

## Chapter 3

# Taiwan and the Taiwan Stock Exchange

### ***3.1. A Brief History of Taiwan and the Republic of China***

Taiwan is a small island, roughly the size of Maine or West Virginia, which lies astride the Tropic of Cancer in the East China Sea, approximately one hundred miles off the coast of mainland China, southwest of Japan. Ethnically, the majority of the residents of Taiwan are Chinese, although there is a small minority of aboriginal Taiwanese of Malay-Polynesian descent. Among the ethnic Chinese majority, there are two major groups. The first group includes those whose ancestors arrived on the island during the hundreds of years prior to 1895, when Taiwan became a colony of Japan, and the second group includes the families of the KMT officials, soldiers, and other refugees who followed Chiang Kai-Shek to the island after his defeat in mainland China at the hands of the Communists.

Ironically, however, even the earliest of these two groups arrived on Taiwan subsequent to the arrival of a Western sea power -- the Dutch. In 1624, the Dutch East India Company, to facilitate its trade throughout Southeast Asia, established a trading station and built fortresses and churches in Taiwan, with a base of operations at "Fort Zeelandia," near present-day Tainan. In mainland China, however, events were unfolding that would soon bring Taiwan more closely into the Chinese fold. Over the next few decades the reign of the Chu imperial family and their Ming dynasty (the last native Chinese imperial dynasty) was being brought to an end at the hands of the Manchurian "Bannermen," whose ruling clan, the Aisin-Gioro family, soon became the ruling imperial family of the Ch'ing Dynasty, China's last imperial dynasty. Among the Ming loyalists who refused to surrender to the Manchus was Koxinga (Cheng Ch'eng-Kung), a half-Chinese/half-Japanese general and pirate. Facing defeat by the Manchurian-led armies, Koxinga made a move that served as a precursor to, and possibly inspired, Chiang Kai-Shek's actions some three centuries later. Koxinga turned his eyes toward Taiwan, defeating the Dutch forces there and seizing control over the island in 1662. Koxinga died soon after, however, and his son was finally defeated by Ch'ing troops in 1683, after which Taiwan came under the jurisdiction of mainland China's Ch'ing government.

For the following 204 years, Taiwan was nominally under the administration of Fujian province, on China's southeastern coast, from which a small stream of settlers made their way across the Taiwan Strait to establish new lives in Taiwan. In 1887, Taiwan's administrative status was elevated to that of a separate province of the Ch'ing Empire. Unfortunately, this new status only lasted for eight years. In 1895, the Japanese decisively defeated the Manchurian navy in the Sino-Japanese War, and, in the Treaty of Shimonoseki, China ceded Taiwan to Japan in perpetuity. During the following half century of Japanese rule, the people of Taiwan faced an occupation government that was harsh and dealt brutally with any dissent. To its credit, though, the Japanese government at least maintained a reputation for lack of corruption. Furthermore, in trying to fully integrate Taiwan into its "Greater East Asia Co-Prosperity Sphere," the Japanese

built up Taiwan's educational system to a level similar to that in Japan and extensively developed Taiwan's infrastructure, trains, roads, and industry.

Shortly after sovereignty over Taiwan was ceded to Japan, the Ch'ing Dynasty in mainland China fell to various rebel groups, thereby ending five millennia of Chinese imperial rule.

Unfortunately, however, no one group was strong enough to gain and maintain control over the entire country, and China soon descended into the anarchy of the "Warlord Era." One of the groups vying for control of China was revolutionary leader Sun Yat-Sen's Kuomintang (KMT) or "Nationalist Party." After being named the first president of the newly formed Republic of China, the Hawaiian-educated Dr. Sun was soon forced to step down in favor of military strongman Yuan Shih-Kai. An attempted rebellion in 1913 by Dr. Sun failed, and eventually, with new backing from Soviet Russia, he formed his own government, the Southern Chinese Republic, based in Canton. Non-Chinese members of the Communist International came to wield great influence within the KMT, and the party was reorganized along Soviet lines. The Chinese Communist Party (CCP) was brought into the KMT organization, and the party's power structure was tightly centralized, with a rigid hierarchy and "with a sinister secret police, active propaganda organs and party cells penetrating society" (to quote from an article entitled "How Taiwan is invading China" in the April 8, 1996, issue of *Forbes* magazine). Furthermore, Soviet military advisors were sent to help establish a military academy, the Whampoa Military Academy. As its first superintendent, Dr. Sun selected a Chinese by the name of Chiang Kai-Shek, who had studied military science in Japan and had captured the city of Hankow during the anti-Ch'ing revolution.

In 1926, the year after Dr. Sun Yat-Sen's death, Chiang Kai-Shek launched his "Northern Expedition" to reunify China under KMT/CCP rule. The expedition was militarily successful, and the KMT became the ruling party of the Republic of China (ROC). However, the Northern Expedition was soon followed by the infamous massacre of April 1927, in which Generalissimo Chiang broke with his former allies of the CCP and ordered their execution. This marked the beginning of a rivalry between the KMT and the CCP that, in one form or another, has lasted to this very day.

Under Chiang's leadership, the KMT was subsequently transformed into an anti-communist, semi-fascist political organization. Over the following years, Chiang tried to completely eradicate the communists, but the Japanese, who had gradually been taking control over increasing amounts of Chinese land, openly declared war on China in 1936, before Chiang could fulfill his plans. Though Chiang wanted to continue his efforts toward first defeating the communists before dealing with the Japanese (in a famous quotation, he argued that, "the Japanese are a disease of the skin, the communists are a disease of the heart"), he was forced, after being kidnapped by a KMT-allied warlord named Chang Hsueh-Liang, to accept a "United Front" with the communists against the Japanese. Thus, the civil war between the CCP and the KMT was put on hold until 1945, when the Japanese were finally defeated by the Allies and World War II was brought to an end.

The defeat of the Japanese in World War II marked the return of Taiwan to the Chinese fold. Chiang Kai-Shek, as the representative of China, sent his KMT troops to accept the surrender of the Japanese on Taiwan. Unfortunately, the end of World War II also marked the open

resumption of the civil war between the KMT and the CCP. Chiang Kai-Shek and the KMT, with an overwhelming military advantage but with the disadvantage of a reputation for having mismanaged China's economic affairs during and immediately after World War II, effectively lost the civil war four short years later, when they were forced to retrace Koxinga's footsteps and flee to the island of Taiwan while Mao Tse-tung declared the establishment of the People's Republic of China (PRC) on the mainland.

Over the following decades, many commentators have pondered the causes of Chiang Kai-Shek's defeat and his "loss" of China. Economist Murray Rothbard provided what is probably the most succinct explanation:

Why did Chiang Kai-Shek "lose" China? The main reason is never mentioned. Because he engaged in runaway inflation, and then tried to suppress the results through price controls. To enforce them, he would up shooting merchants in the public squares of Shanghai to make an example of them. He thereby lost his last shreds of support to the insurgent Communist forces.

During the course of the war with the Japanese, the KMT government had engaged in "runaway inflation" to help finance the war effort. In so doing, KMT China unwittingly became, along with post-World War I Weimar Germany, a classic example of the effects of hyperinflation. As John Maynard Keynes noted in 1920 in "The Economic Consequences of the Peace":

There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.

In addition to forcing much of China's nascent middle class into financial distress, the deleterious effects of China's hyperinflation also fostered corruption and brutality within the KMT itself, as self-interested KMT bureaucrats and military officers utilized the real assets under their control to help augment the rapidly declining value of their monetary compensation (even today the KMT is considered the world's richest political party, with asset holdings worth over \$8 billion U.S.; the KMT's asset accumulation began in earnest during the Northern Expedition, as the KMT gained control of land seized from defeated warlords). And of course, as Murray Rothbard went on to note, currency speculators and merchants who violated the KMT's price controls were brutally and publicly executed, thereby eroding the KMT's support among the group in society whose natural inclinations would otherwise have been the most anti-communist.

During the four years of the resumption of the civil war in the mainland, the people of Taiwan at first experienced relief at being freed from the oppressive rule of the Japanese and being returned to Chinese rule. However, this relief quickly turned to dismay at the extreme corruption and repressiveness of Taiwan's KMT military government, under the leadership of Governor General Chen Yi. This dismay soon culminated in the February 28th Incident ("2-2-8") of 1947, when the brutal beating by KMT soldiers of an elderly woman who was selling cigarettes without a "tobacco monopoly" license led to riots in the capital of Taipei. These riots quickly escalated into widespread demonstrations throughout Taiwan. The KMT was initially taken aback, and native Taiwanese community leaders stepped in to help restore order. In response to this new potential threat to their authority, the KMT secretly sent troops from the mainland, and with the

aid of these troops the KMT officials on Taiwan started to round up and execute a whole generation of leading community figures, students, lawyers, and doctors. In all, over 10,000 people were killed, and during the "white terror" of the following years thousands of people were arrested, imprisoned, tortured, and murdered by the KMT's highly efficient KGB-machine, the Taiwan Garrison Command.

Thus, when the KMT fled to Taiwan in 1949 with the last vestiges of the ROC government, it was moving to a new home where it was not especially welcome among the native population. In response, Chiang's regime maintained martial law over Taiwan throughout the remainder of his life, severely restricting political freedom, prohibiting opposition parties, and punishing dissenters with jail, torture, or death. Furthermore, the KMT froze parliamentary elections until such a time as the ROC regained sovereignty over all of China and all the provinces could participate in free elections. Thus, the legislators who happened to have been elected in 1947 in effect became legislators for life.

But despite its strict political authoritarianism, the KMT nonetheless did learn the economic lessons of its defeat at the hands of the communists. Chiang and his advisors recognized the key role that the hyperinflation had played in their defeat, and they took note of the limited resources that remained available to them. Consequently, they committed themselves to sound monetary policy, encouraging entrepreneurs, and, in general, to promoting free market economics and a free enterprise system on Taiwan. As a result, starting in 1949, despite one major policy initiative that their two governments had in common, the economic path followed by the people of Taiwan diverged widely from that of their brethren living across the Taiwan Strait under the aegis of the People's Republic of China.

The major initial policy initiative that was shared by both the KMT on Taiwan and the CCP in mainland China, and which ironically led in Taiwan to the establishment of the Taiwan Stock Exchange (to be discussed below), was *land reform*, a policy typically associated with communists but rarely with advocates of free market economics. But while the CCP's land reform program entailed the humiliation, and in many cases the execution, of landowners and the direct confiscation of their landholdings and was followed by subsequent efforts to collectivize the land, the KMT's "land-to-the-tiller" program was specifically designed to encourage entrepreneurialism.

In Taiwan's case, the R.O.C. government phased out the feudalistic tenure system that it had inherited from the Japanese and substituted a relatively free market in farm land. While the remaining restrictions of land sales did not allow the flexibility necessary to take advantage of economies of scale, the reform nevertheless created entrepreneurial opportunities for small farmers, who were previously restricted by their traditional status in the farm communities. In short, many small landless farmers were given the land they farmed and allowed to become land-owning entrepreneurs who could sell their products on the market for profit. Taiwan's old landlords, in the meantime, were not liquidated or simply confiscated, but rather were compensated for their farmland with government bonds and shares in state corporations. In the words of K.T. Li, former ROC finance minister and architect of the program, the land-to-the-tillar program "gave our farmers incentive to boost production, and it gave the landlords the capital to become capitalists." A political side benefit of the program was that, by partially

compensating the landlords with relatively illiquid shares in state enterprises, the program forcibly linked the economic fortunes of a part of the native Taiwanese elite to the political fortunes of the KMT. The program thereby precluded some potential challenges to the KMT's continuing authority.

Furthermore, and in contrast to the "South Korean model" characterized by tight collusion between military governments and big industrial conglomerates, or chaebol, the KMT used tax incentives and financial regulations to encourage small enterprises rather than large bureaucratic businesses. As a consequence, Taiwan's economy has been less bureaucratic and more flexible and dynamic than those of other developing countries, including South Korea, and Taiwan's economy has demonstrated a marked capacity to react quickly and successfully to changes in the world economic environment.

These economic policies quickly bore fruit, and in 1965, after having received a total of \$1.5 billion in aid from the U.S., the ROC became the first recipient of U.S. aid to no longer request it. Since then, Taiwan has continued to experience strong economic growth. Its economic growth rate has been 6% or more per annum over the past 30 years, one of the world's highest and best-sustained growth rates. This has propelled Taiwan toward the ranks of "Developed Countries," with a per capita GDP (as of 1995) of \$12,800. By contrast, the PRC's per capita GDP is about \$500, despite substantial economic growth over the past decade or so (though the per capital GDP is substantially higher than \$500 when only the PRC's coastal regions, which have experienced the greatest amounts of growth, are taken into account).

Furthermore, Taiwan has provided the clearest example in recent years of economic freedom paving the way for increased political freedom. As political scientist Joseph Wu notes, "When people have money and education, they become more assertive and seek more freedom." And as Taiwan has become wealthier, its government has allowed more freedom. A full-fledged opposition party, the Democratic Progressive Party, was formed in 1986, and, during the following year, 40 years of martial law were finally brought to an end by Chiang Kai-Shek's son and successor, Chiang Ching-Kuo ("CCK"). CCK died the the next year, in 1988, but his vice president, Lee Teng-Hui, a Cornell Agricultural Economics Ph.D., was chosen to fulfill the remainder of his term, during which Lee continued the reforms started by his immediate predecessor. In 1991, the KMT dropped its claim to be the legitimate representative of all of China, and the Nationalist Chinese legislators from the mainland who were elected in 1947 were sent into retirement. Finally, on March 23, 1996, direct elections for president were held, with Lee Teng-Hui garnering 54% of the vote.

But the events surrounding Taiwan during this election mark the most severe potential threat to Taiwan, its economy, and the Taiwan Stock Exchange. While the Taiwanese were preparing for their first ever presidential election, the People's Liberation Army ( the "PLA," the PRC's military force) held live-ammunition military exercises and missile tests near the coasts of Taiwan and other KMT-held islands. While these wargames did not, as some had feared, escalate into a military invasion of Taiwan by the PLA forces, they did precipitate a drop of over 9% for the Taiwan Stock Exchange Weighted Stock Index (the Taiex) from its previous high and illustrate Taiwan's economic vulnerability to missile attacks and shipping blockades. And while Taiwan's government had renounced its claim to be the legitimate government over all of China,

the PRC's missile tests, which came on the heels of two prior sets of missile tests and war games near Taiwan over the course of the preceding year, dramatically illustrated the PRC's unwillingness to renounce the use of force to maintain its claim as the legitimate sovereign government over Taiwan. Thus, while Taiwan has a relatively strong and dynamic economy, it faces not only the vagaries of the global economy, but also the more distant, but potentially much more severe, threat of military action by the PLA if Taiwan's government does not move swiftly enough, in the opinion of the PRC's leadership, toward normalizing relationships between the two governments.

### **3.2. The Taiwan Stock Exchange**

The foundations of the Taiwan Stock Exchange were first laid in 1953, when the "land-to-the-tiller" program was successfully initiated by the Nationalist government of the Republic of China. The land-to-the-tiller program encouraged large landholders on the island of Taiwan to sell off parcels of their land in exchange for government bonds and shares in government-owned enterprises. This enabled the government to allocate the land to tenant farmers and encouraged the former landholders to take on a new role as burgeoning capitalists. At the time, however, no formal stock or bond markets existed in Taiwan, so it was difficult for former landholders who wanted to raise cash to find investors willing to buy their shares at reasonable prices. In order to facilitate such trading, the Securities and Exchange Commission was established on September 1, 1960, and the Taiwan Stock Exchange (the "TSE") was formed one year later, with operations beginning in 1962. The shares of 18 firms were listed on the TSE as of the end of its first year. Within the past decade, the number of listed firms has grown dramatically. The number of listed firms grew to 246 by December 1992 and had increased again to 331 companies, with a total face value of US\$45.3 billion, by the end of September 1995.

The TSE is the only exchange in Taiwan for trading securities, and TSE-listed companies are top quality companies in Taiwan. They observe strict disclosure requirements, and must disclose a set of financial and operational information periodically and in a timely fashion, both in print and electronic forms. Failure to do so results in trade suspension of the company's stock. Similarly, significant events relevant to a listed company must be announced by the company speaker or on an electronic bulletin board system within two business days of the significant event. All of the trades on the TSE are electronically matched and executed (see, e.g., Rhee and Wang (1996) for additional details), and both payments and deliveries are settled on an electronic book-entry basis. And in addition to a "T+2" rolling net settlement system claimed by the TSE to be "among the most efficient clearance systems," there is a NT\$6 billion "mutual responsibility settlement fund" in place to guarantee the settlement of every trade along with a "securities investors' protection program" to cover an investor's losses up to NT\$1 million if he suffers a loss as a result of a broker's default or insolvency.

Both stocks and bonds are traded on the exchange, but, in order to discourage speculation, there are no listed options or futures traded on the market. Similarly, short-selling of listed shares is prohibited. Furthermore, the S.E.C. has imposed daily price limits on stock price movements, although these are in the process of slowly being eased out. Before October 1987, this limit was 5%. The limit was 3% during the period from October 1987 through November 1988, after

which it was restored to the 5% level. In October 1989, the limit was raised to 7%, from which level it is expected to be raised again and eventually eliminated.

Despite these restrictions and the relative dearth of tradeable securities on the market, the Taiwanese, who have the highest per capita levels of foreign reserves of any nationals, by October 1988 had pushed the TSE to the position of the third largest capital market in the world in terms of total capitalization. Furthermore, by January 1990, the heavy trading of the Taiwanese investors enabled the TSE to challenge the U.S. and Japanese stock markets for the position of world's largest stock market in terms of daily trading volume. These extremely high trading volumes were achieved during trading hours which were limited to the short time spans of 9 a.m. to noon, Monday through Friday, and 9 a.m. to 11 a.m. on Saturday, and with an effective float of shares that is limited to the average of 30% to 40% of total shares outstanding that are not closely held. Thus, with a small number of shares listed, with only a small proportion of the shares outstanding for any of these listings actually available for trading, and with relatively few trading hours available during which to trade these shares, the Taiwanese nonetheless traded actively enough to occasionally give their market the position of the world's most heavily traded equity market.

This situation is even more remarkable when it is noted that there are few outside investors in the TSE, so that virtually all the trading volume is drawn from among the total 20 million citizens of Taiwan. The TSE was totally closed to foreign firms and individuals before December 1983. Since then, foreigners have been allowed to invest in Taiwan through one of four mutual funds, the Taiwan (ROC) Fund, the Formosa Fund, the Taipei Fund, and the Taiwan Fund. On January 1, 1991, the market was opened for more general foreign investment, although the government still sets fairly strict controls on the levels of foreign investment, as well as on the foreign exchange transactions involving the New Taiwan Dollar that would need to be undertaken for foreign investors to make investments in the TSE or to withdraw their profits back to their home countries. Despite a gradual relaxation of the restrictions on investment in the TSE, which should lead to a larger pool of potential investors, the market suffered a drastic decline starting in February 1990. After having suffered many major reversals in its climb up to a peak of 12,495, the Taiwan Stock Exchange Weighted Stock Index (the Taiex) fell nearly 80% to a nadir of 2,560 in October 1990 (see Figures 3.1).

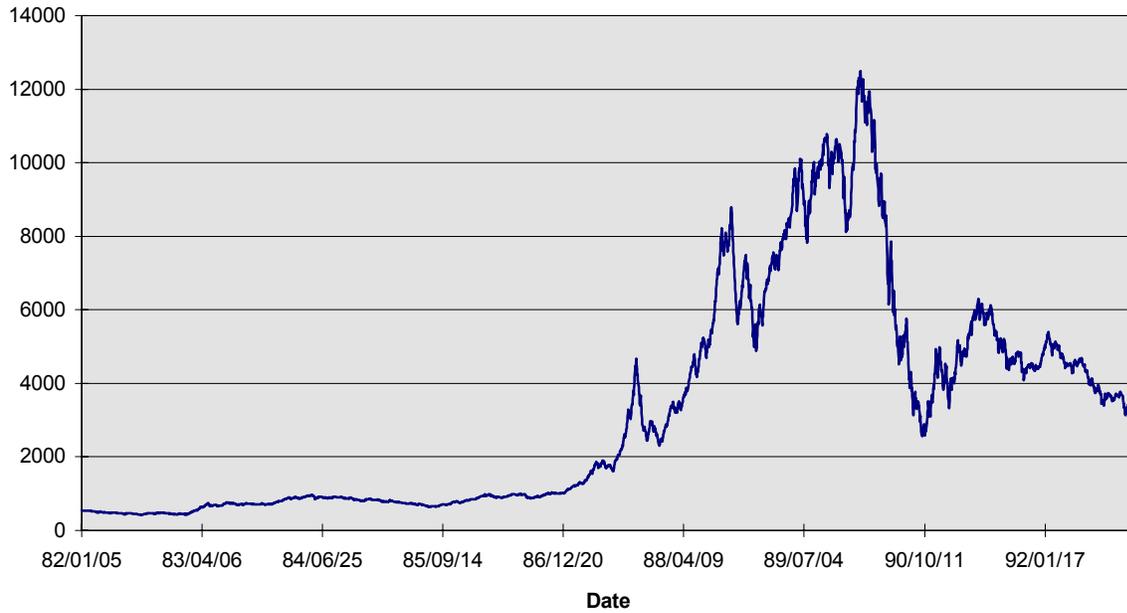
Over the years since then, the Taiex has struggled to regain its lost territory, but it has still not managed to reach its previous peak. The five years following the trough of October 1990 saw a slow, meandering recovery, but this recovery was stalled by the series of military exercises and missile tests in which the PRC engaged during the year leading up to Taiwan's first presidential elections on March 23, 1996. The threat implied in these maneuvers helped push the Taiex back down below the 4600 mark to its lowest point since the end of 1993. The successful conclusion of the presidential elections without the occurrence of the "worst case scenario" of a military takeover of the island by the PRC, however, saw a quick rebound of the stock market. Over the subsequent year and a half Taiwan's stock market has seen fairly steady appreciation, and the final day of July 1997 saw the Taiex close above the 10,000 mark for the first time since 1990.

But despite the "bubble"-like characteristics of Taiwan's stock market over the past decade and a half, the Taiwan Stock Exchange remains a relatively popular investment destination for the

island's general populace. Consequently, the TSE continues to be one of the world's most heavily traded and highly liquid stock exchanges. As a June 1, 1998, *Forbes* magazine article about Taiwan, entitled "Silicon Valley East," noted:

Helping make investment attractive is the tremendous liquidity in the system. Take the Taiwan Stock Exchange. Last year its trading volume, 90% retail driven, was \$1.3 trillion, greater than Tokyo's and the third largest in the world after New York and London. About 30% of Taiwan's population holds stocks, compared with estimates of under 10% in Japan and Korea. Figures such as Acer's Stan Shih and T[aiwan] S[emiconductor] M[anufacturing] C[orp.] boss Morris Chang are as much folk heroes in Taiwan as Bill Gates and Steve Jobs are in the U.S.

Taiwan Stock Exchange Weighted Stock Index  
1/5/82 - 2/26/93



Taiwan Stock Exchange Weighted Stock Index  
12/31/91 - 7/31/97



**Figures 3.1**  
**Taiwan Stock Exchange Weighted Stock Index (Taiex) Values**