The Saga of an Asian Tiger:  
Taiwan’s Foreign Reserves, Exchange Rates,  
Capital Control and the Hot Money in the 1980s  

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Abstract

Undesired balance of payments’ shocks, domestic currency turbulences and inconsistent exchange rate system to fundamentals seemed eternal perplexities in international finance and economics. They are remote from settlement evidenced by the reoccurrences of financial and economic crises in the front. For developing and emerging economies where exchange rates usually serve as crucial manipulated parameters in the pricing structure of global trade during economic transition era, the disturbances from exchange rate chaos might reshuffle the states of trade competitiveness at macro level. Capital control is often another key regulator in the mechanism to complement and escort government’s policy frameworks in exchange rate system, but there exist implications. In making optimal policy selections to square multiple disequilibria derived from the incompatibilities from Mundell-Fleming’s “Impossible Trinity” in exchange rate system, capital mobility and monetary autonomy in the ever-changing economic environments, governments often have to cope with speculative disruptions by irregular hot money flows.

Rigid capital control and undervalued currency seemed to serve as good resorts of defending an invariable policy in stockpiling international reserves which are deemed vital for external liabilities repayment and internal monetary base. Nonetheless, the incompatibilities and disequilibria accelerated must be paid by relative financial and economic consequences once the time is ripe.
In the late eighties – the heyday of deregulations, as a transition economy and a transforming political entity, Taiwan had gone through a streak of inevitable adjustments in exchange rate and capital control regimes propelled by spillovers of Plaza Accord, rapid export boom and speedy foreign reserves accumulation. Unfortunately, financial turmoil and negative economic shocks reversed rosy economic episode with hot money turbulences within a short time horizon. We demonstrate the dynamic systems of hot money and its co-factors that functioned during the disturbances in financial and real sectors on the road to democratization, liberalization and globalization. This research faithfully presents the structural roadmaps and rationales of the episode tracked from Taiwan’s five-decade evolution in economic and financial contexts using an analytical and a narrative approach.

We present evidence that the effect of excess hot money frenzy speculating on drastic currency appreciation inflated financial bubbles and slashed trade competitiveness. Its inevitable retroactions of capital flight kindled a spiral financial crisis with self-fulfilled feedback busts.

We advocate the rethinking on the fallacy of foreign reserves and the implications it plays and threats it poses. Finally, we conclude that the reforms to financial and economic liberalization promote the sustainability of stable economic growth and financial system in a long run.

We believe that our work adds to what is known and will stimulate additional perspectives and theories on relevant areas to yield better insights to policy makers especially in the Greater China region. The progression and
labor pains experienced by Taiwan in the implementation of twin reforms of capital control and exchange regimes surely provides important lessons to China and other protective, trade-reliance economies to draw to withstand the test of times on the road to global integration.