

ARTICLES

FOREIGN EXCHANGE AND CAPITAL MOVEMENT CONTROLS IN TAIWAN

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I. INTRODUCTION

In January 1995 the Taiwanese government launched its “cross-century” economic plan, with the aim of building Taiwan¹ into an Asia Pacific Regional Operations Center (“APROC”). Under the APROC initiative six specific centers are proposed: manufacturing, finance, sea transportation, air transportation, telecommunications and media centers.² The plan to transform Taiwan into a regional financial center has perhaps attracted the most attention. In part, this interest has increased because of the government’s efforts to achieve greater deregulation and internationalization. An international financial center, by definition, is a place where international intermediary services are provided.³ In order to facilitate financial transactions in an efficient manner, it is essential to allow relatively free foreign exchange and capital flows. In the major financial centers of the world, restrictions on

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1. “Taiwan,” “the Republic of China,” and “ROC” will be used interchangeably.

2. See generally COUNCIL FOR ECONOMIC PLANNING AND DEVELOPMENT, THE PLAN TO DEVELOP TAIWAN INTO AN ASIA PACIFIC REGIONAL OPERATIONS CENTRE (1995).

3. See Richard Y. Ho, *Hong Kong as an International Financial Centre*, in THE HONG KONG FINANCIAL SYSTEM 381 (Richard Y. Ho et al. eds. 1991). For definitions and functions of modern international financial centers see GUNTER DUFÉY & IAN H. GIDDY, THE INTERNATIONAL MONEY MARKET 35 (1978).

foreign exchange and capital flows are kept to a minimum or are virtually non-existent.⁴

II. RATIONALES FOR CAPITAL CONTROLS

Historically, foreign exchange and capital movement controls were employed by the Taiwanese government during the island's formative periods of rapid economic growth in order to preserve domestic savings, restrict foreign ownership in certain industries and reduce macroeconomic risks associated with international capital inflows.⁵ As Taiwan's economy approaches maturity and is further integrated into the world economy, the capital account will need to be liberalized in accordance with international trends and agreements.⁶ More importantly, without a fully liberalized capital account, Taiwan may not be capable of becoming a world class, or even regional, financial center. This article seeks to analyze the issues with regard to Taiwan's capital control regime on the basis of current data and information from both legal and economic perspectives. The author will put forward some recommendations which the authorities in Taiwan will have to address, before implementing the fundamental changes in line with the APROC initiative.

At an international level, the International Monetary Fund's ("IMF") Articles of Agreement permit member countries to utilize capital controls.⁷ A survey conducted by the IMF shows that

4. There are no foreign exchange and capital flow controls in the major markets such as London, New York, Tokyo, Singapore, and Hong Kong. See John R. Hewson, *Offshore Banking in Australia*, in 2 AUSTRALIAN FINANCIAL SYSTEMS INQUIRY: COMMISSIONED STUDIES AND SELECTED PAPERS 403, 428 (1982).

5. See WORLD BANK, THE EAST ASIAN MIRACLE 25 (1993).

6. For example, member countries of the Organization for Economic Co-operation and Development ("OECD") have adopted the Codes of Liberalisation of Capital Movements ("the Codes"), which state that "members shall progressively abolish between one another . . . restrictions on movements of capital to the extent necessary for effective economic cooperation." OECD Capital Movements Code art. 1(a). The decisions of the OECD Council have the status of binding obligations. Members, in adhering to the Codes, undertake to participate in an ongoing process of discussion, review and examination in which they are called upon to justify any restrictions they feel compelled to retain and to encourage each other to continue the advance of Liberalization. Article 7 of the Codes provides that, in certain circumstances, member countries may elect to defer, or not to take, the measurements under the Codes. The Codes art. 7; see also OECD, LIBERALISATION OF CAPITAL MOVEMENTS AND FINANCIAL SERVICES IN THE OECD AREA 7 (1990) [hereinafter OECD, LIBERALISATION]. Other international organizations also promote the free flow of capital. For example, the World Trade Organization ("WTO") has been the main focus of the world's efforts to encourage free trade in goods and services, while the International Monetary Fund ("IMF") is the guardian of a free multilateral system of payments for current and capital transactions. Taiwan is neither a member of the OECD, WTO nor IMF.

7. Article VI(3) of the IMF's Articles of Agreement states that "members may exercise such controls as are necessary to regulate international capital movements,

most members have imposed some restrictions on capital account transactions throughout the post-World War II period.⁸ Most restrictions on capital account convertibility have been motivated by the following principal considerations:

(i) *Limiting short-term speculative transactions*

Imposing capital controls has been seen as a means of limiting volatile, short-term capital flows that induce exchange rate volatility or sharp changes in foreign exchange reserves and thereby force the authorities to abandon their medium-term macroeconomic policy objectives. "These flows are thought to be driven by [speculative] investors who ignore fundamentals and conduct transactions on the basis of rumors, trading strategies, or uncertainties about the sustainability of macroeconomic or exchange rate policies."⁹

(ii) *Retaining domestic savings*

Capital controls have been credited with ensuring that the domestic savings of developing countries "are used to finance domestic investment rather than the acquisition of foreign assets."¹⁰ This is because risk-averse investors in an uncertain environment, particularly in developing countries, "prefer to hold a significant portion of their wealth in foreign assets that are perceived to yield higher or more certain . . . returns."¹¹

(iii) *Maintaining domestic tax base*

Restrictions on capital movements have been seen as strengthening the authorities' ability to tax financial activities, income and wealth. To avoid taxes, "domestic residents have an incentive to shift some portion of their financial [portfolio] abroad [C]apital controls have been viewed as a means of either limiting holdings of foreign assets or gaining information

but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments."

8. The IMF's Exchange Arrangements and Exchange Restrictions Annual Report 1990 revealed that 123 of the 153 countries imposed some kind of restrictions on capital or foreign exchange transactions. See DONALD J. MATHIESON & LILIANA ROJAS-SUAREZ, LIBERALIZATION OF THE CAPITAL ACCOUNT: EXPERIENCES AND ISSUES 4 (1993).

9. *Id.* at 4-5; see also OECD, LIBERALISATION, *supra* note 6, at 27.

10. MATHIESON & ROJAS-SUAREZ, *supra* note 8, at 6.

11. *Id.* Some economists have argued in favor of capital controls which would assist in keeping domestic interest rates low (as there was sufficient domestic savings) in order to reduce the burden of public debt servicing in developing countries. See OECD, LIBERALISATION, *supra* note 6, at 27.

on the scale of residents' external assets so that these assets can be taxed."¹²

(iv) *Stabilizing and structural reform*

Capital controls can be an effective method in a country's macroeconomic or trade reform programs. For example, by limiting hard-currency outflows, central banks will be able to exercise a monetary policy and artificially hold down the value of the local currency. As a result, their product will be more competitive internationally and encourage more direct foreign investment into the country.¹³

III. EFFECTIVENESS OF CAPITAL MOVEMENT CONTROLS

A fundamental problem with imposing capital controls is the cost associated with enforcement and monitoring, both in quantitative and qualitative terms. A growing body of studies have suggested that capital controls can be, and often are, evaded.¹⁴ Rational investors will continue transferring their surplus funds to locations where higher returns are promised, despite the existence of the control mechanism.¹⁵ A frequently used method to avoid capital controls has been the under and over invoicing of export and import contracts. To shift funds abroad importers

12. MATHIESON & ROJAS-SUAREZ, *supra* note 8, at 6. This argument has been used particularly in relation to direct investment abroad. Whereas an investor will invest abroad if the after-tax return from foreign assets is higher than the domestic return, the social return to the home country of the investment may be less than that of domestic investment since the employment production and tax revenue benefits accrue to the host country. See OECD, LIBERALISATION, *supra* note 6, at 26.

13. See MATHIESON & ROJAS-SUAREZ, *supra* note 8, at 7. Until the early 1980s, capital control has been used widely in OECD countries as a method to adjust their macroeconomic conditions. See generally OECD, Controls on International Capital Movements - The Experience with Control on International Financial Credits Loans and Deposits 48-56 (1982) [hereinafter OECD, CONTROLS].

14. See MATHIESON & ROJAS-SUAREZ, *supra* note 8, at 1; see also OECD, CONTROLS, *supra* note 13, at 46-48.

15. "In order to prevent the influx of hot money in pursuit of arbitrage gains" during the stock market boom in Taiwan, the authorities "implemented a containment policy for regulating capital inflows." Lawrence S. Liu & Pitman Potter, *Foreign Access to Securities Markets in Taiwan and the People's Republic of China*, 19 MELB. U. L. REV. 330, 334 (1993). In addition to the official capital, the Securities and Exchange Commission ("SEC") also instructed the Taiwan Stock Exchange and local securities firms not to permit foreigners to open brokerage accounts. The Ministry of Finance ("MOF") also directed financial institutions not to take NT dollar deposits from non-resident aliens or corporations (details will be discussed in the next section). Despite these measures, these official and unofficial control systems have not worked well. Hot money from overseas is believed to have come freely into Taiwan's financial system without difficulty. This money has had a destabilizing effect on the securities market. See *id.*

(exporters) would over-invoice (under-invoice) a foreign customer and then use these funds to invest in external assets. By manipulating import and export invoices, investors exploit one of the fundamental tensions in most capital control systems; the need to control unauthorized capital flows without interfering unduly with either normal trade financing for imports and exports, or the typical transfer operations between a parent firm and its subsidiaries.¹⁶ Such under and over invoicing can lead to a distorted view of the trade balance.¹⁷

Similarly, multinational companies ("MNCs") can use transfer pricing techniques¹⁸ to evade capital control regimes. For example, "[b]efore an anticipated exchange rate adjustment, changes in transfer prices . . . enable [related parties in a MNC group] to shift funds in and out of a country."¹⁹ This technique was widely used for a few decades, but its application has become increasingly limited as revenue authorities around the world "are developing their transfer pricing audit skills to capture what they regard as their proper share of tax on profits."²⁰ In 1995 the OECD released a report, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration" in which its member countries unanimously endorsed the arm's length principle and a number of acceptable methodologies for determining arm's length prices.²¹ Despite these developments, transfer pric-

16. See Steven B. Kamin, *Devaluation, Exchange Controls, and Black Markets for Foreign Exchange in Developing Countries*, INTERNATIONAL FINANCE DISCUSSION PAPERS NO. 334 (1988), noted in MATHIESON & ROJAS-SUAREZ, *supra* note 8, at 18.

17. See *id.*

18. Transfer pricing is generally considered a tax avoidance technique. Normally, the object of transfer pricing is to depress assessable income or increase allowable deductions so that operating profit, or tax liability, can be reduced. In a simple illustration, an Australian company might sell property at a low price to an affiliate company in a low tax country, say Hong Kong, which in turn sells the property at its market price. Conversely, an Australian company might purchase property from its Hong Kong affiliate at a high price and sell it in Australia at its market price. Similarly, management or service fees may be inflated or deductions more appropriately attributable to a Hong Kong entity might be borne to an undue extent by a related Australian entity. "Moreover, there may be effective profit-shifting not only where separate entities are involved but also where there is only one entity with a number of branch operations." 1996 Australian Master Tax Guide (CCH) ¶ 30-500. See generally AUSTRALIAN TAXATION OFFICE, INTERNATIONAL TRANSFER PRICING - MINIMISING THE TAXATION RISKS IN INTERNATIONAL ASSOCIATED PARTY DEALINGS (1995).

19. MATHIESON & ROJAS-SUAREZ, *supra* note 8, at 18, citing Ian H. Giddy, *Exchange Risk Under Exchange Controls and Credit Controls*, in EXCHANGE RISK AND EXPOSURE: CURRENT DEVELOPMENT IN INTERNATIONAL FINANCIAL MANAGEMENT (R.M. Levich & C.G. Wihlborg eds. 1980).

20. 1996 Australian Master Tax Guide (CCH) ¶ 30-500.

21. In Australia, there are several acceptable methodologies that an enterprise may use to comply with the arm's length principle. The appropriate arm's length

ing still remains an effective method of avoiding capital movement controls because almost all developing countries, including Taiwan, are not members of the OECD and would not be subject to the OECD resolutions. Furthermore, the taxation and legal frameworks of these countries are not as sophisticated as their counterparts in the western world, and authorities could have difficulty in effectively combating transfer pricing. For example, "Taiwan does not have any specific laws relating to transfer pricing or for determining arms length prices in related party transactions."²²

"Remittances of savings by foreign workers in the domestic economy and by domestic nationals working abroad, family remittances, and tourist expenditures . . . have . . . been used as vehicles for the acquisition or remission of foreign assets."²³ Although there has been limited research examining the extent of this practice, it is generally believed that the arrangement is particularly useful in remitting capital funds overseas in jurisdictions, such as Taiwan, where there are no restrictions over current account transactions.²⁴

IV. FOREIGN EXCHANGE AND CAPITAL CONTROLS IN TAIWAN

Like Japan and South Korea, Taiwan has been subjected to international pressure from its trading partners to open its financial market and convert to a market-oriented foreign exchange system.²⁵ While some financial market liberalization was carried

consideration should reflect the realities of operating in a commercial or financial environment. It is generally expected that reasonable business persons would seek to (i) maximize the price received in respect of the supply of property or services; (ii) minimize the cost associated with the acquisition of property or services; and (iii) be adequately rewarded for any activities carried out. However, in certain circumstances, it is accepted that businesses may sometimes settle for smaller returns in the short term so as to obtain higher profits over the middle to long term. *See* Australian Taxation Ruling TR 94/14; Australian Taxation Ruling TR 95/D23, available in <http://www.ato.gov.au/general/advanced/adv.atm>; Income Tax Assessment Act pt. III, div. 13 (1936) (Austl.); *see also* 1996 Australian Master Tax Guide (CCH) ¶ 30-520.

22. Bernard Marks, *Taxation and Foreign Investment in the Six DAEs Countries: A Summary Background Paper*, in *TAXATION AND INVESTMENT FLOWS: AN EXCHANGE OF EXPERIENCES BETWEEN THE OECD AND THE DYNAMIC ASIAN ECONOMIES* 53, 71 (OECD ed. 1994). "However, it is generally understood that such transactions should conform to regular business practice otherwise they may be set aside." *Id.*

23. MATHIESON & ROJAS-SUAREZ, *supra* note 8, at 9.

24. Interview with Lawrence S. Liu, Partner, Lee & Li, Attorneys-At-Law, Taipei (May 10, 1997).

25. *See* BERNHARD FISCHER & HELMUT REISEN, *LIBERALISING CAPITAL FLOWS IN DEVELOPING COUNTRIES: PITFALLS, PREREQUISITES AND PERSPECTIVES* 133 (1993). In exchange for Taiwan's admission to the WTO, the member countries

out during the 1980s,²⁶ the Taiwanese government has been hesitant in implementing further reforms because significant controls exist.²⁷ In particular, there are both strict limits on the inflow and outflow of portfolio investment and narrow foreign exchange exposure. The foreign exchange market in Taiwan was established in 1979 and since its inception, has had a floating rate system where the U.S. dollar and the New Taiwan ("NT") dollar rates were "allowed to float within a narrow range based on the rate at which the U.S. dollar traded among five authorized foreign exchange banks on the previous day."²⁸ However, "because the system did not allow the exchange rate to react quickly to changing supply and demand conditions," particularly in the bank-customer market, the system was replaced in June 1987.²⁹ In July 1987 eight regulations concerning implementation of these amendments were issued by Taiwan's Central Bank of China ("Central Bank").³⁰ Two of these regulations, the Regulations for Non-governmental Outward Remittance ("RNGOR") and the Regulations for Non-governmental Inward Remittance ("RNGIR"), substantially "liberalize[d] capital movement, including both direct and portfolio investments, to and from Tai-

of the WTO have demanded that Taiwan open up its financial market. See *Taiwanese Stock Market Creaking Open*, *ECONOMIST*, Mar. 27, 1993, at 87, 87.

26. A liberalization of interest rates in stages was the most important of all deregulation measures in the 1980s. In 1989, restrictions on interest rates have been eliminated with the aim of enhancing the role of the market mechanism. See generally BRIAN WALLACE SEMKOW, *TAIWAN'S FINANCIAL MARKETS AND INSTITUTIONS* (1992).

27. See FISCHER & REISEN, *supra* note 25, at 133.

28. SEMKOW, *supra* note 26, at 19.

29. *Id.* The government effectively amended the Statute for the Administration of Foreign Exchange ("SAFE"). Under the new system exchange rates for transactions in excess of US\$30,000 (later reduced to US\$10,000 in July 1989) between a bank and customer were allowed to float freely, "with transactions below this threshold allowed to float within a less narrow range based on a rate determined by a group of nine authorized foreign exchange banks. In December 1990 the foreign exchange settlement amount for small amounts was abolished enabling each bank in the bank-customer market to free[ly] determine its own foreign exchange rate." *Id.* (footnote omitted). While the SAFE amendments and regulations were designed to maintain the existing regulatory framework, they were to liberalize its applications by implementing the required regulations.

30. See *id.* at 156. These regulations include (1) Regulations for the Purchase and Sale of Foreign Exchange by Appointed banks; (2) Regulations for Outward Remittance; (3) Regulations for Non-governmental Inward Remittance; (4) Guidelines for the Operation of Foreign Exchange Business conducted by Appointed Banks; (5) Regulations Governing the Collection Business for Foreign Credit Cards; (6) Regulations for the Central Bank of China's Supervision of Foreign Exchange Operation of Appointed Banks; (7) Regulations for the Establishment and Administration of Foreign Exchange Currency Counters; and (8) Regulation for the Registration of the Balance of Medium-Term or Long-Term Foreign Debts Incurred by Private Enterprises.

wan.”³¹ These two regulations were later replaced by Regulations Governing Reporting on Foreign Exchange Transactions and Trade (“RGRFETT”) in August of 1995.

The RGRFETT allows payments arising from the import of goods and services, i.e. current account transactions, to be freely converted into foreign currencies without restriction.³² Unlike capital account transactions, qualified entities³³ are only permitted to make outward remittances of US\$50 million annually in relation to capital account funds.³⁴ Similarly, natural persons³⁵ are also subject to a capital account remittance ceiling of US\$5 million per annum and reporting requirements.³⁶ Capital account transactions which are subjected to the respective ceilings include payment for foreign equity securities and government bonds, overseas deposits, payment of principal and interest of foreign borrowings, and purchase of foreign real property.³⁷ Other types of outward remittances that exceed the above-mentioned limits require approval from the Central Bank.³⁸ Approved investments by foreign nationals and overseas Chinese investors are exempt from these restrictions.³⁹

In relation to inward remittances, the RGRFETT allows foreign exchange earnings arising from export activities, i.e. current account transactions, to be freely converted into the NT dollar without restriction.⁴⁰ Similar to outward remittances, qualified entities in Taiwan are also subject to US\$50 million quota speci-

31. *Id.*

32. Regulations for Non-governmental Outward Remittance [RNGOR] art. 4(1); Regulations Governing Reporting on Foreign Exchange Transactions and Trade [RGRFETT] art. 4(1).

33. These entities include companies, organizations, proprietors and registered businesses in Taiwan. *See* RGRFETT art. 4(2).

34. The current remittance ceiling (US\$50 million) was announced in June 1997. Prior to this the remittance ceiling for all entities was US\$20 million per annum. *See Market Will be Fully Opened by the Year 2000*, CHINA TIMES DAILY, June 1, 1997, available in <http://www.chinatimes.com.tw>. Meanwhile, all entities are required to report to the Central Bank in relation to any outward remittance that is more than US\$1 million. *See* RGRFETT arts. 1, 3; Central Bank Announcement, May 31, 1997.

35. Natural persons include ROC citizens over 20 years of age and foreign citizens with an alien residency certificate in Taiwan. *See* RGRFETT art. 4(4).

36. Natural persons are required to report to the Central Bank in relation to any outward remittance that is more than US\$500,000. *See* RGRFETT art. 2.

37. *See* Lawrence S. Liu, *Taiwan's Deregulation of Foreign Exchange*, 9 E. ASIAN EXECUTIVE REP. 20, 20-21 (1987) [hereinafter Liu, *Taiwan's Deregulation*].

38. *See id.*

39. Article 13 of the Statute for Investment by Foreign Nationals and article 12 of the Statute for Investment by Overseas Chinese state that foreigners or overseas Chinese can remit out the original investment capital (including any capital gains) that was approved by the government one year after the commencement of such investment.

40. RGRFETT art. 4(1).

fied in the RGRFETT,⁴¹ including the prescribed reporting requirements for each transaction.⁴² Natural persons are also subject to the similar requirements specified in RGRFETT.⁴³ Approved investments by foreign nationals and overseas Chinese are also exempt from these ceilings.⁴⁴

In the past these controls have helped the government to successfully target monetary aggregates and, at the same time, manage the exchange rate. "Low to moderate inflation rates have contributed to a [favorable] macroeconomic background for growth, while competitive and stable exchange rates" have increased the world's demand for Taiwanese manufactured products.⁴⁵ However, these restrictions conflict with Taiwan's desire to become a regional operations center for MNCs. As a regional financial center, headquartered operations in Taiwan would be required to coordinate operational and financial matters of each subsidiary or branch within the group in the region.⁴⁶ The center would likely provide treasury or financial services for member entities in the region, such as liquidity and cash management, financing the sale of goods, and hedging against foreign exchange and interest rate exposure.⁴⁷ The amount and frequency of such transactions for MNCs would arguably be significant. If Taiwan continues to impose tight capital controls, MNCs will limit their functions. For example, MNCs will only establish manufacturing, R&D or training centers, rather than full scale regional headquarters.

In recent years Taiwan has established a national agenda to join various international organizations in an attempt to 'return' to the international community and break through its political and diplomatic isolation. Among these organizations, Taiwan has considered the WTO and OECD prime targets for membership. Although Taiwan has been given general support for its membership bids from members of both organizations, it still faces numerous obstacles. The OECD decided in early 1996 to include Taiwan as a signatory party to its Multilateral Agreement of Investment between OECD members and some "non-member dynamic economies."⁴⁸ Taiwan sent a high level delegation from

41. See Central Bank Announcement, May 31, 1997.

42. RGRFETT art. 4(2).

43. *Id.* art. 4(4).

44. See Statute for Investment by Foreign Nationals art. 13 (Taiwan); Statute for Investment by Overseas Chinese art. 12 (Taiwan).

45. FISCHER & REISEN, *supra* note 25, at 133.

46. See PRICE WATERHOUSE, ATTRACTING REGIONAL HEADQUARTERS TO AUSTRALIA - A SUGGESTED MODEL 1-4 (1992).

47. See *id.* at 9.

48. Some of the agenda of the agreement include (1) abolishing trade and investment barriers such as capital and transaction controls, (2) investment protection

the Ministry of Economic Affairs ("MOEA") to discuss the details of the agreement, however, it withdrew from negotiations because the government refused to remove all barriers on capital account transactions.⁴⁹ Meanwhile, the WTO raised similar concerns in relation to Taiwan's capital control regime.⁵⁰ Underpinning the government's refusal is its concern about the inflow of mainland Chinese capital into Taiwan's economy.⁵¹ The existence of a capital control regime in Taiwan will continue to be a problem if Taiwan wishes to become a WTO and OECD member.

V. CAPITAL CONTROLS AND MARKET REFORM

Foreign investors were not permitted to directly invest in the Taiwanese securities market until the promulgation in December 1990 of the Regulations Governing Securities Investment by Overseas Chinese and Foreign Investors and Procedures for Remittance ("Regulations for Overseas Chinese and Foreign Securities Investors").⁵² Under these new regulations qualified foreign institutional investors ("QFII") that meet prescribed investment criteria are eligible to apply to make direct investments in the

to investors, and (3) establishing a mechanism to resolve investment related disputes between country to country, or country to private investors. *See Restrictions on Maintain Capital Make the Negotiations More Difficult*, COM. TIMES DAILY, July 7, 1997, available in <http://www.ctd.com.tw>.

49. *See id.*

50. The issue of capital control is expected to be brought up in the WTO's Commission on Investment, Technology and Related Financial Issues meeting scheduled in September 1997. Taiwan also expects the issue of the current "severe" restrictions on inflow of the PRC and Hong Kong capital to be raised during the meeting. *See id.*

51. This issue will be dealt with in a later section of this article.

52. During the 1980s foreign investors were permitted to invest indirectly in Taiwan's securities market through mutual funds sponsored by Taiwanese mutual fund management companies, or more commonly known as securities investment trust enterprises ("SITE"). However, various restrictions were imposed, including the percentage of foreign ownership and qualifications of each foreign shareholder SITE's, the amount to be invested and raised in Taiwan, and the time period required in capital raising, and limit on their portfolio turnover ratio. *See Liu & Potter, supra* note 15, at 337. *See generally* Jeffrey H. Chen & Jack T.T. Huang, *Taiwan's Evolving Stock Market: Policy and Regulatory Trends*, 12 UCLA PAC. BASIN L.J. 34, 37-39 (1993). The size of mutual funds has increased significantly as a result of relaxation of SITE Regulations in recent years. In 1986 there were only 5 (open-ended) mutual funds approved by the SEC and they had a total net asset value of approximately NT\$9.2 billion. In 1996 the number of (open-ended) mutual funds had increased to 89 and the net asset value also reached NT\$347 billion. *See* SEC (MOF), IMPORTANT INDICES OF THE SECURITIES MARKET AS AT DECEMBER 1996 IN TAIWAN, ROC (1997). As a result of the government's regional financial center initiative, in early 1996 the SEC removed the foreign ownership restrictions for foreign financial institutions already having a track record. *See also* Lawrence S. Liu, *The Law and Political Economy of Capital Market Regulation in the Republic of China on Taiwan*, 28 LAW & POL'Y INT'L BUS. 813, 828-30 (1997) [hereinafter Liu, *The Law*].

Taiwan Stock Exchange ("TSE").⁵³ In addition to SEC approval, each QFII is required to obtain permission from the Central Bank for inward or outward remittances.⁵⁴ Various restrictions have been imposed by the Central Bank in order to manage the excessive liquidity of this foreign capital. In December 1990, when the government first allowed QFIIs to enter the Taiwanese market, the Central Bank only allowed an aggregate quota of US\$2.5 billion to be invested in the market per year.⁵⁵ The government continues to restrict the maximum and minimum investment amount of each QFII to US\$50 million and US\$5 million respectively.⁵⁶ In order to control speculative transactions, the Central Bank also requires that the original capital be remitted into Taiwan within six months of the approval and may not be remitted out of Taiwan within six months after the initial inward remittance.⁵⁷

Although there have been significant advancements in QFII participation in the securities market, various restrictions are imposed over the amount invested and the percentage of foreign ownership of a listed company. As of March 1998 each QFII is permitted to invest up to US\$600 million per annum in the securities market;⁵⁸ and hold a 10% maximum ownership in each listed company.⁵⁹ In February 1996 the authorities also permitted foreign general investors ("FGI"), including general foreign institutions⁶⁰ or individuals,⁶¹ to invest directly in Taiwan's secur-

53. A SEC announcement provides that QFII generally include banks, insurance companies or fund management institutions. To be qualified foreign banks (excluding investment banks) need to be among the top 1000 banks in the free world in terms of total assets. They must also have securities holdings with a total value of at least US\$500 million. Foreign insurance companies are also required to have at least US\$500 million securities holdings and more than 10 years of operation. Foreign fund management companies are required to manage at least US\$500 million worth of investment funds and be established for at least five years. SEC Announcement, Jan. 16, 1993.

54. Regulations for Overseas Chinese and Foreign Securities Investors art. 9 (Taiwan).

55. This quota was abolished in February 1995.

56. See Liu & Potter, *supra* note 15, at 335.

57. Overseas Chinese and Foreign Investors Regulations arts. 13 & 14. Furthermore, in relation to the profit/capital gains repatriation, each QFII is only allowed to remit the fund from outside Taiwan once per year. Overseas Chinese and Foreign Investors Regulations art. 14; see also Central Bank Announcement, Dec. 1996.

58. MOF Announcement, Dec. 29, 1996.

59. See K.R. Chang, *The Process and Challenge to Develop Taipei as a Regional Financial Center*, TAIWAN ECON. RES. MONTHLY, Nov. 1996, at 35, 40. Furthermore, the maximum foreign ownership in the listed company is limited to 25%.

60. These institutions include (i) branches established in Taiwan by foreign nationals or overseas Chinese with governmental permits, (ii) companies established outside the PRC and registered under foreign jurisdictions, and (iii) non-corporate funds established or registered under foreign jurisdictions. See Wen-Yen Kang & Patricia Lin, *Qualification for Domestic and Overseas Chinese and Foreign Nationals*

ities market to the amount of US\$50 million annually.⁶² However, as there have been no further announcements made by either the Central Bank or the SEC in relation to the new investment quota, one can assume that QFII and FGI will have to share the 25% foreign ownership quota by investing in each listed company.

The SEC and the Central Bank appear to be taking divergent approaches to the issue of foreign capital inflows into the securities market. The SEC believes foreign capital inflows will improve market efficiency by increasing competition in the domestic financial system and possibly reduce financial risks by allowing residents to hold internationally diversified portfolios.⁶³ In contrast, the Central Bank's prime objective is to stabilize the currency, banking and financial systems.⁶⁴ The Central Bank is concerned with whether sudden increases in foreign capital inflows will destabilize the macroeconomy and increase fluctuations in the foreign exchange rate, money supply and inflation rate.⁶⁵ The former Governor of the Central Bank, Yuan-Dong Sheu, publicly stated: "[f]inancial liberalization and internationalization are the predetermined goals of our government. However, before taking action to completely open markets we must cautiously evaluate the potential advantages and disadvantages associated with market opening in the hope that such opening will not seriously affect domestic macroeconomic and financial stability."⁶⁶

Based on the official objectives and public statements, issues such as the liberalization and internationalization of Taiwan's capital market are the Central Bank's *secondary* concerns. Given the power to enforce capital controls under the SAFE⁶⁷ and other related regulations, the Central Bank's jurisdiction

to *Invest in Securities Market*, LEE & LI BULL. (Lee & Li, Taipei, Taiwan), Mar. 1997, at 17, 17.

61. See *id.* Foreign individual investors include "Overseas Chinese and foreign nationals with permanent residences in a region outside the PRC, at the age over twenty, and with legal [identification documents]." *Id.*

62. See Central Bank Announcement, Feb. 10, 1996; see also Regulations for Overseas Chinese and Foreign Securities Investors art. 21.

63. See S.L. Chu, *Discussions on Internationalization of the Securities Market*, TAIWAN ECON. RES. MONTHLY, Nov. 1996, at 41, 44; see also *Taiwanese Stock Market Creeping Open*, *supra* note 25, at 87; Liu, *The Law*, *supra* note 51, at 838.

64. Central Bank of China Act art. 2.

65. See generally Chu, *supra* note 63.

66. Yuan-Dong Sheu, Address to the American Chamber of Commerce (Dec. 7, 1995); Yuan-Dong Sheu, *Current Issues Regarding the Development of Taipei as a Financial Center*, 17 CENT. BANK Q. 6, 6 (1995). Sheu died in the February 1998 China Airlines crash on the way back from the Asian central bank governors' meeting in Bali, Indonesia.

67. Statute for Administration of Foreign Exchange art. 3 (Taiwan).

over capital flows makes it a formidable player in any decision to internationalize Taiwan's securities market.⁶⁸ Without the Central Bank's commitment to reform, Taiwan could not hope to emerge as a key player in the international financial community.

"There is growing sentiment in Taiwan that failure to bring [an immediate] liberalization of the capital and money markets may harm the island's ability to achieve and then sustain its status as a significant financial player in the . . . region."⁶⁹ Although the government plans to fully liberalize the capital account by the end of the year 2000 under its APROC initiative,⁷⁰ it appears that the Central Bank is still "going through a difficult soul-searching process;"⁷¹ if the government fulfils its commitment to remove capital controls by the end of 2000, it also means that the Central Bank will have completely given up one of its most powerful policy tools, i.e. foreign exchange controls. Bearing regulatory psychology in mind, one would not be surprised if the Central Bank explores new areas for market regulation.⁷² Furthermore, practitioners and the financial community are worried that Taiwan will lose substantial 'business' before the year 2000 to other emerging financial centers, such as Shanghai.⁷³

The recent financial crisis in Asia may also impact on the progress of Taiwan's financial sector liberalization and internationalization. It appears that protectionism and conservatism have resurfaced in many countries in the region, including Taiwan. In frustration of the sudden negative change in Malaysia's economic fortunes, Prime Minister Dr. Mahathir Mohamad repeatedly and fiercely blamed foreign currency and stock market speculators (notably George Soros) whom he believed, were trying to destabilize his country's economy. These comments arguably had ramifications beyond Malaysia because they contributed to regional jitters.⁷⁴ During the financial crisis, the Malaysian ringgit plunged approximately thirty-eight percent (37.98 %) in

68. See Liu, *The Law*, *supra* note 52, at 821.

69. Chen & Huang, *supra* note 52, at 61.

70. See COUNCIL FOR ECONOMIC PLANNING AND DEVELOPMENT, *supra* note 2, at 63.

71. Chen & Huang, *supra* note 52, at 61.

72. See Liu, *The Law*, *supra* note 52, at 840.

73. Interview with Lawrence S. Liu, *supra* note 24; Interview with Albert Lee, General Manager, Merrill Lynch (Taiwan), in Taipei; Interview with Ishbell Hsin, Partner, Coopers & Lybrand (Taiwan), in Taipei. The PRC government plans to develop Shanghai as the next international financial center after the handover of Hong Kong in 1997. It is believed that Shanghai will overtake Hong Kong as a financial center within the next 10 to 15 years. See *Bears in a China Shop*, *ECONOMIST*, May 14, 1994, at 75, 75.

74. See I. Steward, *Malaysia's Golden Years No Immunity*, *WEEKEND AUSTRALIAN*, Nov. 29-30, 1997, at 32.

value since the beginning of 1997 (to Nov 30, 1997).⁷⁵ The Kuala Lumpur Stock Exchange has also lost fifty-six percent (55.6 %) of its total capitalization since Jan 1, 1997 (to Nov. 30, 1997).⁷⁶

Much of Taiwan's "relative immunity" from the crisis, aside from having the world's third largest foreign reserves and sound economic performance, stems from its financial markets, which are largely off-limits to foreign speculators.⁷⁷ From many economists' perspectives, Taiwan seems a most improbable place to encounter a currency crisis.⁷⁸ Nevertheless, there has been a growing fear in Taiwan that it will become the next target for international currency speculators. Indeed, the NT dollar depreciated approximately seventeen percent in October and November 1997 – but still much less than those currencies in Southeast Asia.⁷⁹ The Central Bank, despite repeated avowals that it is taking a "hands-off" approach to the money markets, continues to intervene when the NT dollar comes under pressure – it has spent approximately US\$7 to 8 billion to defend the currency.⁸⁰ Such a move triggered a crash on the TSE – a result of tightened supply of money to the local market.⁸¹ The Central Bank's massive bail-out of the NT dollar also infuriated Taiwan's exporters. The strong NT dollar has made Taiwanese products relatively expensive compared to those manufactured in Southeast Asia and South Korea.⁸² In October, the Central Bank joined the "foreigner bashing chorus" from Southeast Asia by slapping punitive overnight borrowing rates on three foreign banks, Citibank, ABN Amro and Swiss Bank Corporation, as punishment for speculating against the NT dollar.⁸³ The government also announced that it would reconsider the timetable for opening Taiwan's capital account.⁸⁴ In other words, it is very likely that the capital account will not be open by the scheduled date, i.e. the end of the year 2000.

75. See *How the Richest Asian Nations Are Coping*, WEEKEND AUSTL., Nov. 29-30, 1997, at 32-33.

76. See *id.*

77. See Bruce Cheesman, *ASEAN Applause for Taiwan*, AUSTL. FIN. REV., Nov. 26, 1997, at 16, available in <http://www.afr.com.au>.

78. See *In Defence of Taiwan*, ECONOMIST, Oct. 18, 1997, at 72, 72.

79. See Cheesman, *ASEAN Applause for Taiwan*, *supra* note 77, at 16.

80. Taiwan's Central Bank has spent about US\$7 billion to \$8 billion in defending the currency. See *id.*

81. See Bruce Cheesman, *Election Jitters Brought on Crash*, AUSTL. FIN. REV. Nov. 10, 1997, at 41, available in <http://www.afr.com.au>.

82. See Bruce Cheesman, *Central Bank Infuriates Taiwan's Exporters*, AUSTL. FIN. REV., Oct. 8, 1997, at 13, available in <http://www.afr.com.au>.

83. See *In Defence of Taiwan*, *supra* note 78, at 72.

84. See *Government Will Reconsider the Year 2000 Timetable*, CHINA TIMES DAILY, Dec. 3, 1997, <http://www.chinatimes.com.tw>.

These moves demonstrate the Central Bank's conservative approach and interventionist attitude in managing Taiwan's monetary and economic policy. Its harsh monetary approach has also invited an avoidable stock market crash. Despite these criticisms,⁸⁵ Taiwan has received top marks from senior Southeast Asian government officials for its handling of the currency and stock market melt down. Several ASEAN leaders, including President Ramos of the Philippines, told Taiwan's representative at the 1997 APEC summit in Vancouver, that they were impressed with Taipei's handling of the crisis.⁸⁶ As a result, the Philippines, Thailand and Indonesia are also planning to send delegations to Taipei to review how Taiwan weathered the region's financial storm.⁸⁷

But did the Central Bank "really" do a good job? While government technocrats like to take the credit for Taiwan weathering the storm better than its Asian neighbors through preventive measures, the most salient defense has been closed financial markets. It is much easier to fight off speculators when capital flows are tightly controlled.⁸⁸ Nevertheless, official "mandates" from foreign leaders are "likely" to only reinforce the Central Bank's interventionist approach to foreign exchange and capital movement. The recent financial crisis in South Korea,⁸⁹ Taiwan's closest economic rival in the region, further strengthens the Central Bank's desire (and certain government officials) to slow down the pace of fully deregulating its foreign exchange and capital accounts.

Notwithstanding, it is hoped that the Taiwanese authorities will not utilize the recent regional financial crisis as an excuse to slow down reform programs. The Taiwanese authorities should live up to their commitment to liberalize the capital account in the shortest possible time. Taiwan should feel confident about itself – it has a sound economy, strong foreign reserves, healthy trade surpluses, and speculative trading is controlled; factors that other economies in the region have lacked in some form or another. If Taiwan wishes to become a regional financial center, its foreign exchange and capital control regimes will have to be abolished or reduced to a minimum. If this does not occur, for-

85. See *In Defence of Taiwan*, *supra* note 78, at 72; see also Cheesman, *Election Jitters Brought on Crash*, *supra* note 81, at 41.

86. See Cheesman, *ASEAN Applause for Taiwan*, *supra* note 77, at 16.

87. See *id.*

88. See Cheesman, *Election Jitters Brought on Crash*, *supra* note 81, .

89. South Korea joined the OECD in 1996. As a result, its financial sector, including its foreign exchange and capital control regimes were significantly relaxed. See *Government Will Reconsider the Year 2000 Timetable*, *supra* note 84.

ign capital will continue to flow to other regional centers such as Hong Kong or Singapore and bypass Taiwan.

VI. FOREIGN RESERVES AND CAPITAL MOVEMENT

One of the results of capital controls is an increase in a country's foreign reserve levels. The increase in foreign reserves might, *prima facie*, be seen as a mark of financial strength and a reflection of a better performing economy.⁹⁰ The size of foreign reserves is often used by government officials in Taiwan as an indicator of national wealth and economic strength. For example, Taiwan, along with other Asian newly industrialized countries, has enjoyed export oriented economic growth in the past few decades accompanied by a consistent trade surplus which has accumulated to become today's foreign reserves (see Table 1):

Table 1. Taiwan's Current and Capital Account Balances and Foreign Reserves

Year	Current Account Balance US\$ billion	Capital Account Balance US\$ billion	Foreign Reserves at the Year End US\$ billion ⁹¹
1987	17.99	10.40	76.75
1988	10.17	-11.46	73.90
1989	11.39	-12.13	73.22
1990	10.77	-15.15	72.44
1991	12.02	- 2.28	82.41
1992	8.15	- 6.91	82.31
1993	6.71	- 4.66	83.57
1994	6.15	- 1.40	92.45
1995	4.82	- 8.19	90.31
1996	10.48	- 8.88	88.04

SOURCE: DIRECTORATE-GENERAL OF BUDGET, ACCOUNTING AND STATISTICS, QUARTERLY NATIONAL ECONOMIC TRENDS, TAIWAN AREA, THE REPUBLIC OF CHINA 76 (1997); DEPARTMENT OF STATISTICS (MOEA), DOMESTIC & FOREIGN REPORT OF ECONOMIC STATISTICS INDICATORS 159 (1997); CENTRAL BANK OF CHINA, FINANCIAL STATISTICS - TAIWAN DISTRICT, THE REPUBLIC OF CHINA (1990-1997).

90. See *Beware of Squirrels*, ECONOMIST, Jan. 11, 1997, at 65, 65.

91. In calculating a nation's foreign reserve levels, net errors and counterpart items should be taken into consideration. However, due to the scope of this article, these figures will be excluded. Figures of current and capital account balances are the aggregate amounts for the respective year. The foreign reserves figures are end of year results, i.e. balances as of December 31 of each year.

However, it is not always correct to equate reserves and surpluses with a nation's economic performance. A large level of foreign reserves in developing countries can be attributed to stringent capital controls. For example, countries like China,⁹² Taiwan, and Brazil are among those countries with the highest foreign reserve holdings in the world,⁹³ which incidentally have imposed various forms of restrictive capital controls.⁹⁴ Moreover, an explosion in a nation's foreign reserves, particularly in developing countries, may suggest that inflows of foreign capital are being managed inefficiently.

The Central Bank, in the period from 1985 to 1989, continued to 'defend' the NT dollar in order to sustain its export ability.⁹⁵ This policy created trade surpluses and animosity from leading trading partners. It also created excess liquidity, inflationary pressure, and a bubble economy in the late 1980s and early 1990s, during which much of the financial liberalization in Taiwan began in earnest.⁹⁶ However, it appears that Taiwan's trade surplus and foreign reserves have gradually decreased since the mid 1990s. This can be attributed to the structural changes in the economy, relaxation of capital controls, investment in foreign countries and a growing number of Taiwanese travelling abroad.⁹⁷ Notably, the gradual currency appreciation of the NT

92. "China," "the People's Republic of China," and "PRC" will be used interchangeably.

93. The top 12 holding nations (as of April 1997) include (by ranking): Japan (US\$215.9 billion), the PRC (US\$104.3 billion), Taiwan (US\$88.6 billion), Germany (US\$81.6 billion), Singapore (US\$75.7 billion), Hong Kong (US\$65.9 billion), Brazil (US\$58.2 billion), the US (US\$57.1 billion), Spain (US\$53.2 billion), Italy (US\$47.8 billion), Britain (US\$40.7 billion), and Thailand (US\$38.2 billion). See *Beware of Squirrels*, *supra* note 90, at 66; *Bottom Line, ASIaweek*, Apr. 18, 1997, at 63, 63. Among these countries, Japan, Taiwan, Germany, Singapore, Hong Kong, and Britain bear no foreign debt while others' foreign debts range from US\$814 billion (the United States) to US\$88 billion (Italy and Thailand). See *International Economic Data*, YAZHOU ZHOUKAN, Apr. 4-11, 1997, at 62.

94. In the PRC, all domestic entities are required to sell all their hard currency earnings to state owned banks. All transactions involving foreign currency, including both current and capital accounts items, are strictly controlled by the State Administration of Exchange Control. See COOPERS & LYBRAND INT'L, 1997 INTERNATIONAL TAX SUMMARIES - A GUIDE FOR PLANNING AND DECISIONS c/59 (1997). In Brazil, all "[e]arnings in foreign currency paid, credited, remitted, received, or invested must be translated into national currency at the official rate of exchange in effect on the date of payment, credit, remittance, receipt, or investment, or at the exchange rate by which the transactions were effectively made." *Id.* at b/61.

95. See Liu, *The Law*, *supra* note 52, at 823; see also SEMKOW, *supra* note 25, at 20. A similar reason also contributed to the significant increase in foreign reserves in the PRC and Japan. The Chinese government has been trying to hold down the value of its currency, the yuan, amid strong inflows of foreign capital. The Bank of Japan is also actively buying U.S. dollars in order "to push the yen down . . . and so stimulate Japan's flagging economy." *Beware of Squirrels*, *supra* note 90, at 65.

96. See Liu, *The Law*, *supra* note 52, at 823.

97. See ECONOMIC DAILY NEWS, THE FINANCIAL YEAR BOOK 191 (1995).

dollar⁹⁸ and a significant increase in operating costs have led to the exodus of many manufacturers to Southeast Asia and the PRC.⁹⁹

Traditionally, most of the Central Bank's foreign currency reserves were held in banks or financial institutions in the U.S. in the form of fixed term deposits or relatively low-yielding American government securities.¹⁰⁰ "At best, this reflect[ed] an overly conservative policy; at worst it smack[ed] of [financial] mismanagement."¹⁰¹ Foreign capital could provide a higher return if invested in more productive areas. Unlike many developing countries which are short of foreign reserves, Taiwan has an abundance of capital and it could be utilized more aggressively to facilitate its industrial development or assist the nation to achieve its economic goals.

There are positive signs that the Central Bank has begun using these reserves in ways other than holding foreign exchange reserves to earn low interest rates on deposits. Firstly, the Central Bank has provided approximately 10 billion U.S. dollars, 1 billion deutsche marks and 15 billion yen as initial starting funds for the Taipei Foreign Exchange Call Market ("TFECM").¹⁰² Secondly, the Central Bank has deposited some of its foreign reserves in overseas branches or subsidiaries of Taiwanese banks to help them become more competitive in their venues abroad. This money assists them in providing full services to Taiwanese enterprises that are investing or expanding their operations abroad.¹⁰³ Thirdly, the Central Bank, subject to its own guide-

98. The NT dollar appreciated over 40% between 1985 and 1989. See Liu, *The Law*, *supra* note 52, at 823.

99. For example, the average labor costs (income) in manufacturing and service industries have increased 37% and 35% respectively during the period from 1991 to 1996. See DEPARTMENT OF STATISTICS (MOEA), DOMESTIC & FOREIGN REPORT OF ECONOMIC STATISTICS INDICATORS 69 (1997). On the other hand, the annual average of consumer index (inflation rate) ranges from 2.94% (in 1993) to 4.47% (in 1992) during the same period. See Directorate-General of Budget, Accounting and Statistics, 76 QUARTERLY NATIONAL ECONOMIC TRENDS, TAIWAN AREA, THE REPUBLIC OF CHINA 48 (1997).

100. These banks and financial institutions include American Express Bank, Bank of America, Bank of Canton of California, Bank of New York, Bankers Trust Co., Chase Manhattan Bank, Chinese American Bank, Citibank, Continental Illinois National Bank & Trust Co., Bank of Boston, First Security Pacific National Bank, Wells Fargo Bank, First Interstate Bank of California and Federal Reserve Bank of New York. See *Where Are Our Foreign Reserves Kept?* CHINA TIMES EVENING EDITION, Jan. 13, 1991. <http://www.chinatimes.com.tw>.

101. *Beware of Squirrels*, *supra* note 90, at 65.

102. See ECONOMIC DAILY NEWS, *supra* note 97, at 191. A call market facilitates the transfer of call money loans by commercial banks to discount houses. Call money loans are generally short term with a lending duration from one day to a week. See CHRISTOPHER PASS ET AL., HARPER COLLINS DICTIONARY OF ECONOMICS (1988).

103. See SEMKOW, *supra* note 26, at 27 n.64.

lines promulgated in April 1990, has provided foreign currency reserves to local banks in a re-lending facility that is used to enable domestic companies to purchase foreign companies or make overseas investments.¹⁰⁴

As Taiwan's market becomes more open, the potential for internationalizing the NT dollar increases. In the early 1980s the Central Bank *had* considered such a proposal. However, it decided that "the [NT dollar was] not yet ready to become an international currency, [largely] because its own research suggest[ed] that were the [NT dollar] to become an international currency, the [Central Bank] would be unable to effectively influence domestic interest and foreign exchange rates by means of its monetary policy and foreign exchange operations."¹⁰⁵

As a result, the NT dollar is neither held abroad in bank accounts by Taiwanese residents, nor held domestically by non-registered foreign owned companies¹⁰⁶ and non-resident foreign natural persons in the form of cheque accounts.¹⁰⁷ Recently, the MOF enacted amended Guidelines¹⁰⁸ to allow foreigners to open NT dollar cheque accounts in branches of foreign banks, foreign securities firms and insurance companies.¹⁰⁹ The Guidelines also simplified the process for foreign companies opening accounts in Taiwan.¹¹⁰

The major concern for authorities is the inability to control the interest and foreign exchange rates by monetary means. However, it is difficult to imagine that the Central Bank would

104. See *id.* at 27 n.65. The Central Bank promulgated the Guidelines for the Central Bank of China Refinancing for Overseas Investments Made by Government Owned and Private Enterprises in April 1990. These guidelines allow designated banks to refinance through the Central Bank foreign exchange loans made to state-owned or private enterprises which make overseas investments or carry out mergers and acquisitions in a number of areas. For example, the Central Bank was involved in 1990's largest foreign acquisition in the US when the state-owned company China Petroleum Corporation acquired Huffington Oil of Houston for US\$700 million. The Central Bank provided approximately US\$420 million in this particular case.

105. *Id.* at 159.

106. Under the old Guidelines on Opening NT Dollar Accounts by Foreigners Without Residential Registration, foreign companies that wished to open a NT bank account had to submit to the authorities the certificate of incorporation from their original country, Taiwanese tax file number, Taiwanese business registration certificate, list of directors, articles of association, and minutes of a directors' meeting approving the opening of a bank account. See *Regulations on Foreigners' NT Dollar Accounts*, APROC NEWSL., Jan. 1997, at 4.

107. However, foreigners with the Certificate of Residence for Aliens are permitted to open savings accounts in Taiwan. See *id.*

108. Guidelines on Opening NT Dollar Accounts by Foreigners without Residential Registration, as amended on Nov. 15, 1996.

109. See *Regulations on Foreigners' NT Dollar Accounts*, *supra* note 106, at 4.

110. Instead of submitting documents as described in note 106, a company is now only required to submit its registration documents and tax file number to the authorities.

be unable to control both rates considering its statutory power over the monetary and financial framework in Taiwan and more importantly, its ability to trade Taiwan's foreign reserves in an open market. In addition to trading currencies, the Central Bank could also influence the rates by a process of "sterilization."¹¹¹ Sterilization policy has proven an effective intervention tool in other economies such as Singapore.¹¹² Such a policy, in theory, would require a large pool of securities to be issued by the government in an open market. In this regard, recent movements to issue government bonds regularly from July 1995 onwards could be viewed as a positive sign of implementing a sterilization policy.¹¹³ As the amount of bonds increases, the authorities will be able to use this mechanism more effectively.¹¹⁴ Taiwan is emerging as a regional capital exporter and the NT dollar has been increasing in circulation unofficially in Southeast Asia, Hong Kong and the PRC.¹¹⁵ It is possible that as the NT dollar is grad-

111. Sterilization is a process through which a central bank uses domestic monetary operations to offset the domestic monetary effects of official reserve transactions in foreign exchange markets. "This means using domestic open market sales of government securities to absorb reserves at the same time that reserves are being created through intervention in the form of purchases of foreign currency or using domestic open market purchases of securities to provide reserves at the same time that reserves are being absorbed through intervention in the form of sales of foreign currency." EDWIN G. DOLAN, *ECONOMICS*, 838-39 (4th ed. 1986).

112. Central to the Singapore sterilization policies "are the combined effects of a public sector budget surplus and the use of the Central Provident Fund, a mighty social pension fund, for the management of domestic liquidity. Employers and employees each have to contribute 25 [percent] of wages to the Fund, a very high proportion which, to a large extent, explains the high level of Singapore's domestic savings." FISCHER & REISEN, *supra* note 25, at 68. Singapore's average savings rate reached 50.11% in 1995. Taiwan also maintains a high savings rate, which should provide domestic sectors with adequate monetary liquidity. In 1995 the average savings rate reached 25.34% in Taiwan. See DIRECTORATE-GENERAL OF BUDGET, ACCOUNTING AND STATISTICS, *supra* note 99, at 55. The savings rate is calculated as follows: savings rate = (GNP - consumption - net current transfer)/GNP. See *id.*

113. See Sheu, *supra* note 66, at 12. The government issued NT\$ 10 billion in government bonds in each month from July to October 1995 and NT\$ 20 billion in bonds in November 1995. According to the Central Bank, the main purpose for issuing bonds is to develop Taiwan's local debt market.

114. In the first half of 1996, government securities issued in Taiwan increased 99% compared to the same period in the previous year. The issued amount during this half-year period was approximately US\$500 million. This, however, is still lower than the debts issued by other regional countries such as Australia (US\$5.5 billion, 11% increase), and South Korea (US\$22 billion, 22% decrease). See *Australia Issued More than 5 Billion Dollars of Debts*, YAZHOU ZHOUKAN, May 5-11, 1997, at 65.

115. For example, China's State Administration of Exchange Control has permitted free circulation of the NT dollar in China's 15 "Tax-Saving Zones" (TSZs). Under the new regulation announced in June 1997, business transactions can be negotiated and settled in the NT dollar or other currencies within the TSZs. In addition business people will be able to open "NT accounts" with Chinese state owned banks or other financial institutions established in the TSZs. See *The NT Dollar Will*

ually internationalized, it may evolve as an important regional or even global currency like the Hong Kong or Singapore dollar. This would enhance Taiwan's image in the international financial community and contribute to Taiwan's efforts in becoming an international financial center.

VII. REMOVING CAPITAL MOVEMENT CONTROLS

For certain periods in Taiwan's economic history, government restrictions on capital flows may have contributed marginally to domestic capital accumulation. However, the trend and experience in Japan and other Asian NICs suggests that capital restrictions are only useful for a limited time: as economies reach maturity, become more sophisticated and are more closely linked to international markets, restrictions on capital exports inhibit efficiency and should be dismantled.¹¹⁶

The benefits of capital account deregulation are numerous. The following efficiency gains can be obtained if a country's capital account is fully liberalized:¹¹⁷ (i) unrestricted capital flows benefit the international economy by facilitating specialization in the production of financial services; (ii) capital account convertibility creates dynamic efficiency by introducing foreign competition in the financial industry from abroad and stimulating innovation and productivity; (iii) global savings can be allocated to the most productive investment if international financial markets price the risks and returns inherent in financial claims appropriately; and (iv) for countries with limited access to private external finance, freedom of capital inflows and outflows may facilitate renewed access to international financial markets.

Although deregulation in the capital account might increase competitive pressures that can lead to important efficiency gains, they can potentially introduce new and highly complex elements of systematic risks that make the pricing of financial instruments increasingly difficult. As a result, this contributes to abrupt changes in credit flows once previously unforeseen risks become evident.¹¹⁸ In addition, more complex financial structures and ownership linkages can make the detection of fraud and other illegal activities difficult.¹¹⁹ An immediate danger of allowing

Be Freely Circulated on Mainland's 15 Tax Saving Zones, CHINA TIMES DAILY, June 4, 1997, available in <http://www.chinatimes.com.tw>. From the author's personal experience, the NT dollar is widely used as a "trading" tender and can easily be converted into local currencies in the ASEAN countries.

116. See WORLD BANK, *supra* note 5, at 235.

117. See MATHIESON & ROJAS-SUAREZ, *supra* note 8, at 20; see also OECD, LIBERALISATION, *supra* note 6, at 30-31.

118. See OECD, LIBERALISATION, *supra* note 6, at 31.

119. See *id.*

foreign capital into the financial market is the possibility of increasing market volatility: a large inflow of foreign capital into the market is likely to increase the price of local assets. However, a large inflow of foreign capital may also lead to a sudden withdrawal of such capital without any warning.¹²⁰

The experience in Mexico demonstrated the important impact that volatile equity flows can have on the variability of share prices in a small local market. In February 1994 US\$280 million was transferred from the US to the Mexican securities market; however, in the following month, US investors sold a net US\$170 million of Mexican equity.¹²¹ This rapid change in capital flows was accompanied by a rapid decline of stock prices and currency value, which soon led to an economic crisis.¹²² The Mexican experience raises serious questions as to the circumstances which must prevail for a country to be 'ready' for a fully convertible capital account. Dr. Mancera, the Governor of the Central Bank of Mexico, commented that the ensuing financial crisis was a direct result of the sudden and complete opening of the Mexican securities market to capital inflows. Mexico might not have been ready for a fully liberalized capital market at that stage.¹²³

Taiwan's Central Bank has continually used "scare tactics" by implying that Taiwan might become the next Mexico if the capital market is liberalized too quickly. So far Taiwan has been unable to overcome the fear of macroeconomic instability resulting from integrating Taiwan's financial market globally.¹²⁴ The question then becomes whether Taiwan's financial system is ready for a deregulated capital account, and if a similar crisis arises in Taiwan, how potential damage and risks to the financial system could be minimized.

120. Sudden capital outflows "are likely to occur when small and illiquid markets are weak. Investors tend to redeem their shares from [investment funds], and fund managers are then obliged to sell shares in the local market, which further depresses prices." David Folkerts-Landau et al., *Effect of Capital Flows on the Domestic Financial Sectors in APEC Developing Countries*, in *CAPITAL FLOWS IN THE APEC REGION* 31, 43 (Mohsin S. Khan & Carmen M. Reinhart eds. 1995).

121. See Y.H. CHANG, *DISCUSSIONS ON THE ISSUES IN RELATION TO LIBERALIZATION OF FOREIGN INVESTMENT AND CAPITAL FLOW* 35 (1995).

122. See *id.*

123. See Sheu, *supra* note 66, at 11. Since the late 1980s, the Mexican authorities have adopted free market reforms in an attempt to resolve the country's economic problems. Such a policy worked in Mexico and has transformed it from a debt-ridden country into a sought-after emerging market. In addition to the existing free-flow policy, the country also became a part of the North American Free Trade Agreement (effective from Jan. 1, 1994), which allows maximum flow of capital, goods and services among America, Canada and Mexico. These movements have strengthened the authorities' belief that free capital movement is beneficial to the country's economic development. See *The Clash in Mexico*, *ECONOMIST*, Jan. 22, 1994, at 13, 13; *The Revolution Continues*, *ECONOMIST*, Jan. 22, 1994, at 19, 19-21.

124. Interview with Lawrence S. Liu, *supra* note 23.

The problems of Mexico suggest that maintaining capital account convertibility requires strengthening the prudential supervision of financial institutions and carefully formulating appropriate macroeconomic and financial policies. These may include establishing more flexible interest and foreign exchange rates and "more clearly defin[ing] the scope of the protection offered by the official safety net that underpins the domestic financial system."¹²⁵ However, there are fundamental differences between Taiwan and Mexico. Taiwan, after more than forty years of remarkable economic development, has emerged as one of the powerhouse economies in the region; whereas in Mexico, the economy was still recovering from the debt crisis that began in the early 1980s.¹²⁶

Around the same time as Mexico's economic woes, Hong Kong was also affected by large scale volatility due to a sudden foreign capital movement. In December 1993 U.S. investors purchased US\$674 million of Hong Kong shares on a net basis; however, in the following month, U.S. investors sold, on a net basis, US\$708 million of Hong Kong shares and set the stage for a rapid decline in the share price in the following months.¹²⁷ Although the absolute outflow amount in Hong Kong was far

125. MATHIESON & ROJAS-SUAREZ, *supra* note 8, at 30. For example, the domestic interest rate on debt financial instruments "must be comparable to those prevailing in international financial markets" or the main capital export countries. *Id.* In general investors would prefer to invest in debt instruments which are denominated in a high rate currency as yield generated from such instruments will be higher than those denominated in low interest currencies. Countries that maintain a fixed exchange rate will enjoy less volatility in the foreign exchange market. However, they might also suffer from interest rate fluctuations. See CHANG, *supra* note 121, at 34; see also FISCHER & REISON, *supra* note 25, at 133.

126. Although the general economic conditions have improved significantly (for example, the inflation rate has decreased from 159% in 1987 to 8% in 1993), the Mexicans still faced various economic problems. For example, while bigger companies raised cheaper funds on international capital markets and prepared to take on the world as a result of open capital markets, smaller companies have struggled to cope with real interest rates of up to 15% and thousands have gone bust. The industry is also overly reliant on foreign assistance and capital involvement: the local productivity and savings rate remained low to sustain the long term economic growth. As a result of low productivity and an increased value of the currency, the current account deficit also hit a record high in 1992 and 1993 and reached approximately US\$22 and US\$24 billion respectively. Foreign capital (mainly from the US) was not utilized effectively in transactions. See *The Revolution Continues*, *supra* note 123, at 19-21.

127. See CHANG, *supra* note 121, at 31. The Hang Seng index started to climb in late 1993 as the result of Morgan Stanley increasing the proportion of Hong Kong shares in its global investment portfolio from 0.2% to 6%. The news encouraged more fund managers to transfer their capital into the Hong Kong stock market. International investors were optimistic about PRC's economic future and shares issued by PRC companies, or so called "red chips", were among the most popular shares. However, in early 1994, a growing fear of inflationary pressure in the US, and the increased possibility of China losing its most-favoured-nation status in the US, con-

greater than that of Mexico, the harm done to the Hong Kong market was comparatively smaller and certainly did not lead to a "national" crisis.¹²⁸ As mentioned above, similar destabilizing financial events also occurred in Asia in late 1997, which seriously affected the half-dozen smaller economies of Southeast Asia. Developments in those economies also decisively affected the bigger economies of North Asia. The total market capitalization of Tokyo, Hong Kong, Taipei, China, Kuala Lumpur, Singapore, Bombay, Seoul, Jakarta, Bangkok and Manila dropped US\$1.8 trillion in the months from September to November 1997.¹²⁹ People are losing their confidence in Asia—market sentiment has turned sour and fundamentals have disappeared as investors are scrambling to liquidate Asian stocks in favor of better prospects elsewhere.¹³⁰ The financial crisis in Asia has thus become an event of global significance. Moreover, the turmoil is also showing some signs of spreading to other markets, including Australia¹³¹ and the United States¹³² (see Table 2).

tributed to the decline in share prices. See C. HU, *THE TRANSFORMING FINANCIAL CENTRE - HONG KONG* 170 (1996).

128. Despite this the Hang Seng index continued to drop from the peak of 12,201 in early January 1994 to the lowest point of 7,670 in December 1994. See *Hong Kong's Receding Nightmare*, *ECONOMIST*, Mar. 19, 1994, at 98, 98. In comparison, the Mexican stock market index dropped from 2857.5 to 1935.32 within four months. See CHANG, *supra* note 121, at 34-35.

129. See Geoff Hiscock, *Tigers Lost Confidence, then Claws*, *WEEKEND AUSTRAL.*, Nov. 29-30, 1997, at 31.

130. See *id.*

131. See generally Alan Mitchell, *How the Regional Contagion Could Infect Australia*, *AUSTRAL. FIN. REV.*, Oct 25, 1997, at 24, available in <http://www.afr.com.au>.

132. It is reported that the Chairman of the US Federal Reserve Board, Alan Greenspan, did his best to calm the US market, noting US "economic growth appears to have remained robust and inflation low and even falling". The Asian crisis, he noted, however, would slow the US economy and take more heat off any inflationary pressures and even the stock market's fall was "less out of line than it would have been". J. Durie, *Mexican Wave Effect Rolls Close to US*, *AUSTRAL. FIN. REV.*, Oct 31, 1997, available in <http://www.afr.com.au>.

Table 2. Summary of Major Events in the 1997 Asian Financial Crisis¹³³

Time	Event
July 1997	Thailand, in economic crisis, floats baht, which plunges. Philippines floats peso.
August 1997	IMF offers Thailand US\$17.2 billion rescue. Malaysian ringgit plunges.
September 1997	Indonesia seeks IMF rescue package after rupiah plunges.
October 1997	World stock markets in chaos, Indonesia gets US\$23 billion IMF rescue.
November 1997	Some Indonesian banks closed. Japanese brokers and banks fail. South Korea's won plunges and Seoul seeks IMF bail out. APEC offers help.
December 1997	South Korea accepts IMF's US\$57 billion rescue package. South Korean won and Malaysian ringgit continue to plunge.

Taiwan's Central Bank has long used "scare tactics" by implying that Taiwan might become the next Mexico if the capital market is liberalized too quickly. It has so far been unable to overcome the fear of macroeconomic instability resulting from integrating Taiwan's financial market globally.¹³⁴ The recent Asian financial crisis, particularly South Korea's economic failure, has also gone toward reinforcing the Central Bank's fears of rapid deregulation. The question then becomes whether Taiwan's financial system is ready for foreign exchange and capital movement deregulation, and if a similar crisis arises in Taiwan, how potential damage and risks to the financial system could be minimized.

The problems of Mexico and Southeast Asia suggest that liberalization of capital account requires strengthening the prudential supervision of financial institutions and carefully formulating appropriate macroeconomic and financial policies. These may include establishing more flexible interest and foreign exchange rates and "more clearly defining the scope of the protection offered by the official safety net that underpins the domestic financial system."¹³⁵ The 1997 financial crisis in Asia

133. Hiscock, *supra* note 129, at 31; see also Colleen Ryan, *IMF Has the Tigers By the Tail*, AUSTL. FIN. REV., Dec. 6, 1997, available in <http://www.afr.com.au>.

134. Interview with Lawrence S. Liu, *supra* note 24.

135. Mathieson & Rojas-Suarez, *supra* note 8, at 30. For example, the domestic interest rate on debt financial instruments "must be comparable to those prevailing

has revealed many problems that currently exist in some Asian economies. It is well known that Asia's economic boom in the early 1990s was largely due to speculative investments in stock and property markets.¹³⁶ Many financial experts have noted that instead of blaming foreign speculators, the governments in Asia should pay more attention to addressing economic shortcomings in their respective countries.¹³⁷ The supervision of financial institutions has been relatively relaxed,¹³⁸ foreign exchange and exchange rates have been rigid,¹³⁹ and most of the countries are making current account/trade deficits with relatively low levels of foreign reserves (see Table 3).

Table 3. Taiwan's Economy Compared to the Other Asian Countries¹⁴⁰

Country	Currency Value ¹⁴¹	Current Account US\$billion ¹⁴²	Foreign Reserves US\$billion ¹⁴³	Foreign Debts US\$billion ¹⁴⁴
Malaysia	Down 37.98 %	(4.40)	26.8	27.0
Japan	Down 10.35 %	82.00	215.9	0
South Korea	Down 26.13 %	(19.00)	29.8	34.7
Philippines	Down 31.45 %	(3.80)	10.0	39.4
Singapore	Down 11.39 %	(15.50)	75.7	0
Indonesia	Down 49.94 %	(7.90)	18.3	107.8
Thailand	Down 60.86 %	(10.00)	38.2	88.0
China	Up 0.13 %	(7.20)	104.3	116.3
Hong Kong	Remains pegged to US\$	(2.60)	65.9	0
Taiwan	Down 15.29 %	9.70	88.6	0

in international financial markets" or the main capital export countries. *Id.* In general, investors would prefer to invest in debt instruments which are denominated in a high rate currency as yield generated from such instruments will be higher than those denominated in low interest currencies. Countries that maintain a fixed exchange rate will enjoy less volatility in the foreign exchange market. However, they might suffer from interest rate fluctuations. See CHANG, *supra* note 121, at 34; see also Fischer & Reison, *supra* note 25, at 133.

136. See Steward, *supra* note 74, at 32.

137. See *id.*

138. See generally Hiscock, *supra* note 129, at 32.

139. Although the exchange rates were forced to "float" when the crisis broke up.

140. *How the Richest Asian Nations are Coping*, *supra* note 75, at 31-32; see also *Bottom Line*, *supra* note 93, at 63; *Economic Indicators*, YAZHOU ZHOUKAN, Nov. 17-23, 1997, at 79.

141. From July 1, 1997 to November 30, 1997.

142. For the year ended September 30, 1997.

143. As of April 18, 1997.

144. As of November 17, 1997.

In contrast to Southeast Asian nations, Taiwan's economic forecasts in 1997 and 1998 are a GDP growth of 6.58% and 6.47%, clearly the highest among Asian Newly Industrialized Countries and perhaps, one of the highest in the world.¹⁴⁵ Exports, expected to benefit from currency depreciation, have considerably improved in the past year with Taiwan predicting a surplus as high as US\$9 billion. It still has strong foreign exchange reserves of around US\$80 billion, about three times that of South Korea, although down considerably from March because of the currency bail out, and has minimal overseas debt.¹⁴⁶ There are no fears of a collapse in the banking sector like in Thailand and Indonesia, and the property market is stable.¹⁴⁷ With a sound economic foundation, one would be surprised if Taiwan suffers a financial crisis.

This calls into question the necessity of the Central Bank's continued conservative approach to capital controls.

VIII. MARKET VOLATILITY AND RISK REDUCTION ARRANGEMENTS

In less sophisticated markets like Mexico and the Southeast Asian countries, it is necessary for the authorities to formulate economic policies to channel foreign capital into productive sectors when the capital account is liberalized. Local (and smaller) investors will require greater protection from the government due to a lack of risk-averse channels in such markets. The authorities in less developed markets may need to establish an effective supervisory system to monitor capital movement so that abnormalities in the market can be identified at an early stage. On the other hand, in a free, sophisticated, and highly internationalized market, investors are still able to diversify their risks through various channels even without major government intervention. For instance, investors can effectively minimize their investment risk by reducing the portion of local shareholding in a global investment portfolio, or by entering into risk reduction arrangements such as hedging and derivative contracts.

Under the *laissez-faire* approach, intervention by the Hong Kong authorities in its financial market is kept to a minimum.¹⁴⁸ Without the government's protection, the private sector and market participants have become more conscious of potential financial risks which may affect their investment positions. As a result, sophisticated investors have developed a series of finan-

145. See Cheesman, *Election Jitters Brought on Crash*, *supra* note 81, at 41.

146. *See id.*

147. *See id.*

148. *See id.* at 216-18.

cial strategies, including derivative or hedging arrangements, to protect themselves from market volatility. One of the benefits of a more open capital account is that rational investors will be able to diversify their portfolios around the world. Since there are no capital movement controls in Hong Kong, local investors can diversify without restriction. Mathieson and Rojas-Suarez suggest that “[i]f financial institutions, firms, and households hold more internationally diversified portfolios, then their income streams and wealth positions will be better hedged against the effects of economy-specific shocks.”¹⁴⁹ This diversification by sophisticated investors, particularly institutional investors, can also serve as an important buffer against requests for government intervention if a crisis arises.¹⁵⁰

Similarly, if the capital account becomes fully convertible, Taiwanese investors would be able to access international investment opportunities and use their funds more efficiently, and possibly reduce their investment risks by diversifying asset portfolios internationally. In addition, the inflow of international funds and investors to the local market will also lead to the introduction of new financial techniques and instruments.¹⁵¹ Foreign institutional investors, who normally pay more attention to analyzing risks and the long-term potential and fundamental value of each asset, will also assume an important role in “educating” speculative local investors. Apart from international portfolio diversification, sophisticated investors will have to utilize one or more derivative or hedging instruments to protect their financial positions in order to reduce the risks associated with an open capital account.

The derivative market in Taiwan is still in its infancy when compared with major international financial markets. In July 1992 Taiwan’s first derivative products legislation, the Foreign Futures Trading Law (“FFTL”), was promulgated to control illegal and fraudulent trading practices¹⁵² by requiring domestic futures trading agents (“FTA”) and domestic branches of foreign FTAs to be registered under the SEC licence and supervision schemes.¹⁵³ The FFTL also provides guidelines for Taiwanese investors seeking to invest in approved foreign futures markets¹⁵⁴

149. MATHIESON & ROJAS-SUAREZ, *supra* note 8, at 31.

150. *See id.*

151. *See id.*

152. For details on illegal futures trading and underground economic activities see generally SEMKOW, *supra* note 26, at 217.

153. Foreign Futures Trading Law [FFTL] arts. 6-30 (1992) (Taiwan).

154. As of December 1996 the following futures markets have been approved by the SEC: Chicago Board of Trade (“COBT”), Chicago Mercantile Exchange (“CME”), Commodity Exchange Inc., Coffee, Sugar and Cocoa Exchange, New York Cotton Exchange, New York Mercantile Exchange, Singapore International Monetary Exchange (“SIMEX”), London International Financial Futures and Op-

and futures products.¹⁵⁵ No legal framework regulating domestic derivative trading existed in Taiwan, nor a local trading market for derivative products, until the recent enactment of the Futures Trading Law (“FTL”) in March 1997.¹⁵⁶ Even while Taiwan’s authorities and legislators work on the details of futures trading on the island, Singapore’s SIMEX, and the CME in the United States, have commenced trading the Taiwan stock index.¹⁵⁷ Meanwhile, another U.S. stock exchange, the Pacific Stock Exchange, also announced its intention to trade with Taiwan-index derivative products.¹⁵⁸ Without its own futures exchange and derivative products, the SEC realized this would contribute to an erosion of Taiwan’s financial and competitive position. In order to protect its own position, and perhaps for the purpose of protecting local investors, the SEC proposed to stop passing TSE daily trading information to the abovementioned exchanges at one stage.¹⁵⁹

A local derivatives market is essential in order to minimize the level of market volatility following capital account deregulation. Without stock index futures or options traded in the local exchange, risk averse investors are unable to hedge investments in volatile markets like the TSE. The absence of these products may potentially affect the market in the following ways. Firstly,

tions Exchange, International Petroleum Exchange, London Metal Exchange, London Commodity Exchange, Marche a Terme International de France, Hong Kong Futures Exchange, Sydney Futures Exchange, Tokyo Commodity Exchange, Tokyo International Financial Futures Exchange, Tokyo Grain Exchange, Tokyo Stock Exchange, and Osaka Stock exchange. See ECONOMIC DAILY NEWS, *supra* note 97, at 155.

155. Approved derivative products include commodities such as petroleum, sugar, gold, cocoa, wheat and financial derivatives such as interest rate options, interest rate swaps, cross currency swaps, forwards and securities indexes and government bonds. Statistics show that the ten most traded commodities in the first half of 1996 were US treasury bonds (15.16% of the total market share), S&P 500 index (14.19%), the Japanese yen (12.25%), the Swiss franc (11.22%), the Nikkei 225 (10.14%), the deutsch mark (7.01%), soybeans (3.83%), corn (3.41%), wheat (3.38%) and the British pound (2.47%). See *id*

156. The Legislative Yuan adopted the FTL on Mar. 4, 1997 to allow the establishment of a market for trading derivatives and the introduction of local futures products. The Taiwan International Mercantile Exchange (“TIMEX”) is expected to be established by October 1997. Initially, only futures, options and stock warrants will be traded. See *Futures Trading Law Adopted*, APROC NEWSL., May 1997, at 2. The process of enacting the FTL was originally expected to be completed by the end of 1995. However, due to legislative and administrative inefficiency, the completion of the legislative process of the FTL was then postponed to 1997. See ECONOMIC DAILY NEWS, *supra* note 81, at 158-59; see also *Legislators Attack the SEC*, COM. TIMES, Jan. 7, 1997, at 18.

157. The trading commenced on January 9, 1997. See Bruce Cheesman, *Taiwan Threatens a Blackout of News*, AUSTRL. FIN. REV., Nov. 20, 1996, available in <http://www.afr.com.au>.

158. See *id*.

159. See *id*.

even if the capital account is fully opened, the level of participation by sophisticated investors will continue to remain low¹⁶⁰ "because without these products they cannot hedge . . . their investments, and must resort to very costly active trading to continually achieve the appropriate . . . portfolio."¹⁶¹ Secondly, without these products, both local and foreign individual long-term investors "retreat from the market, awaiting more stable conditions, leaving continuing active short-term trading [to] the remaining individual investors."¹⁶² Thirdly, as discussed above, the buffer of government intervention will be effectively diminished. Fourthly, if a Mexican style stock market crash were to happen in Taiwan, the potential damage to investors and the economy will be far greater than in other markets where derivative products are available, since investors in Taiwan are not able to protect their positions through such products.

In order for Taiwan to become an important financial center, the island must strive to offer at least the same financial services as its competitors. Otherwise, financial institutions and investors will go elsewhere, looking for more efficient markets in which to hold and trade funds. In any case, the existence of derivative products and futures exchanges is essential for market participants to minimize their trading risks in cross border transactions, particularly when Taiwan's capital account becomes fully convertible. It is disappointing that the continuing delay in legislating the FTL and establishment of the TFE has given rival exchanges a head start. Nevertheless, the authorities and legislators should maintain a forward vision and continue the reform process; otherwise, slow and disjointed deregulation will impede Taiwan's plans to become a regional financial market.

IX. REPORTING SYSTEM AND PRUDENTIAL SUPERVISION

Under the 1995 APROC plan, the Taiwanese authorities recognized the importance of substantially reducing barriers to the flow of capital. The authorities in Taiwan, including the Central Bank, agreed to further liberalize the country's foreign exchange system by introducing a new regulatory philosophy by the end of the year 2000.¹⁶³ The central theme of this proposal is "freedom

160. Individual investors on the TSE make up as much as 90% of the stock buyers. See SEC (MOF), *supra* note 52, at 3.

161. SEMKOW, *supra* note 26, at 220.

162. *Id.* at 220. The volatility of the TSE has been attributed to the number rate of individual investors, most of whom look for short-term profits and actively trade shares.

163. See Lawrence S. Liu, *Creating an International Financial Center: The Case of Taiwan, R.O.C.*, in INTERNATIONAL BANKING OPERATIONS AND PRACTICES: CUR-

from foreign exchange control; foreign exchange would be freely held by the private sector as a norm, subject only to prior reporting and after-the-fact inspections, and government regulations would be imposed only when a national emergency occurs."¹⁶⁴ The authorities further acknowledged that it would require a sophisticated reporting system in order to monitor the flow of capital so that any abnormalities in the market could be detected at an early stage.¹⁶⁵ Such regulatory philosophy over foreign exchange was advised by the Council for Economic Planning and Development ("CEPD") to the government back in July 1987 as part of the process of revamping the SAFE.¹⁶⁶ However, until the recent government announcement to adopt such regulatory philosophy by year 2000, discussion and debate was minimal.¹⁶⁷ A study conducted by the CEPD also revealed that Taiwan's future model and its reporting and monitoring system will be based on the system currently in place in Japan.¹⁶⁸ Although details of the government's new proposal have not yet been finalized, it is worthwhile examining the Japanese system and the CEPD model in order to gain some insight into how the Taiwanese version might emerge.

Japan provides an interesting example because it maintained extensive restrictions when it joined the OECD in 1964 and liberalized nearly all capital movements in steps from that time until 1980, when the Foreign Exchange and Foreign Trade Control Law ("FEFTCL") was enacted.¹⁶⁹ The FEFTCL not only removed restrictions on capital movement, but for the first time, committed the Japanese authorities to the principle of freedom of capital movement by excluding the possibility of introducing restrictions other than in defined circumstances.¹⁷⁰

In Japan, capital account transactions¹⁷¹ can be freely made, but depending on the type of transaction notification or permis-

RENT DEVELOPMENTS 71, 92 (J.J. Norton et al. eds. 1994) [hereinafter Liu, *Creating*]; see also Sheu, *supra* note 66, at 12.

164. Liu, *Creating*, *supra* note 163, at 92.

165. See Sheu, *supra* note 66.

166. See Liu, *Creating*, *supra* note 163, at 92. The CEPD is part of the Executive Yuan "which is charged with advising the Premier on economic policies and reviewing legislative proposals sponsored by various agencies" within the government. *Id.*

167. Although the proposal was briefly discussed in the Legislative Yuan in 1992, no concrete results have emerged. The primary concern of the Legislative Yuan was the government's emergency power to reimpose the foreign exchange controls. See *id.* at 93.

168. See *id.* at 92.

169. See OECD, *CONTROLS*, *supra* note 13, at 45.

170. See *id.*

171. Capital transactions include: (i) transactions arising from deposit or trust relations between residents and non-residents, FEFTCL art. 21(1); (ii) transactions arising from the loan of money, guarantees, or other credit transactions between

sion is required¹⁷² from the component authorities.¹⁷³ Apart from these reporting requirements, government regulations would not be imposed unless a "national emergency" occurred. A national emergency includes the situation where the country suffers an imbalance in its balance of payments, the exchange rate between the yen and international currencies undergoes a dramatic fluctuation, or major inflows and outflows of domestic and foreign funds adversely affects the domestic financial markets.¹⁷⁴

If a Japanese style system is adopted in Taiwan, it would be significantly different from the "prohibited-in-principal" approach which is currently used in Taiwan. The main problem with the current system is that coupled with low levels of administrative efficiency, the level of evasion remains high, which increases the monetary cost associated with law enforcement. The Japanese approach allows authorities to maintain high levels of supervision over the entire system while maintaining the free flow of the capital account. Under this system the authorities are given the power to rectify any potential problems in a national emergency which might cause economic instability or lead to a financial crisis. In other words, if the authorities notice any market abnormalities such as sudden increases of capital outflows, they are able to restore capital controls to stop further capital

residents and non-residents, unless otherwise specified, FEFTCL arts. 21(1), 22(1); (iii) the transfer of foreign exchange between residents and non-residents, unless otherwise specified, FEFTCL art. 21(1); (iv) residents' acquisitions of foreign securities from non-residents or non-residents' acquisitions of Japanese securities from residents, unless otherwise specified, FEFTCL arts. 20(5), 22(1)(ii); (v) the issuance or offering of securities by residents abroad, or the issuance and offering of securities abroad that are denominated or payable in the Japanese currency by non-residents, FEFTCL art. 21(1)(ii); (vi) residents' purchase of foreign real estate, or non-residents' purchase of real estate in Japan, FEFTCL arts. 20(10), 22(1), 23(1); (viii) funding and credit transactions, FEFTCL art. 20(11); and (ix) other transactions involving the conversion between the Japanese and other currencies by residents and non-residents for purposes of obtaining investment returns, FEFTCL arts. 22(1), 22(3). Capital transactions included in the CEPD's proposal are similar to those identified under the Japanese FEFTCL. *See generally* Liu, *Creating, supra* note 163, at 93.

172. These reporting requirements can be classified into the following: (i) transaction is permitted without any notification required; (ii) transaction is permitted but subject to the 20-day waiting period after a notification lodged with the authority; (iii) transaction is permitted and subject to no waiting period after a notification lodged with the authority; (iv) transaction is subject to a prior permission, and (v) transaction is subject to a subsequent notification. *See* ASAHI BANK INSTITUTE OF RESEARCH, *THE PRACTICAL GUIDE TO THE FOREIGN EXCHANGE LAW 1* (1994).

173. *See id.* at 39-41. These authorities include the Ministry of Finance, the Ministry of International Trade and Industry, and the Bank of Japan.

174. FEFTCL art. 21(2). The definition of "national emergency" under the CEPD's proposal is similar to the Japanese one. *See generally* Liu, *Creating, supra* note 165, at 92.

outflows until the share price or the exchange rate stabilizes. However, this monitoring system will only work when it functions on a timely basis. This is because modern telecommunications and information technology allow today's cross border transactions to occur more frequently without time and quantity limitations. It is also important for the authorities to maintain a sophisticated monitoring or warning system which is able to analyze market abnormalities and report them to the authorities. Further, if any prior approval is required for certain transactions from the authorities, the competent authorities must make an immediate response to the applicant without delay; any delay caused by the authorities could mean millions of dollars lost.

The "exceptions" included in the monitoring system of any new law should not be allowed to continually expand, otherwise the process of deregulation will be meaningless. This is particularly problematic for countries such as Japan or Taiwan, where administrative agencies are granted quasi-legislative power to implement rules, or "guidance," in order to overcome legislative inefficiency or administrative difficulties. Furthermore, the reporting procedures should be clear and precise; any complications resulting from regulatory interpretation or administrative ambiguity will cause increased and unnecessary costs for both the authorities and investors. After all, regulation should be perceived as necessary only to the extent that markets may fail, and only when it can be demonstrated that the benefits of intervention outweigh the costs. Regulation should not become the burden of both regulator and investor.

X. THE "CHINA" FACTOR

The success of Taiwan's efforts to become a regional operations and financial center is dependent to a large extent on wider regional concerns, in particular, its relationship with mainland China. A more mature relationship with the PRC also means a politically stable environment, which will boost MNCs' confidence in Taiwan and hence attract more international business to the island.

The ruling nationalist party, or Kuomintang ("KMT"), has traditionally perceived the government in China as a rebellion regime. Under the Temporary Provisions for the Suppression of Communist Insurgency (Temporary Provisions), a strict "Three Nos" policy was adopted. The "Three Nos" policy, namely no contact, no negotiation and no compromise, has prohibited Taiwan's official contact with the PRC authorities. The refusal of the KMT to have any contact with Beijing, let alone recognize its existence, is a reflection of the official state of war that has, until

recently, existed between the two regimes. Although the existence of the communist regime is now fully recognized, the "Three Nos" policy is still enforced and direct investment and trade "will not occur until Beijing meets certain conditions such as . . . the renunciation of the use of [military] force against Taiwan."¹⁷⁵

As a result, Hong Kong has emerged as Taiwan's biggest export destination: more than 70 per cent of Taiwan's exports to China are rerouted to the mainland through the territory.¹⁷⁶ Despite the Three Nos policy, Taiwan has built significant ties with the PRC.¹⁷⁷ It also appears that restrictions on trade and investment between the two sides imposed by the Taiwanese authorities have been relaxed.¹⁷⁸ For the first time Taiwan agreed to allow shipping companies to operate between its "offshore transshipment center" and mainland China which commenced in April 1997.¹⁷⁹

Nevertheless, hostility between the two sides still remains. Taipei perceives Beijing as an immediate threat. Beijing's refusal to rule out military action against Taiwan and its efforts to isolate Taiwan in the international community continues to fuel such hostility. Taiwan's concern with disruptive measures by the PRC also constitutes a political impediment to financial development and reform. For example, Central Bank officials have admitted the reason Taiwan holds such high foreign reserves is for an "emergency" situation.¹⁸⁰ Taiwan's foreign reserves are large enough to cover nine months of the island's imports without any

175. Andrew Godwin, *Legal Aspects of Australia's Commercial Relationship with Taiwan*, 4 BOND L. REV. 41, 48-49 (1992).

176. See Bruce Cheesman, *Trade Figures Fuel Taiwan's HK Fears*, AUSTL. FIN. REV., June 11, 1997, available in <http://www.afr.com.au>.

177. According to the report, over 30,000 Taiwanese companies have already invested in China. The estimated total investment amount is approximately US\$30 billion. However, any investment which exceeds US\$50 million is still banned by the Taiwanese government. See Bruce Cheesman, *Business Set to Defy Ban on Investment on China*, AUSTL. FIN. REV., May 30, 1997, available in <http://www.afr.com.au>.

178. The Taiwanese government has eased controls on indirect trade with the PRC since July 1996 by adopting a "negative list system" on trade and investment. The new system stipulates only those items forbidden from importation. As a result, 4,325 mainland items were approved for importation, and the areas to be approved for investment in the mainland increased to 4,895. Investments of US\$2 million or less will no longer be required to set up a subsidiary in a third area, a relaxation on the previous US\$1 million. Securities companies, which had to obtain approval before opening branches in the PRC, are allowed to establish subsidiaries. Department stores and shipping agencies are allowed to invest in the PRC, compared to the previous system requiring approval on a case-by-case basis. See *Trade Between the Two Sides Eased in July*, APROC NEWSL., July 1996, at 3.

179. *Cross-Strait Shipping Meeting Called*, APROC NEWSL., Mar. 1997, at 4.

180. See ECONOMIC DAILY NEWS, *supra* note 97, at 190.

domestic production or international trade.¹⁸¹ No official has clarified what "emergency" situations are envisaged. However, it is generally believed that they consider direct military conflicts between Taiwan and the PRC, or a situation when Taiwan could be blockaded by the PRC for an extended period an emergency situation.¹⁸²

Moreover, the government is particularly worried that an open capital market will make it more difficult to control China's involvement in Taiwan's securities market, as China could use its influence through the opened market to force Taiwan's hand. The government is also concerned with infiltration of PRC owned enterprises or capital by any foreign companies. It is generally acknowledged that foreign entities which have more than 20 percent of PRC capital, are basically prohibited from investing in all sectors of industry in Taiwan.¹⁸³ The "Taiwanese do not want their [financial market] flooded with Chinese money, as Hong Kong's [market] has been."¹⁸⁴ Similarly, the Taiwanese government announced that the recently increased outward remittance ceilings by business entities (i.e. US\$50 million per annum) would not be applied to any outward investments into Hong Kong.¹⁸⁵ However, it is questionable whether Taiwan will be able to maintain these restrictions when and if it joins the WTO.¹⁸⁶

The general public is also well aware of China's military threat. When the PRC announced it would conduct a series of military exercises in the Taiwan Strait leading up to Taiwan's first direct presidential election, a large amount of capital left Taiwan for safer havens such as the United States, Canada and Australia. An official report stated that during July and August 1995 alone, immediately after the PRC's announcement, approximately US\$3.8 billion worth of capital was transferred overseas from

181. See *Beware of Squirrels*, *supra* note 90, at 65. In comparison, foreign reserves of the U.S., Germany and Hong Kong only cover 1 month, 2 months and 4 months of their respective import requirements.

182. See ECONOMIC DAILY NEWS, *supra* note 97, at 189.

183. See *No Restrictions on Mainland Capital after Joining WTO*, CHINA TIMES DAILY, July 8, 1997, available in <http://www.chinatimes.com.tw>.

184. *Tardy Taiwan*, ECONOMIST, June 4, 1994, at 79, 79.

185. Entities intending to invest in Hong Kong will be required to follow the old ceiling, i.e. US\$20 million per annum, until a further announcement is made by the authorities. See *Relaxed Outward Ceiling Not to Apply to Hong Kong Investment*, CHINA TIMES DAILY, June 3, 1997, available in <http://www.chinatimes.com.tw>.

186. In July 1997 the Taiwan government announced that it will allow a free flow of PRC capital into Taiwan once it joins the WTO. According to the government, inflow of PRC or Hong Kong capital is an unstoppable trend. The government has indicated that it will start formulating strategies to minimize any potential negative impact on the Taiwan economy as a result of these inflows. See *No Restrictions on Mainland Capital after Joining WTO*, *supra* note 185

Taiwan, a significant amount given Taiwan's capital control regime.¹⁸⁷ Although the foreign exchange market was later stabilized as a result of the Central Bank's vigorous intervention, the PRC's actions definitely made a significant impact on Taiwan's economy—the stock market plummeted and the level of financial transactions also decreased significantly.¹⁸⁸ A recent military exercise conducted by China in June 1997 also “spooked” the stock market into the largest daily fall in a month.¹⁸⁹ The fall in Taiwan's stock market also emphasizes the market's concern over instability between Taiwan and China in the lead up to the July 1 handover of Hong Kong.¹⁹⁰

The reform process in Taiwan is complicated further when compared to other countries. During any major reform process, the government has always been compelled to take the PRC factor into consideration. In Taiwan, the government's prime objective is to stabilize its economic and political environments while attempting to insulate them from any possible negative influence exerted by the PRC. However, this has also slowed the pace of deregulation in Taiwan, with authorities justifying delays as being attributable to the PRC factor. It is hoped that increased dialogue between the two sides will contribute to desirable long term economic stability, and a lessening of the PRC factor in the future.

XI. SUMMARY OF RECOMMENDATIONS

(i) In order to build Taiwan into a regional financial center, it is essential the Taiwanese authorities deregulate the capital account. Any negative aspects of an open capital account can be dealt with by government regulations or by an open, sophisticated market place. The author's recommendations are summarized: Various channels can be used in order to avoid capital controls. The Taiwanese authorities should seriously examine the effectiveness of these controls and reassess the associated benefits and costs of these regulations. If costs outweigh the benefits, or the controls do not function to expected levels, the government should consider abolishing or at least reforming these control systems.

(ii) The restrictions and ceilings imposed (ii) by the Regulations Governing Reporting on Foreign Exchange Transactions and Trade should either be abolished or amended to accommodate

187. See CHANG, *supra* note 121, at 6.

188. See *id.*

189. Bruce Cheesman, *China's Military Drills Holes in Market*, AUSTL. FIN. REV., June 13, 1997, available in <http://www.afr.com.tw>.

190. See *id.*

increased levels of foreign capital and to encourage MNCs to establish their regional operations centers or treasury centers in Taiwan. The authorities, particularly the Central Bank, should endeavor to meet at least the year 2000 deadline to fully convert the capital account.

(iii) The authorities should continue to allow foreign capital to be invested in the Taiwanese securities market. The foreign ownership percentage and investment amount requirements in each listed company should either be abolished or at least increased to the level currently adopted by other financial markets in the region.

(iv) At a more general level, the government should continue to improve its macroeconomic environment and strive to ensure economic stability. It is fundamentally important for a country to have a sound macroeconomic framework before opening its capital account.

(v) Taiwan should continue to use its large foreign reserves to facilitate its economic and industrial development. These include regular issuance of government bonds, advancing funds to the Taipei Foreign Exchange Call Market, transferring some of its reserves to overseas subsidiaries or branches of the local financial institutions and providing necessary loans to Taiwanese entities to launch major acquisitions in other countries. The Central Bank should also consider gradually internationalizing the NT dollar.

(vi) In order to reduce volatility, the government should continue to foster the development of the local derivative market, and allow more derivative products to be traded in Taiwan. It is essential for the authorities to develop necessary channels for sophisticated investors to reduce their investment risks. For local investors an open capital account also means the opportunity to diversify their investment risks internationally.

(vii) The government should develop a comprehensive supervisory and reporting system for its foreign exchange movements in order to detect any abnormalities in the market and, at the same time, allow the free flow of capital. The authorities should look to the Japanese model.

(viii) The government should maintain an open dialogue with the PRC in an effort to reduce political tension between both sides. Although the authorities should take the China factor into consideration in implementing policies, in the short term, China should not be used as an overriding excuse to retard financial market reform processes.