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Impact of the East Asian Financial Crisis on Taiwan, Mainland China, and Cross-Strait Relations*

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This article deals with the impact of the East Asian financial crisis on Taiwan, mainland China, and cross-Strait relations. In the near future Taiwan will face stronger pressure from mainland China—a pressure that will implicitly change Taiwan's domestic politics and economy.

KEYWORDS: **Taiwan; mainland China; cross-Strait relations; East Asian financial crisis; international financial system**

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The financial crisis that began in Thailand in early July 1997 rapidly spread across the whole of East Asia and has since become the biggest global economic crisis since the Great Depression of 1929. Government leaders and economists around the world are appalled at the scope and severity of the crisis. While the hardest-hit countries—including Thailand, Indonesia, Malaysia, and Russia—are still struggling with the crisis and trying to rebuild their economies, many other countries are worried they may become the next victims of this turbulence. Even the United States felt

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the negative influences of the crisis and sought to protect its economy by lowering interest rates three times within seven weeks between September and November of 1998. This despite the fact that not long ago some economists still thought the United States was entering a "new economy" where "old economic laws have been repealed, allowing America's stock markets to keep growing indefinitely at the present rate."[1] We are probably entering an economically turbulent era in which the current rules of the international economy need to be reexamined in light of the rapidly changing global economy. The first part of this article will deal with this topic.

Compared to other East Asian economies, mainland China and Taiwan have been relatively less affected by the financial crisis. In 1998, mainland China experienced an economic growth rate of over 7 percent, and Taiwan, around 5 percent. Several reasons have contributed to the immunity from the regional crisis that these two areas have enjoyed. Both still face the challenge of the next-wave financial turbulence, however. For instance, whether to devalue its currency so as to maintain global competitiveness is a tough decision Beijing is contemplating. As a middle-sized and open economy, Taiwan depends on the economic capabilities and performances of other regional nations. At present we may say prudently that the financial crisis has had both positive and negative impacts on mainland China and Taiwan as separate entities and on the cross-Strait bilateral relationship. The second part of this article will analyze these effects.

After the outbreak of the East Asian financial crisis, ROC President Lee Teng-hui proclaimed the official policy of "go slow" in a hope to persuade Taiwanese businessmen not to invest, or at least invest less, in mainland China. Yet in the near future Taiwan will be facing stronger pressure, both politically and economically, from mainland China, and this pressure will implicitly change Taiwan's domestic politics and economy.

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[1] Stephen B. Shepard, "The New Economy: What It Really Means," *Business Week*, November 17, 1997, 48. Two broad trends have been under way, according to this theory. The first is the globalization of business and the other is the revolution in information technology. While undermining the old order, these trends can combine in powerful ways to raise America's standard of living, create jobs, and spur entrepreneurial effort—all without boosting inflation.

The Financial Crisis and the Incompetence of the Current International Economic and Financial Regime

By 1996 most countries of East Asia had enjoyed fifteen years of rapid and sustained economic growth. Labeled as "neomercantilism," most East Asian countries have followed Japan's development model in pursuing interventionist policies to develop their own strategic industries.[2] Japan's Ministry of International Trade and Industry (MITI) is an outstanding example. After World War II, MITI implemented a series of industrial policies, especially in the realms of shipbuilding, steel, automobile, and other industries. Under these industrial policies, Japan successfully became a major exporter in these fields from the 1960s to the 1980s and has become a role model for many East Asian countries.[3] South Korea's automobile and shipbuilding policies, for instance, were in imitation of Japan's.[4] Taiwan and other Southeast Asian countries also have adopted similar industrial policies, although most were not as successful as that of Japan or South Korea. Even Hong Kong, usually considered a free market economy, has pursued its own industrial policy.[5]

The East Asian economic miracle has faced huge problems, however, since Thailand—under the attack of foreign exchange speculators—was forced to devalue its currency in July 1997. Adopting peg-to-the-dollar policies for more than a decade, the stability of local currencies had helped both Thailand and Malaysia to attract foreign investment and build up their industrial bases. Taiwan alone, for example, had invested more than US$2.1 billion in Thailand between July 1996 and June 1997.[6] During the

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[2]Tong Whan Park, "South Korea and the Ambiguities of South-South Cooperation in the Pacific Rim," in *Newly Industrializing Countries and the Political Economy of South-South Relations*, ed. Jerker Carlsson and Timothy M. Shaw (London: Macmillan, 1988), 274-77.

[3]Bela Balassa and Marcus Noland, *Japan in the World Economy* (Washington, D.C.: Institute for International Economics, 1988), 36-42.

[4]Mohammad Shahid Alam, *Governments and Markets in Economic Development Strategies: Lessons from Korea, Taiwan, and Japan* (New York: Praeger, 1989), 23-49.

[5]See Robert Wade, "Industrial Policy in East Asia: Does It Lead or Follow the Market?" in *Manufacturing Miracles*, ed. Gary Gereffi and Donald L. Wyman (Princeton, N.J.: Princeton University Press, 1990), chap. 9.

[6]*Jingji ribao* (Economic Daily News) (Taipei), October 26, 1998, 3.

boom years, however, the economic fundamentals of most Southeast Asian countries began to weaken. This included increasing trade deficits, the collusion of local governments and big businesses, and incorrect policies of local governments.

These weaknesses made the fixed exchange rates of the Thai baht and the Malay ringgit become the prime targets of international and domestic foreign exchange speculators. This put the Bangkok and Kuala Lumpur governments in a catch-22 situation: If the governments kept supporting their overvalued currencies, more and more speculators would attack, and these speculators could force a devaluation after foreign exchange reserves were exhausted. On the other hand, if the governments surrendered to the speculators, their fragile economies would melt down. Both governments thus tried to maintain the stability of their currencies by raising interest rates and using their foreign exchange reserves to support their currencies on foreign exchange markets. Without sound economic fundamentals, however, the supporting measures and limited foreign exchange reserves of these two governments only invited more speculation. Finally, the financial systems of these two countries collapsed, and the crisis quickly spread through both East and Southeast Asia.

Only a few economists foresaw the severity and scope of the East Asian financial crisis. Paul Krugman of the Massachusetts Institute of Technology argued that East Asia's growth was mainly driven by education, savings, and rising labor force participation and therefore concluded that Asia's growth, sooner or later, would slow down.[7] Table 1 shows the real gross domestic product (GDP) growth of select East Asian countries before and after the financial crisis.

With the exception of mainland China, Taiwan, and Singapore, the rest of East Asia (including Japan) had negative GDP growth in 1998. Furthermore, the picture is bleaker than table 1 shows if per capita GDP is measured in U.S. dollars. According to table 2, only mainland China and Malaysia had a positive growth in per capita GDP between 1997 and 1998,

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[7]Paul Krugman, "Dutch Tulips and Emerging Markets," *Foreign Affairs* 74, no. 4 (July/August 1995): 28-44; and "What Ever Happened to the Asian Miracle?" *Fortune*, August 18, 1997, 12-14.

Table 1
GDP Growth of Ten East Asian Economies (%)

Year / Country	1990-95 Average	1996	1997	1998	1999
Japan	2.0	3.9	0.9	–2.8	1.3
China	10.6	9.7	8.8	7.8	8.3
South Korea	7.8	7.1	5.5	–5.5	5.0
Taiwan	6.4	5.7	6.9	4.9	5.2
Hong Kong	5.0	4.9	5.3	–5.1	–0.6
Singapore	8.7	6.9	7.8	1.5	0.7
Thailand	9.0	5.5	–0.4	–8.0	–1.0
Malaysia	8.8	8.6	7.8	–6.8	–0.7
Philippines	2.3	5.7	5.2	–0.5	2.0
Indonesia	8.0	8.0	5.0	–13.7	–0.6

Sources: For 1990-98 statistics, see International Monetary Fund (IMF), *World Economic Outlook 1998* (Washington, D.C.: IMF, May 1998), 133-46; for 1999 estimation, see *Far Eastern Economic Review*, November 5, 1998.

and Indonesia, Thailand, and South Korea would see their per capita GDP in 1998 sink to levels not seen since 1991.

Facing the challenges and manipulation from international financial speculators, some East Asian governments have adopted different policies to defend their currencies or economic interests. Both the Hong Kong and Malaysian governments used anti-free market measures to protect their

Table 2
Per Capita GDP of Select East Asian Economies (in U.S. Dollars)

Year / Country	1991	1997	1998
Japan	27,487	33,251	29,741
Singapore	15,797	31,142	26,377
Hong Kong	14,884	26,806	25,908
Taiwan	8,083	13,151	11,560
South Korea	6,815	9,648	6,226
Malaysia	2,673	3,287	3,344
Thailand	1,725	2,431	1,690
Philippines	722	1,068	847
Indonesia	707	1,079	380
Asia	627	1,070	924

Source: *Far Eastern Economic Review*, October 29, 1998, 86-87.

economic interests and, until now, have performed relatively well. In the case of Hong Kong, for example, the government intervened in the stock, currency, and futures markets in August 1998, buying up Hang Seng index stocks in a bid to drive currency speculators out of the market. The Hong Kong government did gain a first-round victory over speculators, pushing up the Hang Seng index more than 40 percent in three months. The Hong Kong government's successful intervention will probably be at the cost of Hong Kong's credibility as the only real free market in East Asia. Even Alan Greenspan, the U.S. Federal Reserve chairman, brusquely criticized the Hong Kong Monetary Authority's move, saying such actions "erode some of the extraordinary credibility that the Hong Kong Monetary Authority has achieved over the years."[8] However, most East Asian countries have welcomed Hong Kong's market interventions on the ground that not a single government in this region can tolerate such severe turbulence in its capital market as a consequence of foreign capital flows. These countries are delighted to see that Hong Kong, obviously aided by mainland China, has taught foreign hedge fund managers some bitter lessons.

On the other hand, Malaysia has adopted more radical measures to defend its economic interests. In early September 1998, the Kuala Lumpur government imposed capital controls and fixed the currency at 3.8 ringgit to one U.S. dollar. The ringgit was 2.5 to the U.S. dollar when the East Asian currency crisis broke out in mid-1997. Kuala Lumpur's stock market rebounded 40 percent within one week and had maintained the same level by November 1998. Of course, these controversial policies implemented by Malaysian Prime Minister Mahathir Mohamad have invited different reactions from both academics and foreign decisionmakers. Critics denounced Kuala Lumpur's policies by arguing that the short-term benefit of capital controls does not outweigh the expense of their long-term costs.[9] It

[8]*Asian Wall Street Journal*, September 17, 1998, 2.

[9]Roger C. Altman, for example, wrote in the *International Herald Tribune* (September 17, 1998, 8): "[Hong Kong, Malaysia, and Russia] are, in fact, dropping out of the global economy . . . but that is self-defeating." Paul Krugman, on the other hand, argued that "temporary currency controls are a necessary component of a recovery strategy for Asia. . . . The ultimate goal should be to return to world capital markets after a fairly brief interval." See *Far Eastern Economic Review*, September 17, 1998, 32.

is still too early to pass judgment on Mahathir's policies. Yet the noteworthy point is that the East Asian financial crisis is not just an economic problem and, therefore, these countries need both economic and political measures to placate the anxiety of the East Asian people before the crisis can be effectively resolved.

While economists and international media are still arguing about the causes of the financial crisis, many have gradually shifted their attention from East Asia's weak economic fundamentals to the deficiencies of the international financial and economic regimes. When the crisis occurred in July 1997, the overwhelming majority of international media reported that these East Asian countries had many serious weaknesses in their economic fundamentals and the best way out of the crisis is through austerity programs designed by economic experts in the International Monetary Fund (IMF). At present, however, many scholars and reporters place the blame on the international economic regime. The *Asian Wall Street Journal*, for instance, writes: "More and more voices, both inside and outside of Asia, argue that players in the global financial markets, through their simple decisions to buy or sell various securities, had too much scope to wipe out wealth that had taken years to build."[10]

In fact, from the experience of the East Asian financial crisis and Hong Kong and Malaysia's successful countermeasures, we can sense one vital development in the global economy. While entering this new international economic and financial order, we are facing many severe challenges that the present system based on the IMF and its associates cannot solve. Even IMF officials recently admitted that Hong Kong's intervention was necessary in defending its economic interests. The frustrated IMF said: "[S]ound management of fiscal and monetary policies provides no guarantee against major economic crisis."[11] Thus we have to consider alternatives to tame the anarchy of markets that globalization has unleashed.

First, what is necessary is an international economic and financial early warning system under the auspices of the United States to monitor

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[10] *Asian Wall Street Journal*, October 26, 1998, 4.
[11] *Business Week*, October 12, 1998, 47.

member country's economic and financial information. The current international financial evaluating companies, Moody's Investors Service Incorporated and Standard and Poor's, are private institutes that do not have the authority to scrutinize the detailed economic and financial information of every country (some countries even do not provide the necessary information to these institutes). Only a United Nations system can have the authority to collect information and, if necessary, give warnings to both the target country and the international community. This will surely come at the partial expense of national economic sovereignty, but is necessary in order to make this system more efficient and to avoid future economic and financial disasters.

The second vital measure is for a tax to be added on international capital flows. Such a tax was proposed twenty years ago by Nobel Laureate James Tobin. For example, a tax of 0.2-0.5 percent would not eliminate all instability in the international financial market, "but it would go a long way toward correcting a serious and consequential market failure without sacrificing any of the benefits that capital mobility provides," said Jonathan Kirshner of Cornell University.[12] Unfortunately, such remarks did not elicit much response from the international economic community. The *World Economic Outlook*, for instance, wrote: "Regulators in the United States and the United Kingdom, where the most important hedge funds operate, see little need for a specialized policy response to regulate and limit the funds' activities in order to increase financial market stability."[13]

With near two trillion U.S. dollars flowing through global capital markets daily, and only a small part of this capital associated with the actual trading of goods and services, it is almost impossible for small economies to withstand the negative impact of massive capital movement. Furthermore, if we can accept the idea that different countries face diverse economic conditions and need to tailor their economic policies accordingly, then the most likely beneficial is to charge a tax on international capital

[12]Jonathan Kirshner, "Unregulated Capital Blamed for Crisis," *Los Angeles Times*, September 17, 1998, 2.

[13]International Monetary Fund (IMF), *World Economic Outlook 1998* (Washington, D.C.: IMF, May 1998), 5.

flows. Such a move can deter short-term capital flows, because the tax will translate into a high annual rate, while having only a trivial effect on long-term capital flows. Recently World Bank Chief Economist Joseph E. Stiglitz also echoed this idea, saying that the world should now consider "some form of taxes, regulations, or restraints on international capital flow."[14]

Another noteworthy policy centers around an adequate management of derivatives. Of course, the original nation of financial derivatives was to avoid future risk while undertaking investment. Yet as the scale of the futures, options, and swap markets has expanded quite rapidly, financial derivatives gradually became the target of pure speculation rather than a tool of investment. In this case, then, the inevitable result of these speculations would be an increasing number of financial crises. The collapse of giant U.S. hedge fund Long Term Capital Management is only one example. Furthermore, under the current free market system most developing countries cannot avoid their currencies, stock markets, and commodities becoming the targets of speculation if they want to be part of the "global village." In other words, these countries cannot decide on their own economic destiny. These developing economies are in an inferior position because they do not have the necessary capital, business skill, or other techniques necessary to deal with international investors. The only other choice for these developing countries is to exit this system—and probably suffer even more.

In order to find a compromise between being the victim of pure speculation and exiting the world economic system, it is necessary to regulate the "non-trade transactions of capital flows." Some measures can be designed to serve this goal: higher taxes, restrictions on hedge fund activities, or longer required stay for capital in a country. In 1991 Chile, for instance, imposed a 30 percent tax on incoming portfolio investments and refunded the tax after a year.[15] Of course, implementing these measures is

[14] *Business Week*, October 12, 1998, 48.

[15] In fact, Chile recently dismantled its controls on capital in an effort to help the private sector obtain financing during the global market turmoil. Yet this probably is a sensible idea if taxes can be lowered to a reasonable range.

quite complicated, especially distinguishing investment capital from speculation. This step is probably a necessary evil, however, in order to maintain a more stable international economy.

Impact of the Financial Crisis on Taiwan

Mainland China and Taiwan are the only two economies in this region that have maintained relatively healthy growth in 1998, with GDP growth rates at 7.8 and 4.9 percent respectively. Various factors contributed to Taiwan and mainland China's relative immunity from the financial crisis. Taiwan escaped the East Asian financial crisis mainly due to a fundamentally sound economy. Taiwan has the world's third largest foreign exchange reserves and one of the world's lowest foreign debts. Its banks have one of the lowest bad loan ratios in East Asia, and its companies have the lowest debt-to-equity ratios. Taiwan can achieve this partly because of paranoia regarding the threat from mainland China.[16] That is, for Taiwan to face an economic crisis is a life-and-death matter, as the Republic of China is not a member state of the IMF or UN.

As for mainland China, its closed financial system, trade balance of more than US$40 billion in 1998, and foreign exchange reserves of around US$140 billion together help mainland China avoid the economic malaise plaguing its neighbors. While many economists say mainland China's goal of an 8 percent GDP growth in 1999 will be rather difficult to attain, a 7 percent growth will still be spectacular. Moreover, because the Chinese *renminbi* is only partially convertible, the PRC government can maintain the currency's stability so long as its economy is still healthy.

That does not mean, however, that these two economies have not been affected by the financial crisis. They have been hit deeply (albeit belatedly) by the crisis. Part of the reasons for their involvement in the crisis stems from structural weakness. Taiwan's stock market, for instance, is notorious for its almost anarchic nature. Between September and November of 1998,

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[16] *The Economist,* November 7, 1998, "A Survey of Taiwan," 4.

more than ten listed companies were forced out of the stock market. The managers of these companies played money games with other major investors through the use of inside information. They earned huge profits during the bull market and kept expanding their businesses into other fields. When the economy slowed down, they did not have enough capital to maintain their businesses and thus their companies finally collapsed. Although the government did its best to contain the damage (especially at a time just weeks before the legislative and mayoral elections), the effects of this economic mess will be felt bitterly on Taiwan for many years past the elections.

Adding to this economic mess is the negative growth of Taiwan's exports in 1998 and a low growth in 1999, mostly due to collapsed demand from the East Asian region. Taiwan's exports will not pick up in the near future so long as its neighbors are still suffering from the financial crisis. These factors will make it quite difficult for Taiwan to maintain its official GDP growth estimation of 5.5 percent in 1999.

Mainland China is not in a better situation either. Probably the biggest problem for mainland China is the colossal amount of bad loans in its banking sector. The bad loan ration for mainland China is one of the worst cases in East Asia, yet the country has not experienced financial crisis because the banks are owned by the state. Table 3 shows the statistics of bad loans for ten East Asian economies and their ratio to total loans.

Most of the bad loans in China's banking sector were made to cover the huge losses of nearly 100,000 state-owned firms. While China's state sector is in worse shape now than at any time in its economic reform, its fragile and out-of-date banking sector is even a more worrisome time bomb for China's economy.[17]

Mainland China's exports in 1999 are also showing signs of slowing. In 1997 mainland China experienced a 20.9 percent increase in exports, helping to offset lagging domestic demand. However, mainland China faced a negative growth in exports in both 1998 and the first half of 1999.

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[17]Frank Ching, ed., *China in Transition* (Hong Kong: Review Publishing Company, 1997), 55.

Table 3
Bad Loans of Select East Asian Economies

	Bad Loans (US$ Billion)	Ratio to Total Loans
Mainland China	271.0	30%
Hong Kong	5.2	1%
Indonesia	17.0	15%
South Korea	92.2	30%
Malaysia	17.8	15%
Philippines	3.3	7%
Singapore	3.8	4%
Taiwan	14.9	5%
Thailand	80.0	36.5%
Subtotal	506.0	19.3%
Japan	840.0	–
Total	1,346.0	–

Source: Council for Economic Planning and Development, *Guoji jingji qingshi zhoubao* (International Economic Situation Weekly), no. 523 (November 9, 1998): 9.

Its trade surplus declined sharply in 1999. If the trend of negative growth in mainland China's exports continues, the PRC government will face stronger pressure to devalue its currency in the year 2000.

Probably the more severe influence is on the political and economic interaction between Taiwan and mainland China. As mentioned earlier in this article, both Taiwan and mainland China have pursued neomercantilist strategies in developing their economies and have enjoyed decades of rapid economic growth.[18] This model did not come without a significant price, however. A vital point is the self-contradictory nature of this model that makes the interaction between government and private business gradually turn sour. In order to maximize this model, full cooperation between local governments and big enterprises is needed, perhaps sometimes even to the extent of collusion. Such a step is against the principles of the liberal econ-

[18]It seems a little bit exaggerated to classify mainland China in this category as this government is still ruled by a communist party. Yet to the extent that China has implemented a socialist market economy for twenty years and that the relationship between government and business is quite intimate, the author lists mainland China as one of the followers of neomercantilism.

omy, which emphasizes the primacy of market forces over governmental policies. The vital foundations of the East Asian model are accountability, transparency, adequate legal and regulatory structure, and, most likely, Western-style democracy. Unfortunately, most East Asian countries do not have these types of political and economic infrastructures. Even Japan, considered as the most democratic and transparent society among East Asian countries, has similar problems. Therefore, these kinds of cooperation are actually lobby efforts by conglomerates that lead to corruption, nepotism, and incorrect policies. Most East Asian societies are now paying the price for such collusion.

Taiwan's political and economic structure has changed rapidly in the last ten years. Taiwan had been dominated politically by the Chiang family until the death of President Chiang Ching-kuo in January 1988. During the Chiang era, the mainlanders, who fled to Taiwan in the late 1940s, controlled the central government while native Taiwanese, on the other hand, predominated the economy. The elite of these two groups of people built a consensus on strategy of economic development: the government designs and implements industrial policies and protects and supports native businessmen in exchange for the latter's political support.[19] Thus, there is a kind of checks-and-balances in Taiwan's political and economic systems. A group of relatively independent and neutralized technocrats, most of whom are mainlanders and have little connections with local and native politicians, prevailed in the central government, whereas local political factions could not impose strong influence on the central government's policies and strategies. However, the threat from mainland China and pressure from domestic opposition groups kept the collusion between government and business from reaching an unmanageable level. In an undemocratic society like Taiwan, this mechanism helped avoid many large-scale economic scandals and incorrect policies.

The situation has gradually changed since Lee Teng-hui, the first native president, succeeded Chiang. Society has become almost fully democratic and political mobility between the local and central levels is now

[19]For further reference, see Cal Clark, *Taiwan's Development* (Westport, Conn.: Greenwood Press, 1989), chap. 5.

quite smooth. Yet this progress has been made at the expense of the above noted check-and-balance mechanisms. The economic and political interests of local political factions and the central government are gradually converging. In a society still ruled by men rather than by institutions, more and more corruption and scandal cases have erupted in recent years. More than ten companies listed in the stock market collapsed before two months of the national elections held in early December 1998. Almost every owner of these companies maintains excellent relationship with high-level government officials. The whole society thus suffered tremendously after these owners siphoned off large sums of money from their bankrupted companies. In 1997, Taiwan was ranked 29th out of 85 countries as the least corrupt country in the world, according to Transparency International, a consultancy that publishes an annual corruption survey. Taiwan was far behind Singapore and Hong Kong, and at the same level as Malaysia in the Corruption Perceptions Index compiled by international business people.[20] According to one estimate, 30 percent of all government infrastructure spending is still lost to kickbacks.[21]

As the financial crisis continues to hit Taiwan and is forcing many listed companies to collapse, whether Taiwan can overcome the crisis depends on its capability to deal with this economic malaise and to set up new rules governing the relationship between government and business. The government performed well in containing the damage caused by these collapses, hoping to contain any negative influence on the ruling party's chance in the national elections. Yet the real effect of this economic malaise on Taiwan's economy will not be evident until months or even years after the elections. Only with a change of ruling parties at the central government, a political scenario that Taiwan has never experienced, can Taiwan really correct the distorted relationship between government and business.

Taiwan also needs to reconsider its strategy for future economic development. Export-oriented development policy has been Taiwan's major

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[20]*Far Eastern Economic Review*, October 8, 1998, 108.

[21]*The Economist*, November 7, 1998, "A Survey of Taiwan," 10.

Table 4
Taiwan's Direct Investment in Mainland China and Southeast Asia (by June 1998)

	Items	Total Amount (US$ billion)	% in Total FDI
Mainland China	39,821	39.4	44.4
Indonesia	632	13.4	15.1
Thailand	1,314	9.6	10.8
Malaysia	1,543	8.5	9.6
Vietnam	359	4.4	5.0
Singapore	253	1.2	1.3
Philippines	813	0.7	0.8

Source: *Jingji ribao* (Economic Daily News) (Taipei), October 26, 1998, 3.

economic policy since the 1960s. Shirley W.Y. Kuo wrote that "it is evident that after the 1960s, export expansion was a decisive factor in rapid growth, and in the 1970s its importance outweighed even domestic expansion."[22] Taiwan had performed excellently in implementing this policy until the beginning of the East Asian financial crisis. Between 1980 and 1997, for instance, Taiwan's average annual export growth was 15.7 percent, a spectacular figure compared with that of other countries.[23] However, Taiwan has faced severe challenges on both the domestic and regional fronts. Domestically, Taiwan is facing a kind of "hollowing-out" effect after years of overseas investment (for Taiwan's investment in mainland China and Southeast Asia, see table 4). According to a report, "[O]ver the past eight years, Taiwanese companies have invested eighty billion U.S. dollars out of the country, and 300,000 of their best people have followed in order to manage these investments."[24] This hollowing-out effect also can partially explain the financial crises facing many listed companies. Facing rising debt-to-equity ratios, many companies are trying to raise capital from the

[22]Shirley W.Y. Kuo, Gustav Ranis, and John C.H. Fei, *The Taiwan Success Story* (Boulder, Colo.: Westview Press, 1981), 111. The contribution of export expansion to output growth was 22.5 percent in 1956-61; it increased rapidly to 35 percent in 1961-66, 45.9 percent in 1966-71, and 67.7 percent in 1971-76.

[23]Department of Statistics, Ministry of Finance, *Monthly Statistics of Exports and Imports, Taiwan Area, Republic of China*, no. 350 (October 1998): 9.

[24]*The Economist*, November 7, 1998, "A Survey of Taiwan," 20.

stock market by releasing false information, only to face collapse after the recession.

Taiwan's domestic investment, on the contrary, has gradually slowed within recent years. Average annual domestic investment between 1991 and 1994 had increased 11 percent; the figure was down to around 5 percent between 1995 and 1997.[25] As Taiwan's investment environment continues to deteriorate due to escalating wages and property costs, the slowing domestic investment will become a trend that is difficult to reverse.

Regionally, most of East Asia is still an economic mess and will not fully recover until the beginning of the next century. Lacking import demand from its neighboring countries, Taiwan's exports will not be able to expand quickly. Slower exports will in turn force more Taiwanese companies to invest overseas so as to maintain their competitiveness. At that time even a resurgent demand from this region will not be able to stimulate Taiwan's domestic investment since many of their businesses would have already transferred their factories to Southeast Asia and mainland China. This is a vicious circle that will hurt Taiwan's economy unless the government can design and implement new counterstrategies.

An alternative strategy is to upgrade Taiwan's high-tech industry and transform the island into a research-oriented, technology-intensive society. This is not an easy task, however. Taiwan has done an excellent job in developing its computer and information-related industries. In 1999 Taiwan became the world's leading producer of notebook computers, monitors, motherboards, and scanners. But most of these companies are little-known component suppliers who could supply generic parts for the United States and Japanese big brand-name companies at low prices. And many of these companies have set up assembly factories in mainland China to take advantage of cheap labor and land costs. The research and development (R&D) capabilities of most Taiwanese companies are quite far behind those of the developed countries and even newly industrialized countries such as South Korea. If we accept the hypothesis that R&D capability will decide a country's economic future, then Taiwan must travel a long road in order to be-

[25]Directorate General of Budget, Accounting, and Statistics, Executive Yuan, *Monthly Statistics of the Republic of China*, no. 392 (1998): 3.

come a high-tech society.

As achieving a high-tech society takes time to accomplish, Taiwan's economic growth will likely slow to between 4 and 5 percent of annual GDP growth in the near future. Taiwan is not likely to see the 6-7 percent annual growth in GDP it had enjoyed for over a decade.

Impact of the Financial Crisis on Mainland China

The financial crisis has hit mainland China on both the financial and structural fronts. Economically speaking, mainland China is still the least affected area in this region, with an economic growth rate of 7.8 percent in 1998. China has had positive growth in both imports and exports, although growth rates have been far below original predictions. China experienced an unprecedented US$43.6 billion trade surplus in 1998 and foreign direct investment (FDI) remains remarkably strong. The biggest problem facing mainland China at present is a possible deflationary economy, with a negative (–0.8 percent) consumer price increase in 1998. The deflationary drift obviously reflects excess capacity, weak demand, and high inventories.

The financial crisis is hitting the weakest points of mainland China's economy—the banking sector and the debt-ridden state-owned enterprises (SOEs). In mainland China, banks account for almost nine-tenths of all financial mediums linking savers and investors. Yet its financial and banking system suffers from inadequate central bank independence and lax regulation of commercial banks. Some of China's largest banks do not even report their consolidated financial results, reflecting the reluctance of political leaders—especially at the provincial and local level—to give up their power to funnel loans to favored companies. Thus Nicholas R. Lardy claimed that lending irregularities of Chinese banks "may be similar to those under Indonesia's crony capitalism or the corrupt lending practices South Korean banks used to funnel hundreds of millions of dollars into politicians' pockets."[26] Although perhaps exaggerated, his words illustrate

[26]*Foreign Affairs* 77, no. 4 (July/August 1998): 79-80.

the seriousness of the fraud and corruption endemic in China's banking system.

Adding to the dismal outlook of China's banking sector is thousands of troubled SOEs. Over 100,000 SOEs account for around a third of China's industrial output yet gobble up some 75 percent of loans in China. Seven of every ten Chinese industrial workers labor in state factories—a total of roughly 100 million people. This is the most unproductive and inefficient area in China, however. Around one quarter of these workers do not actually perform any service.[27] Furthermore, by the end of 1995, the debt-to-equity ratio of all SOEs (including commercial establishments and manufacturing companies) had exceeded 500 percent. The figure was a sharp increase from the figure of 82 percent in 1988.[28] Only Indonesian and South Korean companies have a similar ratio. Net losses in the state sector eclipse the entire equity of China's banks, making debt write-off impossible.[29] All of these figures show the vulnerability of China's financial system. The East Asian financial crisis has illustrated the critical point that a key factor in securing long-term economic viability is cleaning out and shoring up the banking system.

The PRC government knows these problems and has been trying to find ways to improve these two sectors, but until now has met little achievement. First, the government put professionals rather than political cronies of provincial and local leaders in charge of regional branches. This move was taken in order to strengthen the authority of the People's Bank of China (PBC) to conduct monetary policy, supervise banks, and clean up shaky trust and investment companies. They imposed internationally accepted ratings on domestic debt in June 1998 and the Beijing government consolidated the 31 provincial branches of the PBC into 9 and cut local subbranches from 318 to 133, hoping to take back the control of provincial branches from local politicians. They also tried to slash China's estimated US$250 billion in domestic bad debts to manageable proportions within two years.

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[27]Callum Henderson, *Asia Falling?* (Singapore: McGraw-Hill, 1998), 250.

[28]*Foreign Affairs* 77, no. 4 (July/August 1998): 81.

[29]Matt Forney, "State Enterprises Face Challenges," in Ching, *China in Transition*, 55.

It is questionable whether the PRC government will be able to clean up the mess of its banking system, however. Some structural factors stand out as the main barriers to this financial reform. Probably the largest among them is the lack of an opposition power that can scrutinize and criticize bank misdeeds. In an one-party-system country such as China, the strong will of a few high-level government officials seldom can beat the combination of greedy politicians and bankers. Another vital factor is the monopolistic nature of the banking sector, which does not put pressure on these government-owned banks to improve their service and efficiency. This lack of competition only leads to corruption and incorrect policies. The last, but of course not the least, factor is the existence of thousands of SOEs. So long as China's banking sector has the mandate to support these debt-ridden companies, the prospects for China's banking sector look bleak.

The PRC government is also trying to find effective ways to reform these companies. Worker layoffs, management incentives, mergers with other companies, privatization, and bankruptcies are major measures to improve the financial status and management of these companies. Millions of workers have been sent home with little or no pay. A variety of incentive measures have been introduced to these companies, some of which have had positive results. However, true reform of these companies is still quite difficult to achieve in practice. For instance, several years ago Beijing conceded defeat in its high-profile attempt to make one hundred key enterprises responsible to shareholders. Failure came because the workers, who are used to the former system's stability and career-hiring, opposed the new "higher-paying but less-secure jobs."[30] Large-scale layoffs or bankruptcies surely will become a social and political problem and even hurt the legitimacy of the socialist government. Therefore, the government will most likely not take radical measures to improve the competitiveness of these SOEs as long as the current economic growth level does not drop.

The mess will not disappear automatically, however. Japan's ailing banking sector should serve as a good example for mainland China. The

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[30]Ibid., 56.

US$840 billion in bad debts have made Japan experience its longest recession since World War II. There is no reason why mainland China, without any type of "surgical operation," should be able to escape such a fate. Thus unless the government can show more determination to thoroughly change the system, the troubled SOEs will keep dragging down mainland China's economy in the foreseeable future and eventually hurt mainland China's long-term economic growth.

Ironically, the financial crisis provides mainland China, and to some extent Taiwan, with an excuse to slow down the necessary reform in its banking sector. One of the major reasons for the financial crisis in Thailand, Malaysia, and Indonesia is that these countries have had almost no control over foreign capital or their banking sectors. The relatively tight control of the foreign exchange market in Taiwan and total control of the foreign exchange market in mainland China are the vital reasons why these two societies have escaped the crisis. The temporarily successful cases of Hong Kong's intervention policy and Malaysia's capital control policy to defend their economic interests further reinforce the theory that a full-scale economic liberalization will have both positive and negative effects on the developing countries, with the negative effects sometimes being larger than the positive ones. Therefore the PRC's current thrust of reforms is mainly aimed at improving "the socialist 'efficiency' of the state system and not at embracing full capitalism. Privatization of heavy industry, telecom, energy, and the banking sector is out of the question."[31] Without a competitive banking sector, however, mainland China surely cannot maintain its fast economic growth. If Beijing adopts radical measures to clean up the financial mess, the country will soon face economic turbulence. Either way, therefore, mainland China will have a lower economic growth and even experience some kind of economic upheaval in the near future.

The Financial Crisis and Cross-Strait Relations

The East Asian financial crisis further complicates the already strained

[31] *The Economist*, October 24, 1998, 21.

cross-Strait relationship and puts Taiwan in a difficult situation. Taiwan is mainland China's third largest foreign investor, having invested close to US$40 billion. In 1997, Taiwan enjoyed a trade surplus of US$26.7 billion with China and Hong Kong, helping to offset its huge trade deficit of US$17 billion with Japan.[32] Furthermore, analysts attribute more than 70 percent of the growth in the U.S. trade deficit with China to the exports of Taiwanese-owned firms.[33] So should Taiwan be happy with its intimate economic relations with mainland China? No, because on the contrary, the Taipei government fears that the economic interests of Taiwanese enterprises in mainland China could be used by Beijing to pressure Taipei to open up direct communication links with mainland China. To Taipei, such contacts are a very important bargaining chip in its struggle to attain equal political status at the negotiating table.[34]

Because of such worries, the Taipei government in early 1994 launched the "southward strategy" to encourage Taiwanese businessmen to invest in Southeast Asia rather than mainland China. President Lee Teng-hui further proclaimed the official policy of "go slow" after the outbreak of the East Asian financial crisis, hoping to persuade Taiwanese businessmen not to invest, or at least invest less, in mainland China. The government specifically prohibits big infrastructure projects such as roads and power plants that invest more than US$50 million. In addition to political considerations, Taipei's policymakers also worry about the capability of Taiwanese companies to climb the technology ladder to increased automation and innovation if more and more labor-intensive industries choose to invest in mainland China.

Many Taiwanese businessmen are having second thoughts, however. After losing much of their investments in Southeast Asia due to the finan-

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[32] *Monthly Statistics of the Republic of China*, no. 392 (1998): 4. Because there is no direct trade between Taiwan and mainland China, official statistics only count Taiwan's trade with Hong Kong.

[33] *The Economist*, November 7, 1998, "A Survey of Taiwan," 21.

[34] One of the biggest tensions between Taiwan and mainland China is that Beijing insists that it is the central government while Taiwan is a local government. Taiwan, however, argues that equal political status is the precondition for direct negotiations. For reference, see note 19 above.

cial crisis, Taiwanese businesses have found mainland China to be a major place to make profits. In fact, about half of all listed companies in Taiwan have invested in the mainland. The chairman of Taiwan's leading company, Formosa Plastics Corporation, openly opposes the government's "go slow" policy. This is quite unusual in Taiwan since big business always openly supports the policies set by the government—regardless of whether they actually intend to obey. For these big enterprises, the most attractive point is mainland China's huge potential domestic market. They want to enter this market as early as possible in order to gain the biggest market share. Thus these companies invest in mainland China indirectly, using joint venture corporations with foreign companies. This situation has annoyed the Taipei government for years. The economic turmoil in Southeast Asia further illustrates the relatively sound economic fundamentals of mainland China. This is reflected in the overseas investment of Taiwanese companies. While Taiwanese business investment in Southeast Asia declined almost 90 percent in the period from July 1997 to June 1998, investment in mainland China rose 22 percent in the first seven months of 1998.

Adding to Taipei's annoyance is the recent warming in U.S.-China relations. During his trip to China in mid-1998, U.S. President Bill Clinton affirmed the U.S. policy of not supporting the "independence of Taiwan," or "two Chinas," or "one Taiwan, one China," and that the United States "does not believe that Taiwan should be a member in any organization for which statehood is a requirement."[35] Clinton's statement was a big blow to Taiwan's endeavor to enter the United Nations or to broaden its international space of activities. Taipei also worries that Beijing would exploit Clinton's statement and force Taiwan to negotiate with mainland China on the unification issue. Taipei has always insisted that democratization of China is a prerequisite for unification with mainland China. If the United States accepts mainland China's stance and "encourages" Taiwan to begin early negotiations with mainland China on the unification issue, Taiwan's hope to maintain the status quo as long as possible would be dashed.

Therefore Taiwan will be facing stronger pressure in the near future,

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[35] *Foreign Affairs* 77, no. 6 (November/December 1998): 3.

both politically and economically, from mainland China—a pressure that will implicitly change Taiwan's domestic politics and economy. In the national legislative elections held in early December 1998, the pro-independence Democratic Progressive Party gained only 29.6 percent of the total vote, declining from 33 percent in the last election. One of the implications of the elections is that most people in Taiwan would choose the status quo instead of quick independence. On the economic front, the Taipei government would most likely stick to its "go slow" policy in years to come so as to maintain economic leverage against mainland China.