ECONOMIC OUTLOOK AND FINANCIAL REFORMS IN TAIWAN

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1. Economic Outlook

By the end of 1998 after the Asian financial crisis had stormed through one country after another across Asia, the CIS, and Latin America, the adverse effects of the crisis started to aggravate Taiwan. The damage to Taiwan caused by the crisis has been seemingly underestimated. This is why the Taiwan government had to revise downward its forecasted 1998 economic growth rate on four consecutive occasions, from 6.46% in November 1997 to 5.07% in late 1998. The actual 1998 growth rate turned out to be 4.83%, the third lowest in the history of Taiwan's economic development. However, this growth rate represents one of the best in the region and contrasts with the dramatic contraction that has taken place in many Asian countries.

The sharp decline in exports has attracted the most attention with respect to the performance of different sectors of the economy. According to customs statistics, in 1998 exports dropped by an unprecedented 9.4%, measured in US dollars. The Asian financial crisis had a stronger impact on Taiwan's exports, than did the two oil crises; exports declined 5.9% in 1975 with the first oil crisis and only 1.8 % in 1982 with the second. Imports also dropped off by 8.5% in 1998, the third largest decline in imports since 1971.

The decline in exports is easily attributed to the financial crisis. The sharp contraction in many Asian economies has seriously depressed the demand for goods made in Taiwan. Exports to other Asian countries, which account for 45% of total exports, fell 18% in 1998.

When the trading sector is in the doldrums, hope for economic growth rests with domestic demand. Private consumption in Taiwan increased by 7.1% in 1998, which was key to sustaining GDP growth. Domestic investment was another important source supporting growth in 1998. Investment grew a dramatic 39% in the first quarter. Although investment slowed down in the third and fourth quarters in response to recessionary forces, for the whole of 1998 the investment growth rate reached 9.7%. Investment was the only sector with higher rate of growth in 1998 than in 1997.

In the public sector, government consumption grew a minimal 0.17% in 1998. Furthermore, public investment expanded by only 1.13% and the contribution of the government to economic growth fell significantly. It is true to say that control of government expenditure in 1998 helped balance the budget, but its side effect was to aggravate the business cycle at a time when the economy was struggling with financial turmoil.

In the real sector, industrial production grew by 3.8% in 1998, compared with 3.7% in 1993 and 1.5% in 1996. Strictly speaking, the damage caused by the crisis on the manufacturing sector has not been very serious. However, rate of growth of output in the service, banking, insurance, and real estate sectors has fallen off dramatically.

Over-supply and sluggish demand have driven down the international prices for energy, metals, key components, and many commodities. As a result, when export prices (in US dollars) took a slide due to the depreciation of the NT dollar, import prices plunged. This helped stabilize domestic price levels.

Taiwan's economic performance indicators, which showed a recessionary blue light for all four quarters of 1998, are currently showing a healthier yellow light, indicating that the economy is on the road to recovery. The real rate of change for exports, according to customs statistics, is currently showing a red light, while real rates of change for new manufacturing orders and for industrial production have returned to green light status. Meanwhile, although the non-agricultural enterprise change rate and the manufacturing finished product inventory rate still both carry a yellow-blue light indicator, this represents only a tiny improvement over their performance in the fourth quarter of 1998. The four financial indicators continue to show a blue light. Overall, in real terms the performance of these indicators should be taken as a good sign, although the financial indicators' performance leaves much to be desired.

The comprehensive leading indicators of economic performance all pointed to economic shrinkage throughout the four quarters of 1998. In January of 1999 they rebounded, but in February they shrank again. The trend of change in these indicators is still far from clear, and more observation is required. However, on the basis of January and February, the number of industrialists who are optimistic about economic performance in the second quarter of 1999 is clearly on the increase and outstripping the number of pessimists. This indicates that confidence in the future recovery of the economy among manufacturing firms is already starting to gain ground. Furthermore, Taiwan exports for the first two months of 1999 (combined) were 6.5 percent higher than exports in the same period last year. This is a surprising statistic, and one indicative of returning economic health. Imports and exports have grown most significantly in the information and electronics products industries, while all other imports continue to experience a downturn. Exports of rubber and plastic, automobile, and metal products are increasing. The U.S. and Japan are the fastest growing markets for Taiwan exports, followed by mainland China. The decline in exports to Malaysia, South Korea, the Philippines, and Thailand seen in 1998 has been replaced by positive growth; exports to Korea have attained a growth rate of 47 percent, suggesting that Taiwan's exports to the East Asian region are improving.

Generally speaking, according to international economic forecasts, predictions for the global economy in 1999 do not look particularly promising. Economic growth may only approach the level recorded in 1998, though prospects for the year 2000 are better. For these reasons, we estimate that Taiwan's economic growth rate will be 4.97% in 1999 and 6.01% in the year 2000.

2. Financial Reforms

The Asian financial crisis has created many problems for Taiwan, ranging from currency depreciation and a fall in stock prices, to a decline in exports and imports, a slowdown in production and investment, worsening corporate earnings, and a rise in the unemployment rate. However, many of these problems are largely cyclical. As long as the US economy keeps its head above water, for instance, stabilization in the Asian economies will restore a degree of positive export growth in 1999. Corporate sales and production will then also recover. However, there are other problems that are deeply rooted in the structure of the Taiwan economy that must also be resolved before Taiwan can recover in this post-crisis era.

Since July 1998, a dozen or more local conglomerates have suddenly found themselves facing serious liquidity problems. Ironically, the reason behind the collapse of these conglomerates was neither the fall in exports nor the decline in sales. Rather, it was the combination of falling stock prices, ailing property prices, and over-leverage in the conglomerates as a whole which caused the trouble. Liquidity problems triggered the failure of two bill companies, a run on a business bank, and a further decline in stock prices. Because of the rapid expansion of credit availability in the financial system, the aggressive risk-taking of many corporations, and manipulation of stock prices, the decline in asset prices has led to the deterioration of the asset quality of banks. The non-performing loan ratio in the financial system jumped from 4.4% before the crisis to over 5.5% as of the beginning of 1999. After the launch of a program to stabilize the stock market and a rescue package for financially stricken companies, the banking sector became exposed to higher and higher credit risks. A heavy non-performing loan burden in banks carries a bigger threat to the economy than the aforementioned cyclical factors. Having said that, it is very likely that the Taiwan economy will fully recover from the crisis within two years, though it may take longer for the financial system to shake the shadow of the crisis off for good.

In order to prevent the economy from experiencing a credit crunch, the Central Bank of China has lowered the required reserve ratio five times since the inception of the crisis—twice in 1997, twice in 1998, and recently in February 1999. Also, to assist the banking sector in writing off its bad debts, the business tax rate has been cut from 5% to 2% for banks and insurance companies. The ceiling on foreign ownership of Taiwan stocks will be increased from 30% to 50%. This is an unprecedented measure taken by the government in an attempt to revitalize the financial system.

In order to restore long-term, healthy, and sustainable growth, it is very important for economic policies to "return to the fundamentals", in addition to providing emergency rescue packages for troubled firms. This is exactly why the government's latest stimulus package focuses on improving the rules of the game in financial markets, restoring industrial competitiveness, and strengthening the regulation of corporate behavior.

In this package, the Industrial Upgrading Law will be extended for another 10 years. Tax deductions for R&D and personnel training investments are to be raised from 15% to 20%. Business operation costs will be reduced as a result of reductions in import and inspection fee tariffs. New rules designed to improve the stock market by strengthening supervision and increasing transparency will be introduced. New guidelines for the enhancement of the motives for banks to dispose of bad loans will be established. Credit ratings, applicable to financial institutions from banks to brokerage houses, securities underwriters, as well as companies issuing bonds and commercial papers, will be implemented. The Securities and Futures Commission will be empowered to investigate irregularities in listed companies, and listed firms will be obligated to disclose their (and their subsidiaries') financial information clearly and on a timely basis.

New reforms would also require stringent regulations on the appointment of board directors with respect to cross-shareholding and the use of shares as collateral for bank loans. Efforts would also be made to attract more foreign institutions to Taiwan as a means of increasing the ratio of institutional investors and expanding the scale of the local stock market.

The Asian financial crisis wrought economic turmoil in many countries, including Taiwan, inflicting hardship and suffering on millions of people around the world. As a result of this crisis, however, the specific weaknesses of each and every affected economy have been exposed, such that governments, businesses, and the public can now differentiate, in terms of the market economy, what is fundamentally right and what is fundamentally wrong. This is the major lesson learned from the crisis.