# The changing financial system in Taiwan

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## 1. Progress in the deregulation of financial institutions

Taiwan, a highly open economy, has been ranked among the top 20 trading countries in the world for 12 consecutive years. In 1995, its exports and imports amounted to US$ 111.7 billion and US$ 103.6 billion respectively. As at the end of May 1996, the country's foreign exchange reserves amounted to US$ 84.8 billion, the second highest in the world when measured in per capita terms. Foreign assets held by the private sector amounted to approximately US$ 65 billion. In view of the increasing need for financial services to keep pace with the rapidly growing external sector, extensive financial reforms have taken place over the last decade. In particular, most reform measures taken have been directed towards market orientation and internationalisation with the aim of developing Taipei into a regional financial centre.

Beginning in the early 1980s, the Central Bank adopted a series of measures to gradually free banks from long-standing interest rate controls. In 1989, bank interest rates were totally liberalised. This dismantling of interest rate controls has enabled banks to compete more effectively. However, in 1989 nearly 46% of deposits and 68% of loans in Taiwan were handled by the 12 state-run banks, and the establishment of new private commercial banks was not yet permitted. Owing to the lack of a competitive market structure, the immediate impact of interest rate liberalisation in terms of putting pressure on the spreads between deposit rates and loan rates was not very significant.

Two further events which followed interest rate liberalisation also affected interest rate competition. First, the Fair Trade Law, which prohibits the manipulation of prices, including interest rates and fees charged by banks, came into effect in 1991. Secondly, the sudden entry of

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15 new private commercial banks (each with a paid-in capital of over NT$ 10 billion) between the end of 1991 and the middle of 1992 initiated price competition, especially with regard to passbook savings deposits. In addition, the entry of new private commercial banks exerted an impact on the market structure of banking activity. At the end of 1995, there were 16 new private commercial banks, with a 7% market share of deposits and a 10% market share of loans, the market shares of deposits and loans held by state-run banks falling to 35% and 54% respectively.[1] Furthermore, the privatisation of state-run banks is currently under way, and this will further improve the market structure of the banking sector.

In addition to deregulation of the entry of new private commercial banks in 1991, entry barriers in other parts of the financial sector were also removed in the late 1980s and early 1990s. The establishment of new securities firms was allowed in 1988, of new insurance companies in 1992, and of new bills finance companies and new securities finance companies in 1994. In addition, geographical limits regarding the branching by regional banks began to be relaxed in 1994. The growing number of new financial establishments has spurred greater competition and contributed to the vitality of the financial markets. Some progress with respect to entry deregulation has also been made in an international direction in order to modernise the local financial sector. Foreign banks were allowed to set up branches in Taiwan as early as 1964, although numerical and geographical limits on their branch networks were gradually lifted only in the mid-1980s. Foreign securities firms were permitted to set up branches in Taiwan in 1989, and foreign insurance companies to operate in the country in 1994.[2] At the end of May 1996, 39 foreign banks had established a total of 62 branches in Taiwan and another 26 foreign banks had established representative offices. A total of 10 foreign securities companies have set up branches in Taiwan, 21 foreign insurance companies (covering both life and property) have established branches or representative offices.

As regards lines of business, the activities in which a financial institution may be authorised to engage are prescribed by the Central Bank and the Ministry of Finance, within the framework of the Banking Law. Both

[1] The remaining market shares in loans and deposits were accounted for by existing private banks, foreign banks, community financial institutions and the postal savings system.

[2] In accordance with the ROC-USA trade negotiations in 1978, American insurance firms were allowed to do business in Taiwan in 1981, earlier than other foreign life insurance firms.

domestic and foreign financial institutions in Taiwan are allowed to engage in an increasingly wide range of financial activities. Banks, for example, may now engage in offshore banking, foreign currency deposit-taking, securities brokerage and underwriting, and trading in financial derivatives.[3]

## 2. Developments in financial markets

In addition to the above-mentioned deregulatory measures with regard to financial intermediaries, the Central Bank has also played an important role in the establishment and reform of local financial markets. This section describes recent developments in the short-term bills market, the New Taiwan dollar call-loan market, the foreign currency call-loan market, the stock market and the bond market.

*The short-term bills market*

The short-term bills market, established in 1976, has the function of extending short-term funds to firms, especially smaller ones, which often face difficulties in borrowing from banks. Since it is enterprises and banks, and not the Government, that are most deficient in short-term funds, commercial paper and certificates of deposit are the major types of money market instrument issued. The volume of Treasury bills outstanding is by contrast relatively small. When compared with neighbouring countries in the East Asian region, the outstanding volume of Taiwan's money market instruments (including bonds with maturities not exceeding one year) is exceeded only by the money markets of Japan and Korea, while in terms of turnover the Taiwanese market is second only to that of Japan.

In recent years, different local financial institutions, attracted by the high profits made by the big three existing bills finance companies, have sought to enter the market. The Central Bank and the Ministry of Finance

[3] So far, note issuance facilities, NT dollar forward rate agreements, NT dollar interest rate swaps, NT dollar interest rate options, third-currency swaps, third-currency futures, third-currency options, third-currency margin trading, foreign currency interest rate swaps, foreign currency forward rate agreements and cross-currency swaps involving the NT dollar are all allowed. However, currency futures, currency margin trading and currency options which involve the NT dollar are still prohibited.

eventually allowed banks to engage in short-term bill transactions on a brokerage or dealer basis in 1992, and to undertake underwriting and certification business in 1995, and also allowed new bills finance companies to be set up in 1994. At the end of May 1996, there were a total of 11 bills finance companies in operation. The competition in this market has intensified, and the market has consequently grown more rapidly than before. Furthermore, how to build a wall between commercial banking and investment banking has now become a new and important issue for the financial regulatory and supervisory bodies.

In fact, the urgent need for strict financial supervision of the short-term bills market has already been illustrated by the serious fraud scandal at the International Bills Finance Co., one of the big three bills finance companies, which surfaced in August 1995 and jeopardised the functioning of the market. The Central Bank immediately injected emergency funds of over NT$ 30 billion into the market to meet the large redemptions by investors. This incident illustrates the importance of adequate internal controls in financial institutions and strict supervision by inspectors in order to ensure the orderly functioning of financial markets.

Apart from this incident, a long-discussed problem in the short-term bills market is the complicated procedure for the issuance of short-term bills. In the absence of a credit-rating system, most private enterprises are required to obtain guarantees from either banks or bills finance companies when issuing short-term bills or corporate bonds.[4] This in practice limits issues of money market instruments, and also makes it difficult for investors to evaluate credit risks associated with the investments. To tackle this problem, a credit-rating system is to be set up in 1996. Its first task will be to evaluate the credit ratings of the banks and bills finance companies that offer guarantees for bills or bonds issued by private enterprises. This system will serve to streamline the issuance procedure, which may also lower issuance costs in the future. In addition, the current market settlement system also needs to be improved. It has been recommended that a book-entry system be introduced to replace the current practice of physical delivery.

[4] Public enterprises and first-tier listed companies are not required to obtain a guarantee when issuing bills and bonds. However, first-tier entities may sometimes seek to boost sales by obtaining a guarantee from banks or bills finance companies for their new issues.

*The interbank NT dollar call-loan market*

The interbank NT dollar call-loan market, which enables banks to adjust their reserve positions, was established in 1980. Bills finance companies, securities finance companies and the local branches of foreign banks are the major borrowers in this market, and large state-run banks are the major lenders. In 1994, to prevent the spillover effect arising from stock market speculation from impairing the effectiveness of the interbank call-loan rate in reflecting bank reserve availability, the Central Bank ordered the securities finance companies to permanently withdraw from this market. In addition, the electronic funds transfer system was established in May 1995 in order to promote transactions in the market as well as to improve the efficiency of the payment system for interbank transactions. Furthermore, in order to conform to international practice, business tax on transactions in interbank call loans denominated either in the NT dollar or in foreign currencies, as well as transactions in corporate bonds, bank debentures and financial derivatives, was abolished in September 1995.

However, the sources of funds in the market are still concentrated in the hands of two large state-run banks, the Bank of Taiwan and the Taiwan Cooperative Bank. The Bank of Taiwan, acting as fiscal agent on behalf of the provincial government, holds the major part of provincial government deposits, and the Taiwan Cooperative Bank, serving as a central banking institution for cooperatives, holds a portion of the reserves of community financial institutions. The authorities first have to deal with these thorny institutional problems in order to promote the efficiency of the market and improve the functioning of the interbank rate as an information indicator for monetary policy.

*The interbank foreign currency call-loan market*

Although the Central Bank has played an important role in the establishment and reform of local financial markets, it only trades in the markets when irregularities occur. The sole exception to this is found in the local foreign currency call-loan market, which was established in 1989. During the early stages of its development, foreign currency funds were often in short supply among banks. This phenomenon was partly due to the fact that banks were reluctant to hold large amounts of foreign currency funds so as to avoid exchange rate risk. The Central Bank, taking advantage of its large holdings of foreign exchange reserves, provided up to US$ 10 billion, DM 1 billion and ¥ 15 billion as seed funds in order to foster the development of this particular market. In addition, online link-ups have in recent years been arranged between the local money brokerage house and large international money brokerage houses in Singapore, Hong Kong and Japan.

*The stock market*

Taiwan's relative price stability during the past three decades and the burgeoning trade surpluses of the past two decades have contributed to a large pool of private savings and financial deepening. Hence, the country has had little need to rely on foreign capital to fund the development of local financial markets. In fact, the excessive liquidity generated by the huge trade surpluses of the second half of the 1980s was once a great cause for concern in view of the speculative fever that swept over the local stock market. Reforms in this market have been very necessary. In approaching the reform of the market, the first step is to identify the main obstacles to its development. Taiwan's stock market was established in 1962. At the end of May 1996, a total of 362 companies were listed on the exchange, and there were 227 securities companies. Total market capitalisation at the end of May amounted to some US$ 210 billion at the exchange rates then prevailing. However, the outstanding volume of shares is still relatively small. Furthermore, individual investors usually account for more than 90% of share transactions, which is much higher than the averages of 30–40% in the case of the United States and Japan. Speculative behaviour is intrinsic in such a market structure, as evidenced by high turnover rates.[5]

In recent years, a series of measures have been taken by the financial authorities to reform this market.[6] Because the stock market has gradually matured, and has been opened to foreign participation, Morgan

[5] The turnover rates in respect of listed stocks in the Taiwan market have exceeded 150 since the mid-1980s, with a peak of 523 in 1989, while those in the US or Japanese markets have been somewhere between 40 and 100.

[6] Major liberalisation measures with regard to the stock market introduced by the authorities have included: permission for foreigners to invest indirectly in the local stock market by purchasing beneficiary certificates issued abroad by local securities investment and trust companies (1983); completion of a two-phased procedure to computerise stock trading (1985 and 1988); a gradual increase in the percentage limit on daily fluctuations in the prices of individual

Stanley has announced that, from 2nd September 1996 onwards, Taiwan's share prices will be included in the Emerging Market Free index and will account for 7.9% of the index. It is expected that this inclusion will attract more foreign investors to the Taiwan stock market. In the future, the authorities will continue to release the shares of public enterprises through the privatisation process, assist qualified private companies in preparing for stock market listings, and also encourage more institutional investors to participate in the market.

*The bond market*

The local bond market is relatively underdeveloped when compared with the stock market and the short-term bills market. The main impediment to its development has been associated with limited bond issues. There are two major factors behind this slow development of the issue market. First, the 0.1% transactions tax on corporate bonds discourages trading in the secondary market directly, while a lack of liquidity makes the issue of corporate bonds in the primary market difficult in the first place. Secondly, issues of government bonds have also been small under the conservative fiscal policies of the past 30 years, but this situation has gradually changed, with more government bonds being issued since the implementation of the Six-year National Development Plan in 1991.

In order to broaden and deepen the bond market, the financial authorities have in recent years allowed the issue of foreign currency bonds and NT dollar bonds by the Asian Development Bank and the issue of Taiwan

shares (1988 and 1989) to the current level of 7%; permission for the establishment of new securities firms (1988); permission for foreign securities firms to set up branches (1989); permission for foreign institutional investors to invest directly in the local stock market (1990); permission for the establishment of new securities finance companies (1994); abolition of the requirement that a foreign institutional investor keep more than 75% of its funds invested in the stock market after the funds were inwardly remitted (1995), and permission for foreign institutional investors to invest up to 30% of incoming portfolio funds in money market instruments, government bonds and time deposits, while the remainder, if not used to purchase shares, may be held in checking accounts or passbook deposits; abolition of the US$ 7.5 billion ceiling on total foreign investment in locally listed stocks, and an increase in the maximum percentage limits on individual and total shareholdings in a locally listed company by foreign institutional investors to 7.5% and 15% respectively (1995); an increase in the maximum investment quota for each foreign institutional investor investing in domestic securities from US$ 200 million to US$ 400 million (1995); abolition of the restrictions on outward remittances of principal and income on foreign investors' investments (1996); permission for foreign individual investors to invest directly in the local stock market, and an increase in the maximum percentage limit on shareholdings in a locally listed company by all foreign institutional and individual investors to the current level of 20% (1996).

depository receipts by foreign enterprises in the local market, and have begun to regulate the timing of issues of government bonds as from the 1996 fiscal year. In the past, both the timing and the size of central government bond issues varied mainly according to the needs of the Treasury. This change will help to facilitate bond trading and establish a benchmark interest rate in the market. Currently, the revised draft of the tax law, which includes the abolition of the transactions tax on corporate bonds and bank debentures, is awaiting finalisation by the Administration. Furthermore, the Central Bank's plan to reducing reserve requirements and raise liquidity requirements will increase banks' holdings of bonds significantly. As a result of these developments, as well as the increasing demand for bonds arising from rapid growth of the insurance industry and mutual funds, together with the more market-oriented management of both government pension funds and labour pension funds, the bond market has become increasingly active since 1993. However, there are still two issues to be resolved. First, the lack of a credit-rating system applied to corporate bond issuers keeps the risks in investment in corporate bonds high. Secondly, the outdated settlement system also needs to be improved.

## 3. The development of the exchange rate system

Taiwan's exchange rate system alternated between dual rates and multiple rates until 1963, when a single rate arrangement was finally maintained. In 1979, the foreign exchange market was established and a system of managed floating was adopted. As the new system began to operate, the highly open Taiwanese economy was still vulnerable to large movements in exchange rates, and exchange rate policies were implemented to keep the currency within a range of roughly between NT$ 36 and NT$ 40 to the US dollar. As from 1985, Taiwan's trade surpluses expanded significantly, reaching a peak of US$ 18 billion in 1987, the year in which foreign exchange controls were significantly relaxed. With the NT dollar under strong upward pressure, the Central Bank frequently made large purchases of US dollars in the local exchange market with the intention of slowing down the appreciation. This policy of gradual appreciation, which lasted for about four years, proved a failure since it induced huge speculative capital inflows during that period, provoking excessive expansion of domestic credit and fuelling speculation in the stock market.[7] As a result of this experience, the Central Bank changed its exchange rate policies in the late 1980s and by and large allowed the market mechanism to determine the value of the currency except in cases where it drifted away from the economic fundamentals. This experience indicates that exchange rate flexibility can be helpful in maintaining domestic monetary stability especially when quantitative restrictions on capital movements are being relaxed.

## 4. The liberalisation of capital flows

Expanding exports constituted the main driving force behind Taiwan's economic growth in the 1980s. However, the resulting trade surpluses also gave rise to a problem of excessive liquidity. Trade liberalisation proceeded mainly during the second half of the 1980s through the reduction of tariffs and the removal of quantitative import barriers. This opening-up of the domestic market to foreign commodities, partly in response to pressure from the US Government, has helped redress the trade imbalance and has forced local firms to become more competitive in the world market by either improving the quality of their products or developing new high-tech products. The Central Bank also embarked upon the deregulation of external financial transactions around the same period with the intention of correcting the overall external imbalance by encouraging capital outflows. It has adopted a gradual approach by first of all relaxing constraints on trade-related capital flows (current account convertibility), then easing restrictions on long-term direct investment flows, and finally easing restrictions on portfolio and short-term investment flows.[8]

There are two major reasons why the Central Bank is hesitant when it comes to lifting the restrictions on portfolio and short-term investment flows. First, Taiwan welcomes new technology from abroad to upgrade its domestic industry, but as a capital-exporting country, it is not in great need of funds from abroad. Secondly, portfolio and short-term capital

[7] Although the sterilisation was incomplete, the quasi-fiscal cost of financing high levels of bank reserve holdings by the Central Bank was already significant.

[8] An over-hasty relaxation of controls is not desired by the Central Bank because of concern that an eventual reimposition would create unnecessary uncertainty in the minds of potential investors about future rules and regulations.

flows, which move quickly across borders, often cause financial instability, especially in countries with relatively small financial markets.

At present, most of the remaining capital controls in Taiwan relate to portfolio investment. However, these restrictions, which are designed to shield the economy from a surge in speculative capital flows into the local stock market, may sometimes be ineffective. For example, some foreign institutional investors increased their actual stock investment quotas, which were worth several times the US$ 200 million ceiling, as they were able to register under the names of various affiliates. Consequently, the authorities raised the maximum investment quota for each foreign institutional investor investing in domestic securities from US$ 200 million to US$ 400 million at the end of 1995. A further example is that foreign individual investors, who were not then allowed to invest in the local bourse, sometimes opened sub-accounts in an overseas subsidiary of a qualified foreign institutional investor and invested in Taiwanese stocks under the name of the institution. Eventually, the authorities allowed foreign individual investors to invest directly in the local stock market in March 1996. In fact, market participants always seek to circumvent existing restrictions, and this usually forces the regulators to abandon ineffective controls.

Besides the microeconomic aspect of deregulation of capital flows, there are also some macroeconomic considerations. As mentioned, the adoption of a policy to slow down the appreciation of the NT dollar between 1986 and 1989 triggered monetary expansion and a surge in inflows of speculative capital through many different channels into the stock market, even though foreign investors were not allowed to invest directly in the local stock market at that time. Similarly, political tensions in 1990 as well as in the second half of 1995 and early 1996 resulted in huge capital outflows and shook the stock market. These experiences demonstrate that stable political, economic and financial conditions are also preconditions for the effectiveness of remaining capital controls.

## 5. The sequence of liberalisation

An ordered process of financial liberalisation is often emphasised in order to minimise the adverse impact of possible disturbances from the deregulation process on economic and financial stability. It is often suggested that domestic financial deregulation should ideally be implemented prior to opening the financial sector to competition from foreign financial institutions and the relaxation of foreign exchange controls. Similarly, it is suggested that trade deregulation should precede the liberalisation of external financial transactions, and that current account deregulation should be implemented prior to the deregulation of capital flows.[9]

In practice, however, the sequence may be distorted as a result of political considerations or pressure from both domestic and foreign interest groups. An example in Taiwan is that the correct sequence for deregulating the banking system would be to first streamline the banking supervisory system, then privatise government-owned banks, and finally allow the entry of new private commercial banks. However, protests from different interest groups and the lengthy administrative and legislative process have seriously delayed the privatisation process and upset the planned sequence. In the event, the entry of new private banks has been allowed first, the bank supervision system has not yet been fully streamlined, and government-owned banks are not yet privatised.[10]

## 6. Implications for financial institutions and the central bank

Financial liberalisation and internationalisation have clearly changed the traditional contours of the financial system. The volatility of interest rates and exchange rates has increased. Competition among financial institutions has become more intense. New financial products are being developed continuously. Faced with the changes in the deregulated environment, financial institutions on the one hand have to actively seek new markets and develop new financial services to meet the growing needs of their customers, while on the other hand they need to exercise caution when developing new financial product lines.

The changing financial environment also presents important supervisory challenges. In addition to adapting outdated laws and regulations to changing market realities and improving the financial infrastructure, the Central Bank is also in a position to ensure that financial institutions are aware of the full range of risks inherent in new financial products, such as

[9] See Kuo (1989).
[10] See Liang (1992).

derivatives, when it approves such activities and to restrain financial institutions from engaging in excessive risk-taking through close financial supervision. From a longer-term perspective, it is important that the Central Bank should carefully formulate and implement its monetary and exchange rate policies with a view to maintaining macroeconomic stability, which is the prerequisite for success in sustaining the current financial liberalisation or preparing for further liberalisation measures.

The changing financial environment may also affect monetary policy operations to some extent. It is suggested in some of the literature that an efficient money market will lead a central bank to shift from non-market-oriented to market-oriented operations. In the case of Taiwan, the problems associated with traditionally high reserve requirements, such as the distortions rooted in banks' choice between taking reserve-carrying deposits and collecting funds via non-reserve-carrying debt management, and the disadvantages inherent in a local financial centre with high reserve requirements competing with foreign financial centres with low reserve requirements, have attracted considerable attention. Reserve requirements must be gradually lowered to an internationally comparable level to solve these problems. In fact, as at June 1996, the Central Bank had already lowered reserve requirements on ten occasions since 1990. In the future, market-oriented policy instruments, including open market operations, are expected to play a more important role in the Central Bank's operations, and market interest rates and exchange rates will be able to provide more valuable information for policy purposes.

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