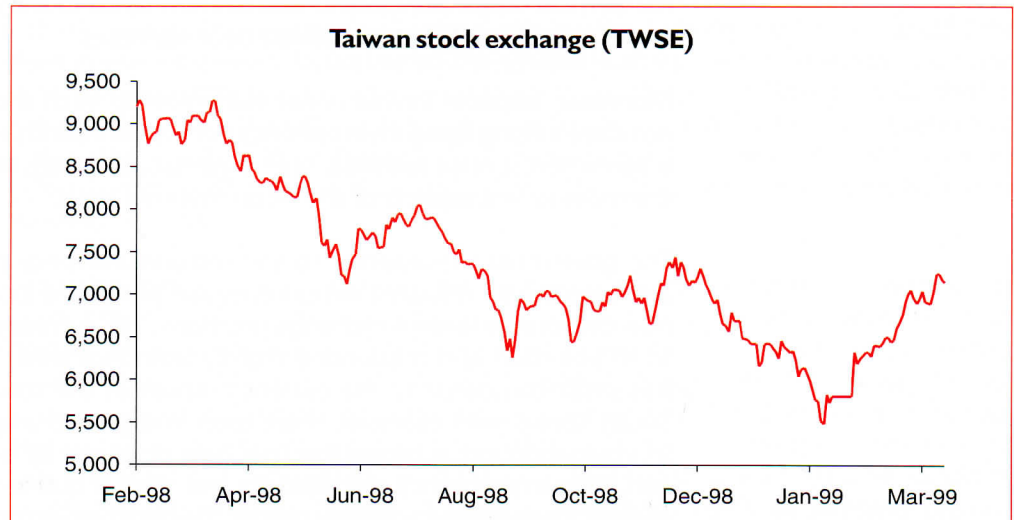
*And both banks and corporate customers are too heavily exposed to the stock market*

The banks are heavily exposed to the stock market, through their own stock market positions, through loans collateralised by stock, and through margin credit to customers. It is common for companies to engage in a kind of pyramid financial scheme: the company sets up subsidiaries whose primary purpose is to buy the company's stock. These subsidiaries buy large amount of the stock, relying heavily on margin credit from banks. This pushes the stock price very high. The company then borrows from the banks using its overvalued stock as collateral. The subsidiaries book high profits on the appreciation of the stock, and these profits become the basis for getting more outside buyers to acquire the stock. Knowledgeable businesspeople in Taiwan estimate that over 30% of listed companies engage in such schemes. Such practices compound quickly. Companies that do not engage in them risk being financially overwhelmed by competitors that do. Hence, there is a severe risk of creating the kind of bubble that inflated and then imploded with devastating effect in other Asian economies.

The banks' corporate customers are also heavily exposed. And Taiwan's stock market is largely a retail market, buoyed by margin buying to a far greater extent than is common elsewhere, so individuals and their banks are uncomfortably exposed in any decline. Hence, an economic decline quickly creates a vicious circle: firms get weaker, the stock market declines, and the effect of the stock market decline hits the banks both directly and by exacerbating the weakness of the banks' customers.

*Judgement year in 1998*

This is exactly what happened in 1998. Although a slowdown to just under 5% GDP growth would have been a triumph in most other Asian countries that year, incautious banking had allowed many of the most favoured companies to gear themselves to a degree that was only sustainable by growth of 6% or more — and to expose themselves so much to the stock market that they were vulnerable to any downturn. In the first two months of 1999, losses on stock investments at the big three banks came to NT\$448m (First Commercial Bank, 2802.TW, NT\$62.00, coverage pending), NT\$56m (Hua Nan Commercial Bank, 2803.TW, NT\$61.50, coverage pending) and NT\$666m (Chang Hwa Bank, 2801.TW, NT\$52.00, coverage pending).



Source: Bloomberg

In 1998 growth slowed, the stock market turned down, companies got into trouble (starting most notably with An-Feng Steel and half a dozen others in August), the banks demanded more cash to offset the falling value of their stock collateral, and companies frantically borrowed money to buy their own stock to prop up the value of their collateral. This further worsened the companies' debt problems. Lack of transparent balance sheets meant that the difficulties of a few companies created unnecessarily broad and deep anxiety about the situation of Taiwan companies in general; people stopped buying and banks stopped lending. In November 1998, Taichung Business Bank failed, as did Central Bills Finance and Hung Fu Bills Finance. Frightened banks were less willing to lend. The financial system was nearly knocked over by a domino effect.

*We expect reported NPLs to rise to 7-8% for 1999*

Banks' non-performing loans rose to 4.91% by February 1999, sharply up from 4.47% in December 1998 and about 4% at the end of 1997<sup>3</sup>. In all banking systems, the real level of NPLs turns out to be higher than such official reports because, for instance, some customers are bailed out by new loans from their bankers; this was true even in the US savings and loan crunch of the early 1980s, and Taiwan has a much less transparent system than the US. These reported NPLs include only unsecured NPLs, and Taiwan bankers say that the collateral on the secured loans often proves to be bad; adding in the secured NPLs would bring the NPLs up to around 5.4%. Bankers in Taiwan estimate that the real level of NPLs is 1.4 to 2 times the reported levels. We expect the reported levels to rise to 7-8% for 1999. This is quite modest compared with Asian crisis countries (Thai NPLs now hover around 50%) but substantially higher than those of Hong Kong and Singapore, which are much more transparent and range around 3% and 6% respectively.

<sup>3</sup>In Taiwan, a loan is classified non-performing if the principal has not been paid for more than six months, or the interest for more than three months. Unlike the situation in South-east Asian countries like Thailand, Taiwan's banks can and do foreclose on the assets of companies with non-performing loans, and they pursue such collections vigorously. In this aspect, Taiwan's financial system is much more developed and less ridden with cronyism.

*Misallocation of capital was made worse, cutting future growth rates*

Unlike the situation in many Asian countries, the issue in Taiwan is not that misallocation of funds could threaten the viability of the banking system. A long history of conservative financial management has left Taiwan with a limited national debt (23% of GDP) and huge foreign exchange reserves. The Ministry of Finance could simply bail out all the troubled companies and buy out all the banks' non-performing loans and still be in better financial shape than the vast majority of the world's economies. Instead, the problem is one of making an already serious misallocation of capital even worse and thus cutting future growth rates.

On 19 February 1999, the government announced a new set of measures focused on increasing the profitability of banks and thereby helping them to write off their non-performing loans. In particular, the measures sharply reduced banks' taxes and reserve requirements. A tax on interest revenue was cut from 5% to 2%, with the tax savings to be earmarked for writing off non-performing loans. The government calculates that over three years this will enable banks to write off NT\$300bn of the official total of NT\$700bn NPLs; the other NT\$400bn is already covered by banks' existing reserves.

By demonstrating that it would act to recapitalise the banking system, the government restored financial confidence. The authorities also reduced the stock market transaction tax (an important measure because turnover is very large), created tax incentives for hi-tech industries and reduced the transaction tax for issuing corporate bonds, and announced a government restructuring to reduce bureaucracy. In addition, a highly stimulative October 1998 budget, with a deficit (including subsequently-announced tax cuts) that came to 2.7% of GDP, began to boost the economy by the end of the first quarter of 1999. By bringing projects forward and increasing expenditure, the government added US\$38bn of public investments for 1999 and 2000. With this move, fiscal policy is pushing a statutory limit that restrains the deficit to 15% of total revenue. This budget was controversial in fiscally conservative Taiwan, but one that this historically frugal economy could easily afford.

*However, recent measures augur well...*

The government has also pointed to longer-term measures. Companies are being successfully pressed to divulge more to their banks, although not to the public. Regulators are speaking of the need for bank mergers. Clearly, Taiwan does not need so many banks. On the other hand, bankers express concern that small mismanaged banks will simply be consolidated into bigger mismanaged banks. It is much harder to lay off employees in Taiwan than in the US, and most Taiwan banks have similar rather than complementary business lines, so the potential cost savings from mergers are, they argue, much more limited. What everyone acknowledges to be beneficial is a gradual process whereby banks absorb cooperatives.

Fundamental reform of the banking system raises huge political issues, because control of the banking system is one of the ultimate sources of KMT power and patronage. The political problem of modernising the banking system has striking parallels in both Tokyo and Beijing. All three face the test of whether the governing parties are willing to modernise their financial systems at the cost of abandoning or modifying a hugely potent source of political influence. Money politics has become more important in recent years, and a campaign is now estimated to cost NT\$1.5bn so the pulls of politics and of financial modernisation are sharply opposite.

*...and results are beginning to kick in*

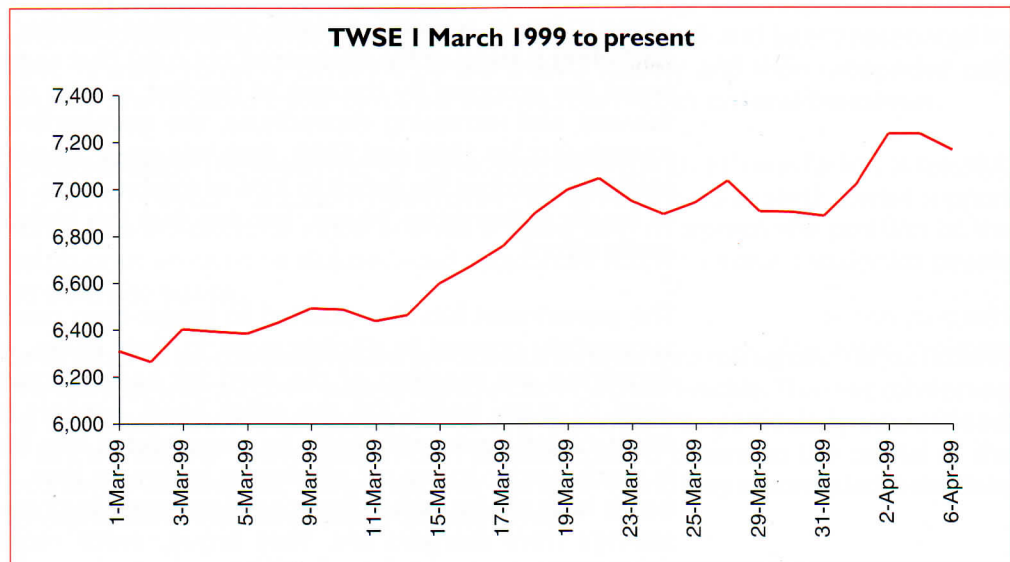
Notwithstanding the absence of persuasive long-term reforms, the short-term measures proved sufficient to restore financial confidence. They happily coincided with the glimmerings of a revival of the electronics export market and of growth in some of Taiwan's troubled neighbours. Exports for the first two months of the year rose 6.8% after a period of decline. Notably, exports of electronics rose 16% and exports to Japan increased 17.8%. Export orders for future delivery grew sharply. Industrial production rose 4.4% over the previous year — not a large number, but in

the right direction after a negative number in December. Leading indicators stabilised, and the business indicators improved. Consumer product inflation for the first two months was 1.2% — helpfully low, but avoiding the negative effects on consumption that a negative number would have implied. Wholesale price inflation, on the other hand, was minus 9%, helping Taiwan's export competitiveness. Unemployment dropped to 2.2% in February 1999.

*The signs are that Taiwan is coming out of its crunch before it really got into one*

Crucially, money supply, bank lending and deposits continue to grow. M2 money supply increased over 7% in both January and February — at the lower end of the government's target range of 6% to 11% but enough to support business growth. M1B (demand deposits plus passbook savings plus cash), the best correlate of stock market performance, turned positive in February (+3%) after being negative in January; it is noteworthy that this turnaround immediately preceded the stock market rebound. Bank loans grew 4.8% y-y in February and loans to private enterprises increased 6.8% , a low level but again sufficiently positive to sustain growth. Deposits grew 7% in February, with the loan-to-deposit ratio at 76% (compared with 83% in February 1998) indicating that the banks are being very conservative but still lending.

Renewed financial confidence and exports combined to lift the stock market<sup>4</sup>, which got many companies, individuals and bank portfolios out of a margin squeeze. Taiwan appeared to be coming out of its crunch almost before it had really got into one.



Source: Bloomberg

*It is noteworthy that hi-tech firms did not have difficulty raising funds even during the worst moments*

One particularly noteworthy aspect of Taiwan's performance during the crunch is that hi-tech firms did not have difficulty raising funds even during the worst moments. These companies fund themselves substantially through retained earnings, and the banks have continued to fund successful companies. Worldwide Semiconductor managed to sell a major rights offering. The credit crunch has focused on the conglomerates and the traditional sector. This means that Taiwan's leading edge has been able to fly forward into the future largely uninhibited by financial constraints, a huge advantage compared with its principal competitors.

<sup>4</sup> There has been no stock market stabilisation fund operating since Chinese New Year, so the market lift was not due to a government fund.

## Political factors

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*Another dimension to the country's resilience to the regional crisis*

In other Asian countries, the regional crisis has precipitated political struggles that in turn have created uncertainty about economic policies. For instance, in Indonesia and Malaysia, the financial crisis has accelerated succession struggles among factions that advocate very different economic policies. In Thailand, the opposition frantically opposes the most important economic reforms, and an elitist Senate delays or blocks critical government-sponsored reforms such as laws on creditors' rights and the ability of foreigners to own local businesses. In Japan, the political divide has exposed the leadership's inability to act decisively even in a crisis. Taiwan has not suffered from such problems, adding a political dimension to the country's resilience to the regional crisis: there is a clear succession and a consensus on critical areas of economic policy, with limited challenges in the areas outside the consensus.

As noted, Taiwan has a clean, democratic, generally accepted procedure for managing succession. The next president will be chosen on the basis of an election to be held next year, and although Taiwan's democracy dates back only about a decade there seems little chance of significant violence or economic disruption. As is common elsewhere, the government does tend to try to pump up the economy and the stock market during the run-up to an election.

Both major parties, the KMT and the DPP, as well as the splinter New Party, consider economic policy to be primarily a security issue. Unlike most other Asian countries, where the security fears of the Cold War era have largely evaporated and Cold War disciplines have evaporated too, concern about China still disciplines every aspect of economic policy in Taiwan. There is a consensus on maintaining huge foreign exchange reserves against a potential rainy day and on following disciplined, frugal budgets.

*Security concerns bridge the political divide in Taiwan's economic discussions*

Although the emergence of democracy has, as elsewhere, brought pressure to reduce the share of GDP going to taxes (once 22%, now 14%) and to increase welfare programmes, in every Taiwan discussion of these issues, security concerns hang in the background as an often unspoken but always potent influence. Unlike elsewhere in Asia, and indeed elsewhere in most of the world, the defining issues in Taiwan do not concern division of the economic pie but rather political power and China policy. There are no ideological divisions that would parallel the old differences, for instance, between Britain's Conservative Party under Margaret Thatcher and its Labour Party under Neil Kinnock. Voices for rapid increases in social spending are heard in the lower echelons of Taiwan's politics, but not at the top.

The DPP, which is the principal opposition party, does criticise the KMT's economic decisions. It criticises corruption. It lambasted the KMT for submitting a budget with a deficit of 2.1% of GDP and then later submitting tax cuts that increased the deficit to 2.7%. It complains about excessive intervention in the stock market and the housing market and excessive tax breaks for particular business groups. But these criticisms are at the margin; they are criticisms from inside the consensus, and they tend to instill more discipline rather than less. On broad economic policy, the DPP has abdicated, acknowledging that it lacks the experience and expertise to formulate a truly independent policy. As the DPP has become a moderate voice on China policy, it has become an eloquent voice about the problems of interest group influence and corruption, which by all accounts have become serious problems under the current administration.

Rather than facing instability because of escalating conflicts over economic policy in the manner of most of its neighbours, Taiwan's critical economic policy problem is that there is no urgent, organised force for financial reform. This, too, derives from security concerns. The DPP's acknowledgment that expertise matters is far from universal in Third World policy debates, and the feeling that one must have expertise

and not rock the boat without it, derives ultimately from security concerns. Universal public acknowledgment that the KMT does have great expertise, and that its expertise saved Taiwan from communism, is a central (and accurate) unspoken assumption behind virtually every policy debate.

*Taiwan's potential could  
be realised with  
financial reform*

On balance, Taiwan appears fine. It is creditworthy. It is coming out of the Asian crisis faster than anyone else, and indeed never entered the crisis in the same sense that other Asian countries did — no recession, no banking collapse. But much of its potential will be unrealised unless there is financial reform. The severity of the problem is suggested by comments that leading Taiwan bankers make about what should be done. One suggested nationalising all the private and partially-private banks and selling them off quickly to investors unrelated to both the government and the big private companies. Another said sardonically that Taiwan needs a colonial power, like Britain in pre-1997 Hong Kong, to come in and separate banks, along with the insurance companies and major brokerages, from political and corporate interference. A more sober voice, from outside the financial industry and therefore less driven by frustration, suggested that if the government would just enforce existing laws rigorously, the system would be reformed very quickly. However, there are powerful political inhibitions against strict enforcement.



## The China equation

*A misguided view of Taiwan and its relationship with China*

In the Western press, particularly in US newspapers and in US Congressional commentary, there is a familiar view of Taiwan's relations with the mainland: the people of Taiwan crave independence. The opposition DPP strongly advocates independence, and its coming to power would precipitate a crisis with China. For its part, China is increasingly aggressive and militaristic towards Taiwan as shown by its missile-throwing in 1996. Following the recovery of Hong Kong in 1997 and the forthcoming recovery of Macau in December 1999, Chinese President Jiang Zemin is anxious to recover Taiwan during his tenure; he has set a timetable for doing so and for this purpose is frantically building up military forces, including a sudden huge increase in missiles opposite Taiwan. Over in Taiwan, President Lee Teng-hui is caught between these forces and is bravely standing up for his beleaguered Republic of China.

The remarkable thing about this widely-held view is that very little of it is true. Public opinion polls show that while the people in Taiwan have a horror of being swallowed by communism<sup>5</sup>, and while those in Taiwan who have a direct attachment to the mainland have gradually died off, a clear majority has always opposed declaring independence and still does. Voters in the December 1998 parliamentary election delivered major defeats both to the New Party, which advocates greater efforts to achieve unification with the mainland and to the leading candidate of the DPP, Taipei mayor Chen Shui-bian, who once was outspoken in advocating moves in the direction of independence. The opposition DPP, as it has come closer and closer to sharing real power, has gradually moved towards the centre of gravity of public opinion; while it has not altered its original pro-independence written charter, current leaders support the status quo.

*Both the governing KMT and opposition DPP support the status quo*

The lead towards accepting the status quo was provided by the DPP's previous chairman, Mr Hsu Hsin Liang, and has now been substantially followed by Chen Shui-bian. They bridge the gap between the original charter and their current stance, on those rare occasions when it is necessary to do so, by saying that Taiwan already has real independence and therefore the important thing is to defend what they already have. A declaration of independence, most of them acknowledge, would be a sure way to jeopardise what they currently have. Moreover, DPP officials have been vigorous in advocating closer economic ties with the mainland — a crucial issue for their Taiwanese business political base.

Similarly, the governing KMT has gradually moved over many years from a position that it is the sole legitimate government of China to the position that it is one of two governments of China; as with the DPP, the core of the party leadership effectively endorses the status quo. This move has led to the formation of the splinter New Party, which feels more strongly about eventual unification, but the New Party's electoral support is minimal. In short, while there are still differences of emotion and rhetoric, for all practical purposes the leaderships of the two major parties have converged on a consensus supporting the status quo.

In short, a vital shift has occurred in Taiwan politics. On the China issues, the KMT has moved out from under its leader to a position of even greater moderation than in the past. The DPP has shifted from being primarily a party of independence to primarily a party demanding clean government and serving as an advocacy channel on local issues. The New Party has largely abandoned its advocacy of early efforts toward reunification and in any case its weak electoral base is getting weaker. The leadership consensus of the parties reflects opinion and reality for the Taiwan public. Life in Taiwan is very comfortable, and one must search very hard to

<sup>5</sup>78% of those polled in a southern city of Taiwan in 1998 opposed rule by Beijing: "China Blasts Taiwan for Playing Democracy Card," Reuters News Service, 16 December 1998

find anyone who yearns to die for independence; Taiwan is not Kosovo and it is not East Timor. The centre of gravity of Taiwan public opinion prefers the DPP stance on relations between politics and business (less corruption, less interest group influence) and the faction of the KMT (led by James Soong) that is most reassuring about supporting the status quo in relations with China.

*Even China has a consensus on moderate policy...*

China too has a consensus on moderate policy. In September 1981, it invented the policy of "one country, two systems," advocating that Taiwan and the mainland acknowledge their formal unity under Beijing but promising that Taiwan could retain its current political system, its current economic system, all its current leaders, and even its armed forces. That has been Beijing's policy ever since. In effect, Beijing endorses the status quo except for the flag. When Taipei rejected "one country, two systems," Beijing offered it to Hong Kong the following year, 1982, and has kept all its promises to Hong Kong while repeatedly urging people in Taiwan to watch how it keeps its promises.

While China is quite capable of building up military forces capable of attacking Taiwan, it has not done so. It has not sought the kinds of military aircraft, navy ships, or transport that would make an attack on Taiwan feasible. It has only a few dozen modern jet fighters, a negligible blue water navy, and virtually no modern tanks. In all these aspects, Taiwan's forces remain markedly superior. In fact, Taiwan is so saturated with modern military equipment that, despite its pre-eminence in the modern hi-tech economy, it would take Taiwan five years to train personnel and adjust its systems to use all the hi-tech forces it already has<sup>6</sup>. It is true that there has been a very gradual modernisation of all of China's military forces, including its missile forces, but there has been no sudden or recent change in this gradual build-up. And the build-up itself has been remarkably moderate; the share of the Chinese economy devoted to the military has steadily declined for two decades<sup>7</sup>.

*...based on gradual seduction over a long period of time*

China's policy is one of gradual seduction over a long period of time. Beijing believes that gradual economic integration and increasing social exchange will increasingly tie the two together. The success of Hong Kong's "one country, two systems" policy will gradually, according to this theory, diminish Taiwanese fears about Beijing's sincerity, and the mainland's rapid development of economic prosperity, modern institutions, and the rule of law will make the mainland and Taiwan much more socially compatible than in the previous era of flaming Maoist ideology, mutual isolation, mainland backwardness, and a generation of leaders like Chiang Kaishek and Mao Zedong who were determined to fight each other to the death.

China does want to make progress, keeps pushing for negotiations, and demands that negotiations address the political relationship. While it commits informally to a policy of peaceful seduction, it does reserve the right to use force if Taipei were to declare independence; in Beijing's view, this is no different from Abraham Lincoln's attitude toward secession by the southern United States. Lincoln wanted peace but reserved the right to use force in a pinch. Currently, China is going through a desperate economic squeeze, and the regime will likely stand or fall based on the economic success or failure of the next few years. A Beijing-initiated military conflict over Taiwan would ensure a strong international reaction and that, in turn, would ensure economic failure and collapse of the regime. There is no leader in Beijing who misunderstands that.

<sup>6</sup> Oxford Analytica, "Taiwan Missile Defences," reprinted by Reuters News Service electronically, 18 February 1998.

<sup>7</sup> Readers of the Western press would find it almost impossible to know this. By unspoken and often unconscious convention, Western press accounts of Chinese economic growth always present real growth, after inflation has been removed, but military budgets are virtually always presented in the form of nominal growth, with inflation left in. Since China had substantial inflation prior to the last few years, ranging up to 22% in 1992, the resulting accounts, which generally have headlined the theme of "China has doubled military spending in only a few years," provide a spectacularly distorted picture. There is no substantial difference between the coverage of this subject provided by a newspaper of record like *The New York Times* and the tabloid press.

Taiwan's ties to the mainland are very extensive. Some 30,000 Taiwan firms operate on the mainland, with US\$18bn of trade between the two and huge trade between Taiwan firms operating on the mainland and the rest of the world. These firms have invested a cumulative US\$30bn in the mainland according to official Taiwan statistics and double that according to some unofficial estimates.

*Taiwan had put the status quo at risk in the mid-1990s...*

Initiatives that put the status quo at risk have in fact come primarily from Taiwan's President Lee and from Congressional initiatives in Washington DC. In the mid-1990s, President Lee mounted a drive for increasing recognition that focused on an effort to use nominally informal personal visits and large doses of economic incentives to upgrade Taiwan's international status. Large economic contracts and favours were dangled before various small countries. A presidential visit was billed as a purely personal vacation prior to the visit and then trumpeted as a presidential breakthrough afterward. Initially, this approach succeeded only in a small number of very small countries. But then it suddenly came to fruition in the most powerful country of them all, the United States.

A large donation was made to Cornell University, soon followed by an announcement that President Lee would accept an invitation from Cornell to visit the university where he had obtained his highest degree, purely as an alumnus. This was accompanied by a very expensive lobbying campaign in Washington and by Congressional talk of upgrading Taiwan's status, advocacy of re-admitting Taiwan to the United Nations, and even by a special Senate invitation to Madam Chiang Kaishek. (Simultaneously, there was much threatening talk about Tibet and Hong Kong, the other sore spots on China's anatomy, and the view spread in Beijing that powerful forces in the US were determined to dismantle China.) Prominent Republicans like Newt Gingrich, the famously outspoken new Speaker of the House, spoke eloquently of the need to treat Taiwan better. As with such "private" visits elsewhere, as soon as the visit to Cornell actually occurred, accompanied by effusive shows of support from leading US members of Congress, Taiwan trumpeted it globally as a great diplomatic breakthrough.

*...by dragging the US into the picture...*

All of this appeared to Beijing, and to administration China specialists, as being on the verge of repudiating the basic Sino-US deal — supported by Presidents Nixon, Ford, Carter, Reagan, Bush, and Clinton — to deprive Taiwan of formal recognition in return for Beijing's pursuit of a policy of peaceful seduction. (The US always made clear its determination to ensure that any reunification would occur peacefully and without depriving the Taiwan people of any of their freedoms.) Many solidly patriotic US believers in the original 1972 and 1979 deals that stabilised Sino-US relations were frightened by this new push to upgrade relations with Taiwan. Most notably, Henry Kissinger intervened with Newt Gingrich to persuade him to tone down the rhetoric. In fact, the administration initially promised China that it would not grant President Lee a visa but then, under Congressional pressure, suddenly reversed itself.

Beijing protested diplomatically, then openly, but nobody was listening. So Beijing decided that it required dramatic means to get the attention of the other side. The attention-getting means comprised a military build-up, naval manoeuvres, and the flinging of missiles into the water off the coast of Taiwan. This convinced a good many of the world's journalists and politicians that China was preparing to invade Taiwan. It did not convince senior US military officers that there was any such intention. They noted that at no time did Beijing assemble anything like a force that could actually attack Taiwan. Beijing scrupulously avoided ever having a single ship cross the median line of the Taiwan Strait dividing Taiwan from the mainland. Every scrupulous military officer could read such signals that this was a diplomatic event using military means, not an imminent attack. But that was not clear to foreign journalists and politicians and it was not clear to the people of Taiwan.

*...and getting a dramatic response from Beijing*

If Beijing had stopped a week earlier and kept the missiles falling far out to sea, the signalling might well have achieved its goal without serious negative consequences. But the mainland leaders were too cut off from public opinion in both the US and Taiwan to get the balance right. The missiles got uncomfortably close Taiwan's great port of Kaohsiung and US military and China experts shifted radically against Beijing. In went a US carrier task force to reassure Taiwan. Both sides, shocked at the escalation, backed away from confrontation and sought a way to restore the old peaceful equilibrium.

Realisation that fiddling with the old deal could bring the world's two largest powers to the brink of confrontation shocked the new ideological Congressmen of both right and left, and they toned down. It shocked the administration, which began actively seeking a way to lock in a peaceful relationship with China. And Beijing, equally sobered by the US carrier task force, redoubled efforts to develop a solid working relationship with Washington. These efforts led to Clinton's trip to China, President Jiang's trip to the US, and the Clinton administration's articulation of the idea of "strategic partnership" with China. Many China experts and foreign policy officials in Washington and elsewhere adopted the unspoken view that President Lee, although he runs a democratic, prosperous society that is widely admired, had become a trouble maker. When President Clinton visited Beijing, he explicitly endorsed the "Three No's", including "No support for Taiwan independence."

In Taiwan itself, President Lee, though still feisty, seemed to run out of new initiatives that would upset the equilibrium. More importantly, it became clear that both the KMT and the DPP leaderships were much more supportive of the status quo than President Lee. For some time, the image of President Lee as a beleaguered figure caught between Beijing's pressures for early reunification and local demands for more independent status has been completely false. As noted, there is an emerging core consensus among the KMT and DPP leaderships about the importance of preserving the political status quo in the relationship with China. The most important supporters of both also want greater economic and social ties with China. President Lee and his immediate entourage now stand outside this consensus. Most people in Taiwan identify President Lee as more "splittist" than other leaders. There is virtually unanimous agreement in Taiwan that any of the four principal candidates to succeed President Lee (two KMT candidates, two from the DPP) would take a much more moderate approach to relations with the mainland than President Lee has.

Hence, the Beijing-Taipei-Washington triangle was restored to peaceful equilibrium, and that equilibrium was due to be reinforced by the coming departure of President Lee. Or so it seemed. But no sooner was the equilibrium restored than new disturbances developed.

*The new initiative from the US is not directed at China, but provocative North Korea*

**Theatre Missile Defence (TMD).** The new risk to the equilibrium comes from the idea of incorporating Taiwan into a system of theatre missile defence. Washington proposes a system of anti-missiles to defend its friends against missile attacks. Friends of Taiwan want to incorporate Taiwan into the system. Most people on Taiwan say, well, if it would help us defend ourselves, why not? But this proposal has the potential to create a much bigger crisis than the 1995-96 confrontation.

Washington's intentions in creating a TMD system are not directed at China. The problem is North Korea, which has been testing missiles by shooting them over Japan; the undiplomatic way it has done so may even be deliberately threatening. North Korea is famously provocative and irresponsible and is potentially a nuclear power. It has successfully used the threat of becoming a nuclear power to blackmail the US, Japan, and South Korea out of billions of dollars of concessions, and it might well be tempted to use actual nuclear capability to blackmail these allies out of much, much more. The US needs to counter the actual military threat and to reassure South Korea and Japan. If Japan becomes convinced that the US cannot adequately protect Japanese interests, it is likely to engage in a great military build-

up. This, in turn, might well start an arms race with China and destabilise big power relations in Asia. So the US intention in proposing a TMD system is benign and at this level ultimately could serve China's interests in stable big power relationships.

*Taiwan's striving to be included in the defence system is bound to elicit another reaction from China*

Taiwan's friends in the US Congress and elsewhere think that if the main US allies in Asia are to be defended in this way, then Taiwan should be included too. In justification, some of them have highlighted the increasing numbers of Chinese missiles along the coast. The more extreme have alleged a Chinese intention to take Taiwan militarily and a Jiang Zemin timetable for capturing Taiwan; there is no evidence whatsoever of these and a great deal of evidence that China sees such a strategy as completely contrary to its interests. US military experts say that any increase in Chinese missiles has been very gradual and a natural outgrowth of China's increasing economic prowess. There is no evidence of any change in strategy or any aggressive intention. China continues to lack the ability to forcefully seize Taiwan, and it continues to have the ability to disrupt Taiwan by interfering militarily with its trade; strategically, neither of these things has changed in a generation and the missiles are just the latest footnote to those strategic realities.

For China, the proposal to include Taiwan in a missile defence system constitutes a far more fundamental break in its 1972/1979 deal with Washington than did the Taiwan diplomatic offensive of 1995-96. The key strategic element of that deal was the removal of Taiwan from the US military alliance system. The US formally severed its military alliance with Taiwan and removed its troops from the island — while continuing to demonstrate its determination that the Taiwan issue must be dealt with peacefully. What TMD would do is to incorporate Taiwan explicitly into a regional military network that would include all the major forces which are potentially hostile to China. That total reversal of the strategic gains of the past generation is bound to elicit an explosive reaction from China.

*The excitement is coming out of Washington, not Taipei, and out of politicians, not military experts*

Taiwan's experts see the military aspects essentially the same way as the US professionals. Taiwan's leading analysts there see no significant change in China's strategy and are not quaking in fear of a Chinese missile offensive. They do not believe China has set a timetable for reunification. The excitement is coming out of Washington, not Taipei, and out of politicians, not military experts. The idea of having a defence against Chinese missiles is inherently attractive. But this particular system is likely to be very expensive, and there is at best conflicting evidence that it will be possible technologically to create an effective defence against missiles coming from the Chinese coast a mere 90 miles away.

To Taiwan's politicians, there is a different calculation. Most simply think it would be nice to have all defences available; the strongest supporters of TMD are in the DPP, which tends to assume that having such nice defences would lock in the status quo. Some ruling party politicians understand, though, that missile defence is what US political strategists would call a wedge issue. Locking the US into a formal military alliance system, thereby enraging Beijing and creating a Beijing-Washington confrontation, could polarise relations between Washington and Beijing for the indefinite future, handing Taipei the biggest diplomatic victory of the modern age. (This assumes of course that the ensuing confrontation gets sorted out in some way satisfactory to Taipei; in reality, one cannot rule out the possibility of military hostilities or the possibility that the confrontation would backfire worse than President Lee's 1995-96 offensive did. Aside from precipitating a closer US relationship with Beijing, that offensive led elsewhere to the loss of diplomatic recognition by the last of the big countries that previously recognised Taipei.)

*A risky period for Sino-US relations*

In the event, the emergence of the TMD issue coincides with other events that create a risky period for Sino-US relations. China is under immense economic strain, with the two-decade-long reform process entering a life-or-death phase. The US is reacting very negatively to a huge trade imbalance. A scandal over alleged nuclear spying has created an anti-China fever. And with the year 2000 presidential elections looming, Congressional Republicans are using China policy against Clinton in the same demagogic way that Clinton used China policy against Bush. To some extent this is a seasonal phenomenon, but there is always the risk that it can get out of control; only a few years ago, a drive to deprive China of most-favoured-nation status nearly plunged the relationship into a new Cold War.

It is unclear how the TMD issue will evolve, but the potential for a confrontation much bigger than the 1995-96 one means that it will behoove investors to learn more about the theatre missile defence proposals than they ever wanted to know.

## Risks to the recovery

*A crisis with China over the TMD poses a risk to our forecast*

Our forecast is for above-consensus growth and for politics both in Taiwan and with Beijing that support recovery. We believe that gradual recovery in nearby Asian economies will support increased growth in Taiwan. There are, however, significant risks to this forecast. One, which has been elaborated at considerable length, is a crisis with China over some formal incorporation of Taiwan into a US-Japan TMD system.

*KMT disunity leading to a DPP victory could elicit a strong Chinese reaction*

Another Beijing-related risk derives from domestic Taiwan politics. KMT disunity could conceivably lead to a DPP victory in the presidential election next year and that, in turn, could elicit a strong Chinese reaction. Both parts of this scenario are low probability, but it is nonetheless worth watching. The DPP cannot win in the absence of a KMT split. But the KMT could split. The most popular KMT candidate would likely be James Soong, the former provincial governor of Taiwan. President Lee, who favours his protégé Lien Chan, abolished the provincial government and left Soong out of a job; he regards Soong as an impatient upstart who should wait his turn until the older generation has enjoyed the jobs. Both he and Soong currently oppose a compromise that would run Soong as the candidate for vice-president under Chan. If this conflict were to split the party and open the way for a DPP president, Beijing's reaction would be negative. However, even then, there would be some chance of a rapprochement based on the DPP's moderation of its position on relations with the mainland.

*Much more serious risk is in a US economic downturn*

A much more serious risk is a sharp downturn in the US economy, possibly precipitated by an interest rate rise and a New York stock market collapse. Market interest rates are in fact rising in the US and a decision by the Federal Reserve to formally raise interest rates could cause major changes. Like other Asian economies, Taiwan can only recover if US growth remains strong over the next year.

*China's economic health is also vital to Taiwan*

Taiwan's economic relations with mainland China are important to Taiwan. Virtually all of mainland China's growth in 1999 is coming from fiscal stimulus, and virtually all of it comes from state enterprises building infrastructure projects. This is a kind of growth that is unhelpful to Taiwan and Hong Kong, which benefit primarily from the growth of smaller, non-state enterprises and from foreign trade growth. These helpful kinds of growth have gone negative in 1999. Exports are crucial to Taiwan's growth, and 18% of those exports go to the mainland, generating a trade surplus of about NT\$10bn with the mainland in 1998. The exposure of Taiwan's banks and corporations to China is far greater than any of the official statistics would indicate; every informed observer emphasises that Taiwan companies borrow heavily for secret investments in the mainland and maintain large illegal mainland investments with large unreported streams of revenue; one reason why credit in Taiwan is such a huge percentage of GDP (170-180%) is that a lot of the credit is actually used for purposes that get accounted in the mainland's GDP, not in Taiwan's. When the mainland economy is healthy, that is reassuring, but the mainland's economy is currently the least healthy it has been in two decades. A major downturn on the mainland, which we do not expect but which is hardly impossible, would be discouraging for Taiwan's economy and stock market.

*Taiwan's weak financial system remains a major risk*

Finally, the most important risks derive from the stock market/bank pyramid schemes noted in page 10 in the section on Taiwan's weak financial system. If not checked decisively, such schemes always grow eventually to a magnitude that leads to implosion. Given the lack of transparency, it is impossible to know just how big the problem is. Frantic government efforts to prop up the stock market testify to the urgency that the government sees in the problem; transactions of this kind are a major source of turnover for much of the brokerage community. At this time, the economy and market seem to have passed through the squeeze and to be on the way to recovery. But there is always a risk in what one knows to be there but cannot see clearly.

# Detailed economic forecast

Kevin CHAN and Silvia LIU

*Quarterly real GDP growth is expected to accelerate from 3.7% to 5.5%*

We expect the Taiwan economy to see strong economic growth, low inflation, low interest rates and stable exchange rate in the next 12 months.

Following a year of consolidation with falling exports and slower domestic demand growth, we believe the Taiwan economy should recover this year. We expect real GDP growth to rise from 1998's 4.8% to 5.1% in 1999, and to 5.6% in 2000, on the back of a better-than-expected outlook of IT-related exports, completion of inventory adjustments, a stable exchange rate and expansionary monetary policy. Although the acceleration in annual growth appears to be modest, economic growth is expected to pick up sharply from 4Q98's eight-year-low of 3.7% y-y to above 5.5% in 2H99.

*Inflation should remain low*

Meanwhile, inflation is expected to stay low, given modest wage growth and abating imported inflationary pressures as a result of the NT dollar depreciation. With core inflationary pressures remaining soft, we expect CPI inflation to fall to 1.0% in 1999 from 1.7% in 1998. The recent pick-up in global commodity prices is only expected to impact Taiwan's inflation in 2000, with CPI inflation forecast to rebound to 1.6%.

*Stable NT dollar/US dollar rate seen, despite a strong yen*

On the foreign exchange front, we expect the NT dollar to fluctuate narrowly around the current level of NT\$33:US\$1; we are looking at the yen remaining largely stable at around ¥115:US\$1. Despite a strong yen, the Central Bank of China (CBC) is unlikely to allow the NT dollar to appreciate sharply in order to help exports recover.

*We believe the central bank should keep monetary policy loose*

Against a backdrop of low inflationary pressures, the combination of a strong yen and a stable NT dollar/US dollar exchange rate implies rising liquidity domestically, as the CBC will need to increase NT dollar money supply to prevent the currency from appreciating. Fundamentally, we believe a loose monetary policy is needed in order to facilitate the economic recovery as well as to help restructure the banking system recovering from a mini crisis.

## Forecast summary

	1994	1995	1996	1997	1998	1999F	2000F
<b>Activity</b>							
Real GDP (y-y %)	6.5	6.0	5.7	6.8	4.8	5.1	5.6
Private consumption (y-y %)	8.6	5.5	6.2	7.7	7.0	6.0	6.5
Private investment (y-y %)	5.7	5.5	2.4	10.0	7.5	4.7	5.7
Government expenditure (y-y %)	-1.2	1.3	5.2	5.8	3.1	5.0	4.5
Industrial production (y-y %)	6.7	4.2	1.5	6.3	4.9	5.5	5.2
Unemployment rate (%)	1.6	1.8	2.6	2.4	2.7	2.5	2.3
Nominal GDP (US\$bn)	241	260	272	281	262	277	302
GDP per capita (US\$)	11,426	12,209	12,690	12,958	11,970	12,546	13,520
<b>Prices</b>							
CPI (y-y%)	4.1	3.7	3.1	0.9	1.7	1.0	1.6
<b>External balance</b>							
Exports (BoP, y-y)	9.4	19.9	3.8	5.4	-9.5	5.5	6.0
Imports (BoP, y-y)	10.4	21.2	-0.1	9.6	-7.0	6.0	7.5
Trade balance (BoP, US\$bn)	11.8	13.2	17.6	14.4	10.4	10.4	9.5
Current account balance (US\$bn)	6.5	5.5	11.0	7.7	3.5	3.5	3.0
Current account balance (% of GDP)	2.7	2.1	4.0	2.7	1.3	1.3	1.0
Foreign exchange reserves (US\$bn)	92.5	90.3	88.0	83.5	90.3	92.5	95.0
<b>Interest &amp; exchange rates</b>							
M2 (y-y %, year end)	15.1	9.4	9.1	8.0	8.6	9.5	9.5
Overnight rate (% , year-end)	8.0	6.8	5.5	7.9	5.6	4.0	4.5
NT dollar/US dollar rate (year-end)	26.4	27.3	27.5	33.0	32.0	33.5	30.0

Sources: CEIC Data and Nomura International



*Moderating private consumption and investment growth*

Before we explain our bullish stance on the Taiwan economy, an analysis of the weaker spots of the economy in 1999 is in order. Despite our expectation of recovering exports and low real interest rates, domestic demand should see a moderate slowdown, especially in 1H99. Private consumption growth should ease to 6.0% in 1999 from the 7.0% growth in 1998 (ie, similar to that of the pre-1997 boom), reflecting falling wage growth and negative wealth effect stemming from the decline in the Taiwan Stock Exchange Index in 2H98. However, consumption is likely to pick up in 2H99 as labour market conditions are likely to improve with rising exports, and the impact of monetary expansion will likely feed through to the economy.

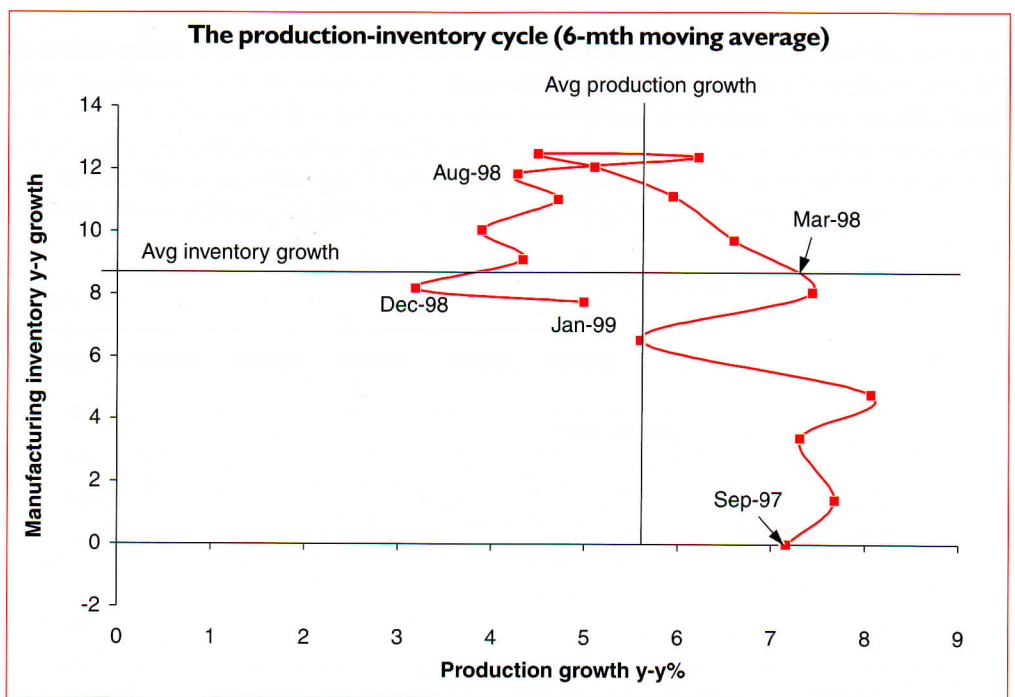
Investment growth is expected to slow down too. First, a one-off rise in military goods imports in 1998 boosted investment growth by approximately 1.5 to 2.0 percentage points. Assuming this does not recur in 1999, investment growth should fall in 1999. Private investment should stay weak until clear signs of a better export performance emerge by mid-1999. In addition, the trouble in the banking sector in 1Q99 could also have a temporary impact on public confidence, which could delay corporate investment decisions. Nonetheless, investments should pick up in 2H99, helped by improving export orders as well as low interest rates.

*Completion of inventory adjustments*

One of the key reasons for our bullish view on the Taiwan economy is the completion of its inventory adjustments. True, the depletion in inventory helped to cause a sharp slowdown in Taiwan's GDP growth in 1998, knocking off around 0.5% of GDP growth. However, the need to replenish inventory in 1999, in the face of relatively resilient US IT-related demand, should trigger a recovery in manufacturing production this year.

*The Production-Inventory Cycle*

We believe that inventory adjustments are best demonstrated by the Production-Inventory Cycle chart below. The horizontal axis in the diagram plots industrial production growth and the vertical axis depicts manufacturing inventory growth. To minimise distortions from seasonal factors, data used since January 1995 are shown as a six-month moving average. In Quadrant I, both production and inventory are rising faster than average, while the reverse is true in Quadrant III. In Quadrant II, production is accelerating but inventory growth is slowing, whereas Quadrant IV implies the opposite.



Source: CEIC and Nomura International

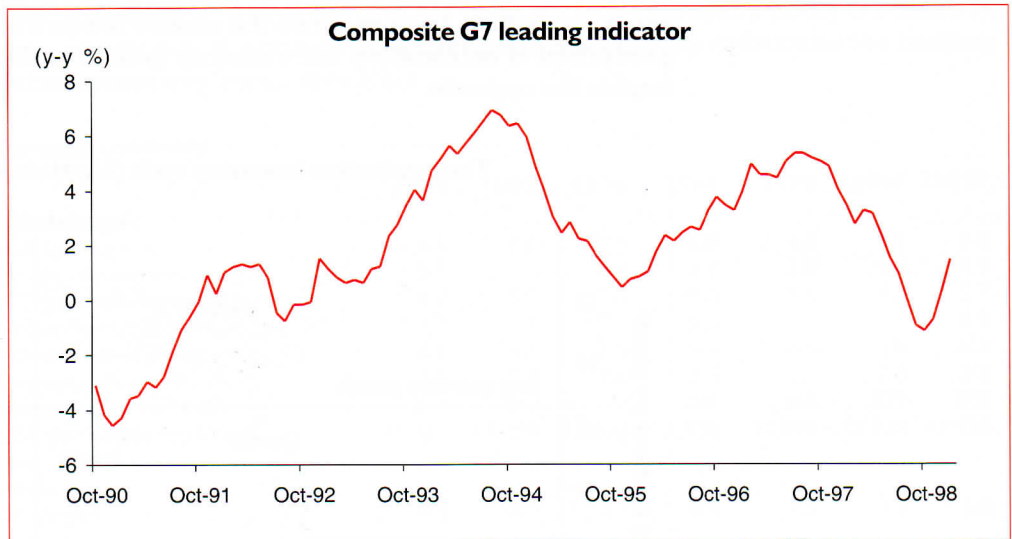
*Rising production, falling inventory growth*

When the Asian financial turmoil started to cause the NT dollar to depreciate in September 1997, the Taiwan economy was in Quadrant II (production was booming and inventory growth was slow). But the sudden and unanticipated weakness in exports forced the growth of inventory to accelerate and these adjustments took the economy to Quadrant I in March 1998. Producers began to scale back production in the face of falling aggregate demand growth and the economy entered Quadrant IV in August 98 (industrial output growth was decelerating while inventory growth remained high).

The economic consolidation continued until the end of 1998, after which the Taiwan economy entered Quadrant III, suggesting that growth in inventory has decelerated to sub-average levels. We believe that this is a bullish signal and, indeed, production growth has showed signs of rising since then\* (January 1999 in the chart on the previous page). Although production growth is still below the norm (the average level), the need to replenish inventory suggests that production growth is bottoming. In order words, production growth should accelerate in response to a pick-up in demand.

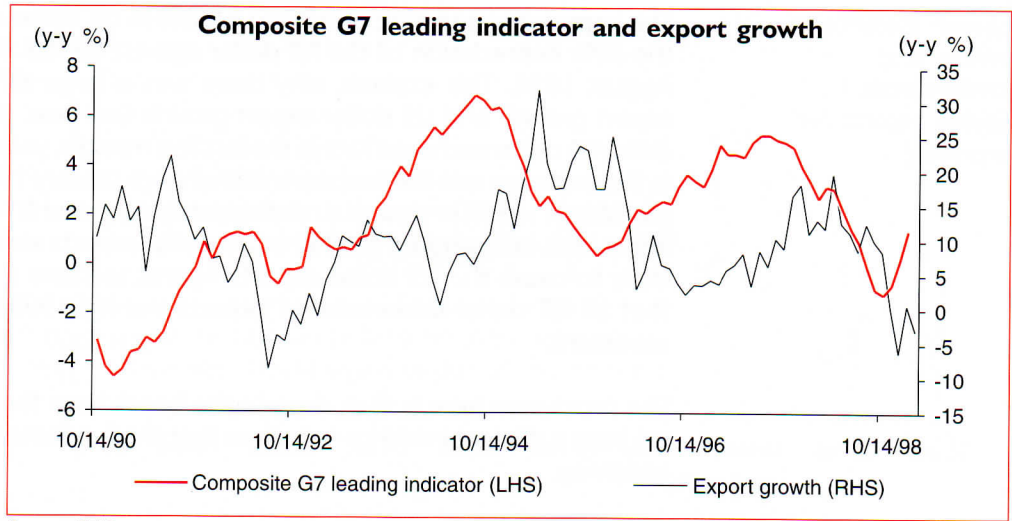
*Signs of improvement in global demand growth*

The above conclusion is also gaining support from certain recent G7 economic indicators. Historically, the OECD G7 leading indicator is a reliable predictor of Taiwan's exports. Mainly due to a better outlook of the US, and perhaps Japanese, economies, the G7 economic outlook has shown signs of turning around in the last few months. In particular, strong results from major global IT-related companies suggest that demand for electronics products could outperform other commodities this year. Besides, while demand for intra-regional trade is unlikely to turn around soon, it is unlikely to worsen either. The likelihood that export orders for IT-related goods are showing signs of bottoming also points to stronger export growth for IT products this year. As 46% of Taiwan's exports go to G7 and IT-related exports account for around 50% of total exports, we expect Taiwan's production and export growth to recover this year.

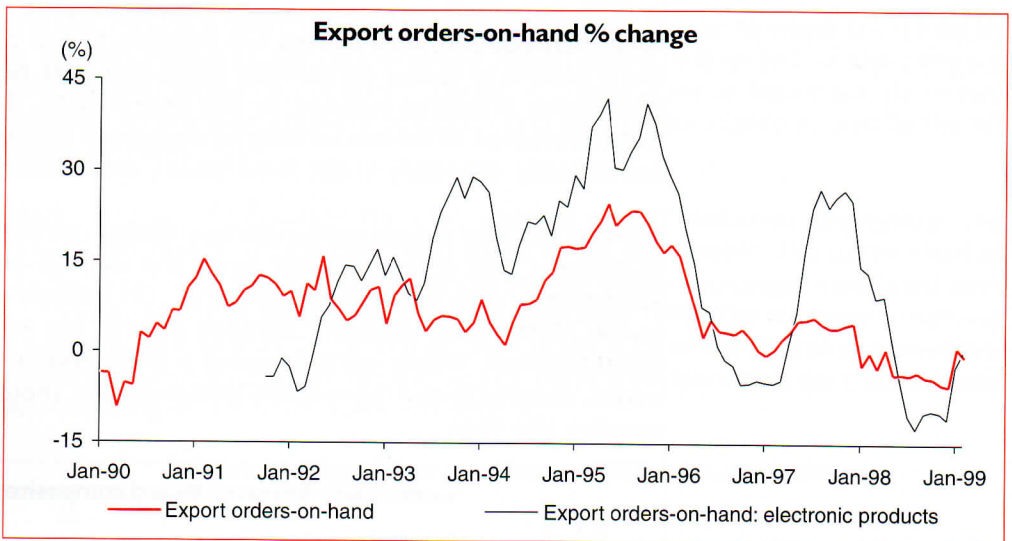


Source: CEIC

\* As all the data plotted are six-month moving averages, the improvement in January reflects a medium-term trend movement rather than seasonal fluctuations.



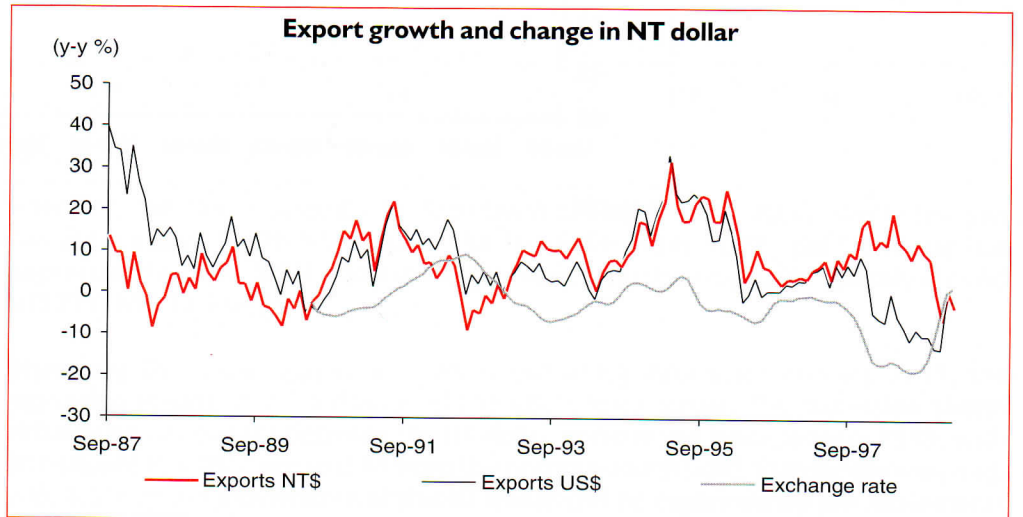
Source: CEIC



Source: CEIC

*No more drag from currency translation effect*

As a side issue, one has to be careful in interpreting export figures from Taiwan this year. Taiwan reports external trade data denominated in both US dollars and NT dollars, with US dollar exports being the benchmark indicator. Theoretically, both sets of data should show the same trend, but the rates of change are not necessarily the same. The difference between US dollar export growth and NT dollar export growth rates reflects percentage changes in the NT dollar exchange rate.



Source: CEIC

*Enough evidence to believe that fundamentals for Taiwan exports are improving*

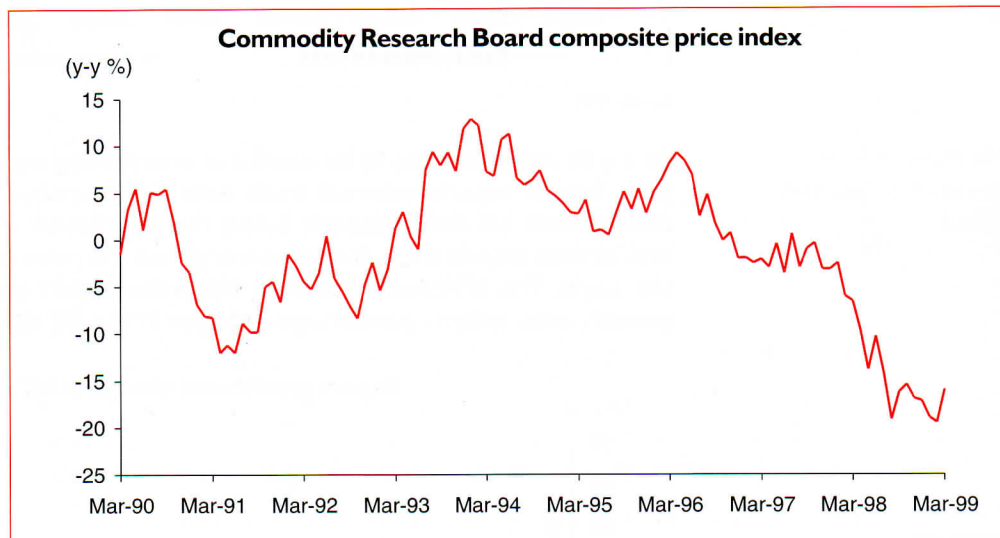
The important issue here is that the decline in US dollar exports was exaggerated by the 20% depreciation of the NT dollar against the US dollar during October 1997-August 1998. This explains why there was a large difference between NT dollar export growth and US dollar export growth last year. Given the stability of the NT dollar/US dollar exchange rate in the last few months, year-on-year percentage change in the exchange rate has become minimal since January 1999 (virtually zero in February and March 1999). In view of a relatively stable yen and NT dollar, the negative currency effect that exaggerated the fall in US dollar exports should be disappearing. This is likely to cause the US dollar exports figures to show a sharper improvement than that of NT dollar-denominated exports during 1999; this could boost investor sentiment.

The conclusion here is that, despite the boost from the currency translation effect, we have sufficient evidence to believe that the fundamentals for Taiwan's exports are improving.

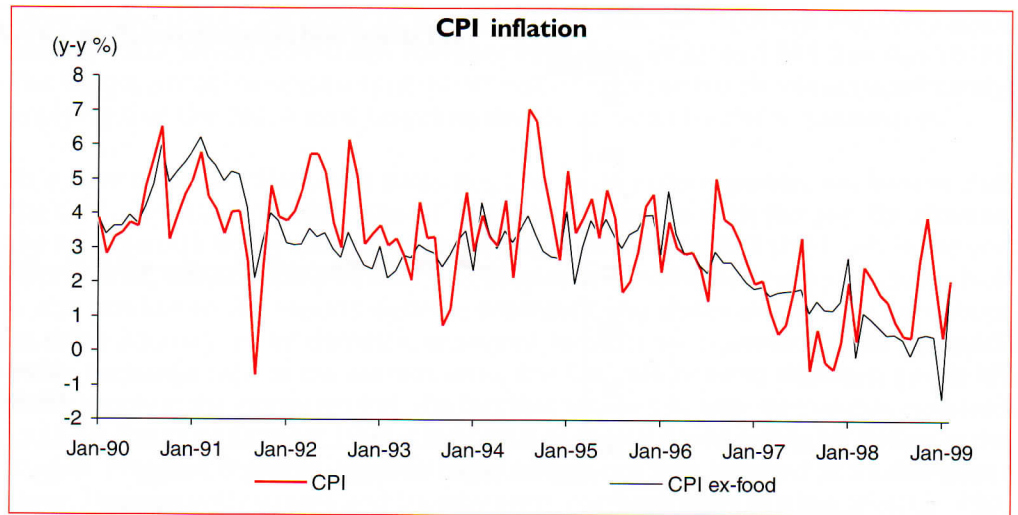
*Benign inflation*

In recent years, Taiwan's inflation has consistently been below market expectations. In 1998, the widely-expected imported inflationary pressures, stemming from the NT dollar depreciation, only caused CPI inflation to rise 80 basis points to 1.7%. The sharp decline in global commodity prices last year helped to offset some of the inflationary pressures induced by the depreciation. But other important factors that contributed to the low inflation environment last year were intense competition domestically, especially in the retail sector, and slowing domestic demand.

Inflation this year should remain benign. Global commodity prices may have started to rebound, but in year-on-year terms the rise will be minimal. Despite seasonal fluctuations, core inflationary pressures (CPI ex-food and energy) have remained muted. With slower domestic demand growth last year and a modest increase in unemployment, labour costs recorded a 0.9% decline in 1998. The moderation in wages, coupled with a more stable exchange rate, should ensure a minimal inflation scenario this year.



Source: CEIC

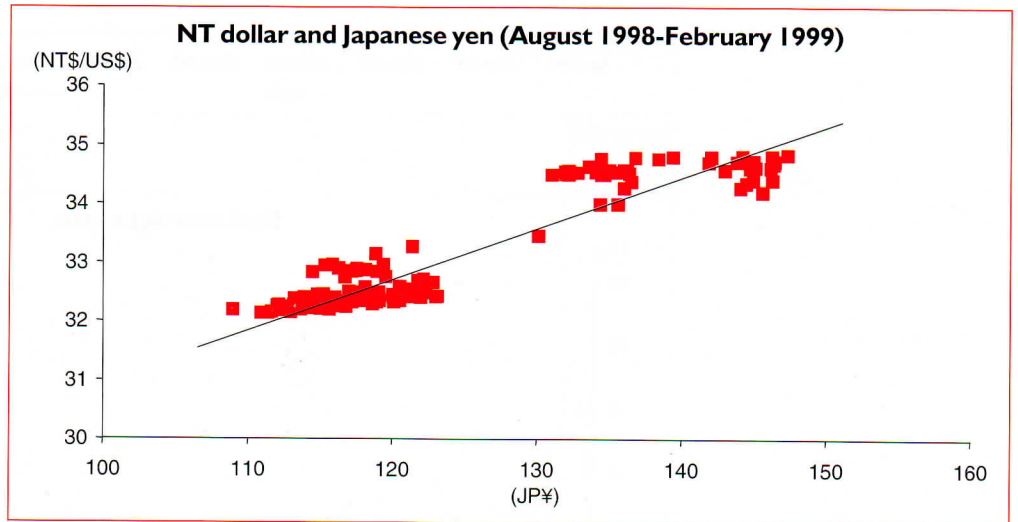


Source: CEIC

**Exchange rate outlook**

The CBC has long been linking the NT dollar exchange rate to either the US dollar or the yen. However, the rate at which the NT dollar is targeted, or the currency that the CBC targets to, changes. Hence, it is important to figure out these two variables to produce accurate forecasts on CBC's policy stance as well as the NT dollar exchange rate.

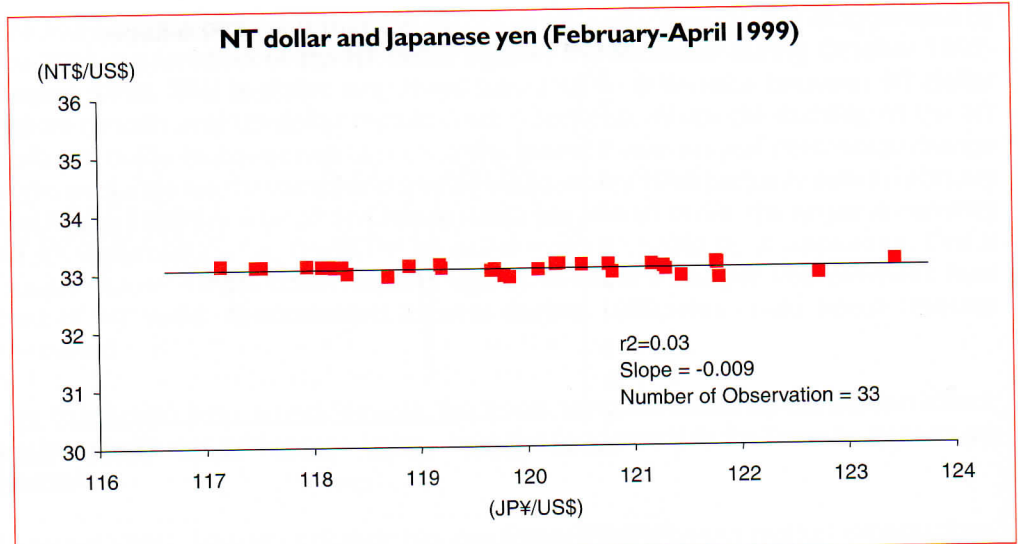
Since October 1997, when the CBC allowed the NT dollar to depreciate, the authorities appear to have tied the NT dollar to yen movements. The scatter chart of the NT dollar/US dollar and the Japanese yen/US dollar exchange rates fitted with a OLS regression line below uses data since October 1998. The regression showing a r-square value of 0.41 suggests that, statistically, 41% of the NT dollar movements can be explained by the yen. In other words, there is evidence that the CBC has used yen-targeting as one of its policy instruments.



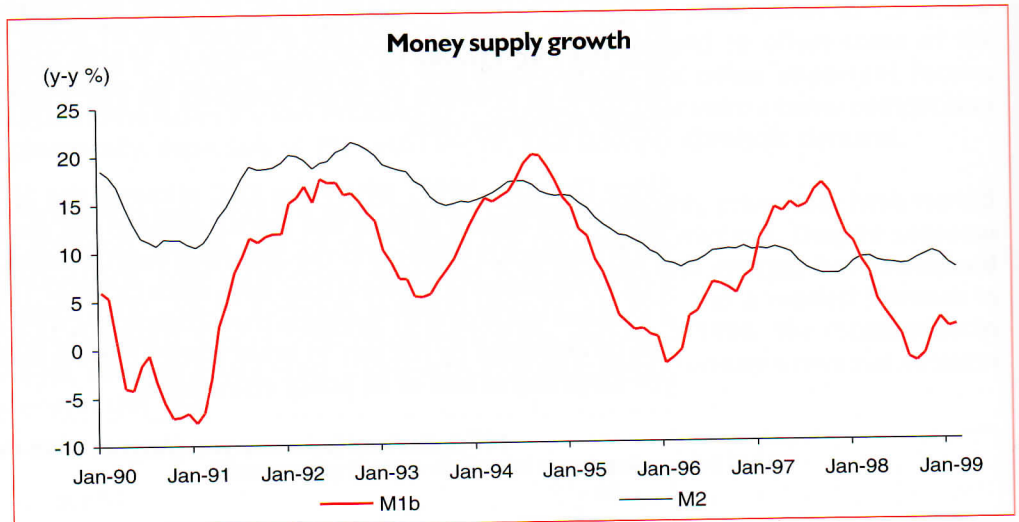
Source: CEIC

However, the target appears to have been changed since 4Q98. While the yen has appreciated by 16.8% against the US dollar from 3Q98, the NT dollar has appreciated by only 5.9% against the greenback, fluctuating quite steadily around NT\$33.0-NT\$33.5:US\$1.

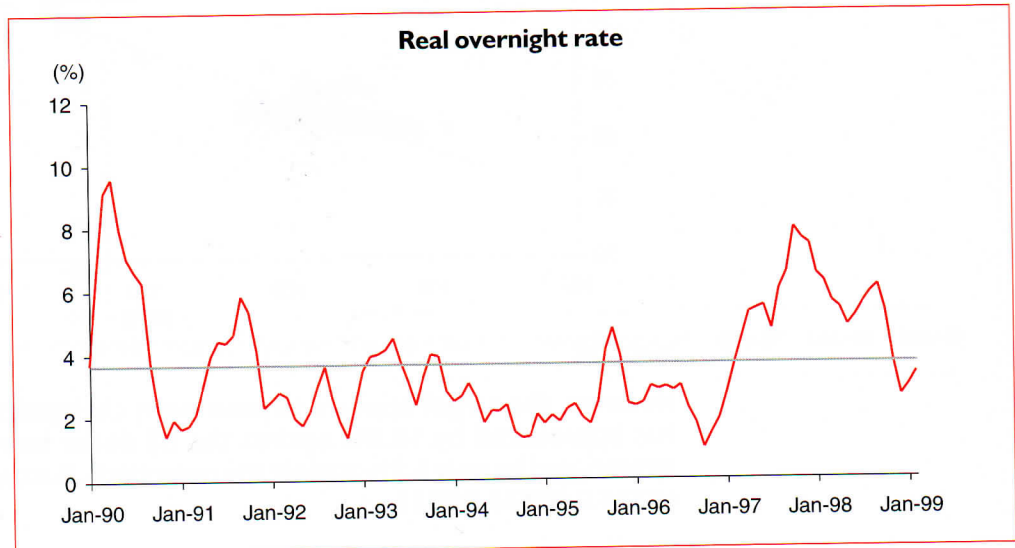
Repeating the same regression analysis but using data since January 1999, the regression results reveal a change in the CBC's forex target. The regression shows virtually no correlation between the NT dollar and the yen since January 1999, with an r-square of 0.045 (versus 0.41 from the previous regression). Statistically speaking, only 4.5% of the movements of the NT dollar can be explained by yen movements during this period.



Source: CEIC



Source: CEIC



Source: CEIC

*Ample liquidity*

More interestingly, the slope of the regression line has flattened markedly since January 1999, falling from 0.085 (October 1998-April 1999) to 0.045 (Jan-Apr 1999). This suggests that the sensitivity of the NT dollar to the yen has decreased significantly, implying that the CBC is now targeting the NT dollar to US dollar movements.

At a time of tame inflationary pressures and weak export growth, we believe that the CBC is reluctant to allow the NT dollar to appreciate with the yen. By allowing the NT dollar/US dollar exchange rate to stay at around NT\$33:US\$1, while the yen appreciated, Taiwan should be able to gain relative competitiveness from Japan which is also positive to the exports outlook. Moreover, this policy should also contribute to rising liquidity in the domestic economy. In order to maintain the NT dollar/US dollar exchange rate at the current level, the CBC will need to maintain ample NT dollar supply in the money market. The fact that Taiwan's foreign reserves has increased by US\$8.4bn since October 1998 is indicative of central banks selling NT dollars in the market. Provided that this injection of liquidity is not fully reversed at a subsequent stage, liquidity will increase and thereby keep interbank rates at a low level (ie, 4%). With a benign inflation outlook and the need to maintain export competitiveness, we see no strong reason for the CBC to fully neutralise the injection in the short term. With our forecasts of 4% overnight rate and 1% CPI inflation, the real interest rate is envisaged to be 3% for 1999, still below the average real rate of 3.7% seen since 1990.

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