The Great Taiwan Bubble

By Steven R. Champion

Chapter 1: At the Peak

As Taiwan celebrated the arrival of the lunar year of the horse in early 1990, it seemed that all the normal laws of economics and finance had been suspended. It was as if the Chinese had discovered how to exceed the speed of light, freed themselves from all previously binding physical constraints, and arrived in a strange new dimension where clocks stopped and parallel lines intersected.

The factor that had changed all the normal rules of the game was fast and easy money, and the country was awash in it. Money was pouring into Taiwan as a result of the unprecedented trade surpluses which were made possible by years of steady industrial development and nose-to-the-grindstone work by the well educated and adaptable local people and which were multiplied by the waves of offshore "hot money"[1] that had flooded into the country to take advantage of the steady, predictable appreciation of the local currency.

This influx of new wealth was heady medicine for a country that so recently had been an economic basket case. The country had been dirt poor following the disastrous evacuation of the Kuomintang government from mainland China in the late 1940's, and, even in the early 1960's, Taiwan

[1] Although "foreigners" were often blamed for this torrent of hot funds, much of it was simply the repatriation of stockpiled offshore funds accumulated over many years by Taiwan-based companies and individuals.

had a per-capita national income that ranked it between Zaire and the Congo in world economic statistics.[2]

Now, after forty years of 9% average annual economic growth, Taiwan seemed suddenly rich. The country's international reserves had ballooned to over US$70 billion, second only to those of Japan and by far higher on a per-capita basis. Salaries had spiraled upwards, and the year's annual bonuses were the best ever, ranging from a modest month and a half of extra pay for civil servants, to three months pay to workers in relatively low profit businesses like the automakers, to seven to eight months pay in more prosperous businesses like the cement cartel[3], and up to the stratospheric seventy, ninety, or a hundred months bonuses in the booming new securities companies.[4] Some of these excesses, like the extra NT$10,000,000, roughly 500 months wages for the average worker, pulled down by Chao Hsiao-feng, President of the Taiwan Stock Exchange (TSE), were angrily denounced in the legislature, but this was regarded by most as petty jealousy from those who simply didn't know the rules of the game.[5]

Once you had a bit of this new wealth, accumulating even more had never been easier, and the crowd's investment horizon had never been shorter. Rates of return in Taiwan were routinely measured on a monthly basis, and Chinese investors were bemused by foreigners who measured their investment returns *per annum*. Even those local investors

[2] "The Visible Hand," The Economist, June 1, 1991.

[3] 楊森,’年終獎金爭議將成爲春節情景,” 財訊月刊, 1990 年, 2月.

[4] Branegan, Jay, "Roulette? Try a Real Gamble," Time, May 15, 1989.

[5] “ 現場目擊：交易所是暴利中的暴利 ,” 財訊月刊, 1990年, 1月.

who were too lazy or backward to take advantage of the easy money to be had in more sophisticated markets could make 4% or more *per month* by dealing with polite, young account officers employed by the unlicensed, but openly operating, underground banks which were free of the heavy regulation imposed on the government controlled, licensed banks. After all, it seemed that the authorities merely winked at these technically illegal operations, which were run by self-proclaimed financial geniuses who were thought by many to have close ties to the government.

If 4% *per month* wasn't enough, anyone could get more by organizing a "*biao hui*", a type of mutual savings scheme which could yield 6% *per month* or more. For the more daring players, there was the booming underground commodities futures business which had sprung up almost overnight and where big money could be made quickly in heavily margined bets on the volatile futures and options markets. Many of the 350 or so new commodities brokers seemed outwardly solid enough and had well publicized but vague international connections. These brokers worked all night to conform to Chicago and New York trading hours and operated on a mind boggling scale, employing up to three hundred Reuters terminals per office. However, few contracts were actually cleared through overseas exchanges, and most transactions were merely bets on the sequences of numbers flashing by on computer screens.[6]

Even more in the gambling spirit were the "Everybody Happy" or "Mark 6" lotteries, which snarled the country's telephone system and brought work to a halt before their twice-a-week drawings. More exciting still were the

[6] "MJIB Fights Illegal Futures Trading," The China Post, September 4, 1990.

“hada” game, where up to $750 million in daily bets on the movement of the stock index were taken by specialized, underground brokers around the island[7], and the illegal "air trading" of shares, where up to $3.7 billion per day in trades that never settled on the exchange stirred the animal spirits of the crowd.[8]

Slightly more conservative investors could jump into the real estate market where prices had doubled and doubled again over the last few years. Thousands of real estate brokers, unrestrained by American standards of practice, jumped into the market and actively drove up property prices and, of course, their resulting commissions.

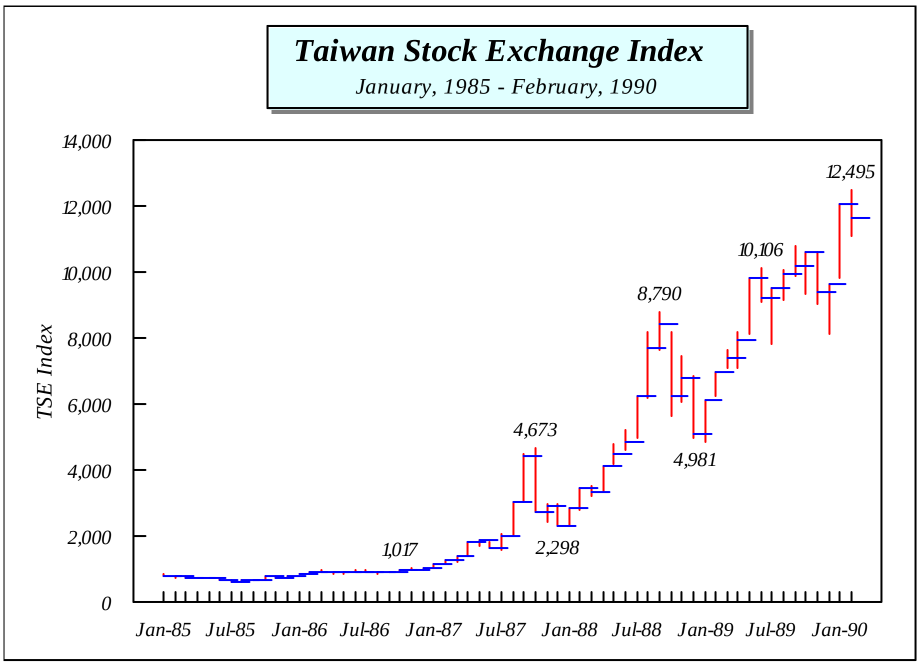
On a more rarefied level, some of the more sophisticated players began speculating in the international art market and were major bidders at auctions in Hong Kong, London, and New York. Aggressive bids by Taiwan buyers fueled the boom in prices of Chinese paintings and porcelain, and the heaviest hitters had open telephone lines to Sotheby's and Christie's to bid on trophy French impressionist paintings. One of the country's most respected and hard charging businessmen successfully bid $6.6 million for Claude Monet's painting "*La Berge a Argenteuil*," and with major Japanese collectors and Alan Bond paying top dollar for major art works it looked like there was no way for even the most unsophisticated buyer to lose.

All these money games, however, were only sideshows for the biggest, fastest wealth creating game that had ever

[7] Kaye, Lincoln, "Taipei's Dazed Star-Gazers," Far Eastern Economic Review, February 8, 1990.

[8] "Illegal Stock Sales, Gambling Probed," The China Post, June 14, 1989.

come to town. That game was the local stock market, and suddenly nearly everybody wanted to play. The local market index, which had reached a historic high by breaking through the 1,000 barrier only a little more than three years before, was now *twelve times higher* after one of the great, bumpy, parabolically rising bull market runs in world history.



The Taiwan Stock Exchange Index had taken twenty-five years to surpass the 1,000 level in late 1986, but then began breaking through to new, higher levels with astounding speed and regularity. The 2,000 level was broken in only nine more months, and 3,000 and 4,000 were then broached within the next two months. Taiwan was not immune to the worldwide market crash in the fall of 1987, and the bull market was temporarily interrupted by a dizzying 51% drop before bottoming out in late December at just under 2,300.

While a faint-hearted few may have found this collapse discouraging, the party was far from over, and by the next June, the market had surpassed its previous peak and had broken through the 5,000 barrier for the first time. The index went through 6,000 in July and surged past 7,000 and 8,000 in August. Another great bull market spike came to an end in late September, 1988 just after trading closed at 8,790 at the end of a two hour Saturday trading session when Finance Minister Shirley Kuo announced the imposition of a capital gains tax. The market again went into free-fall beginning on the following Monday morning, eventually plummeting a whopping 43% to below 5,000 just prior to year-end.

Seemingly right on schedule, the market took off like a shot in 1989, and this time it took only a bit over four months to reach its previous high. As the market re-broke the 6,000, 7,000, and 8,000 levels, stockbrokers held wild celebrations on their trading floors, featuring free champagne, exploding firecrackers, balloons, buffet lunches, and musical performances. Everyone had their eyes on the 10,000 level, and while a few sober observers of the market scoffed at the idea that the market could reach such a seemingly absurd valuation, few real market players doubted that they could make it happen.

The true believers were right. In June, only a month after reaching the previous market high, the index broke through 9,000 and finally smashed through the 10,000 level a few days later. The champagne flowed freely and the crowds held wild celebrations on brokerage trading floors, but the market then seemed to stall out during the last half of the year as the country was preoccupied with legislative elections. Finally, in the waning days of the lunar year of the snake, mid-January, 1990, the index broke 11,000, and it welcomed in the lunar new year by surpassing 12,000 on the last day of the month.

The strength of the bull market on some trading days seemed to be limited only by the regulatory ceilings on price movements. One day in late November, for example, the market surged 590 points or 6.5% upward to close at 9630. All 185 issues traded that day[9] rose in price, and 175 shares traded up to their 7% ceiling prices. In a market like this, it didn't matter very much which stocks you bought; you only had to play the game to be a winner.

At this pace, even the average punter had been earning more than 8.5% *per month* over the last three years through the many ups and few, but terrifying, downs, and this was achieved even by those who didn't bother to lever up. With the easily available, but generally illegal, margin credit[10] provided through many brokers[11], even a random stock selection strategy could easily yield 15 to 20% *per month* on average.

Of course, one could do far better than just randomly picking shares by throwing darts at the stock market tables carried in the local newspapers. It made much more sense to bet on a "brand name" stock picked and supported by your friendly, local broker. Better still, if you had the money and the right social connections, you could join the nightly revels at Madam Boom-Boom's very expensive

[9] Includes non-corporate listings like closed-end funds.

[10] Margin purchases of stock use borrowed funds to finance a portion of the transaction. Underground margin credit was estimated to finance about 40% of total stock trading.

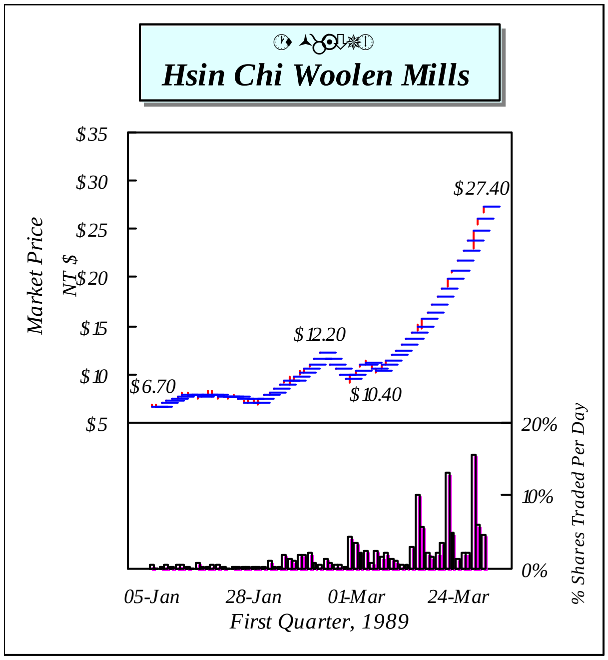
[11] "TSE Starts Massive Audit of Stock Trading Records," The China Post, August 31, 1989.

nightclub where Taiwan's equivalents of the robber barons like "Grasshead" Tsai, "Exorcist" Yu, "Little Boss" Weng, "King of the Monster Bulls" Cheng, "Antique" Chang, "Chili Pepper" Chiu, "Little Devil" Tsai, "American" Chen, or "Big Tuna" Chuang[12] might drop by for a nightcap or two. If you could ride along on a hot stock being manipulated by these "big hands," you could strike it rich in a matter of a few days.

Alternatively, those with less access to this privileged information could play the stocks being ramped daily by underground stock "fan clubs" which, though not legally organized, placed daily coded advertisements in the financial pages to advise their clients of their rapidly changing telephone numbers. A quick call to one of these numbers yielded the recommended stock play of the day.

The rewards of picking the right "brand name" over the short term could be significant. For example, in early 1989, Hsin Chi Woolen Mills, one of the curious "full delivery" shares listed on the Taiwan Stock Exchange, came into play. Ideal candidates for ramping, the "full delivery" shares are almost *pure plays on the greater fool theory* since they have absolutely no economic fundamentals to shore up their share prices. "Full delivery" companies, which would be declared bankrupt in most countries, generally have no income, no assets, no employees, no operations, and, of course, pay no dividends, but they are allowed to keep their listings under the often arcane and counterintuitive rules of the exchange.

[12] The "Big Tuna" achieved unwanted local notoriety in Taipei when he was rumored to have refused to allow the panicking patrons of one of his mammoth seafood restaurants escape from a blazing flash fire until they had settled their bills. Although this meant that a few more of his loyal customers were incinerated along with the abalone and sea slugs, he was back in business within a matter of weeks.

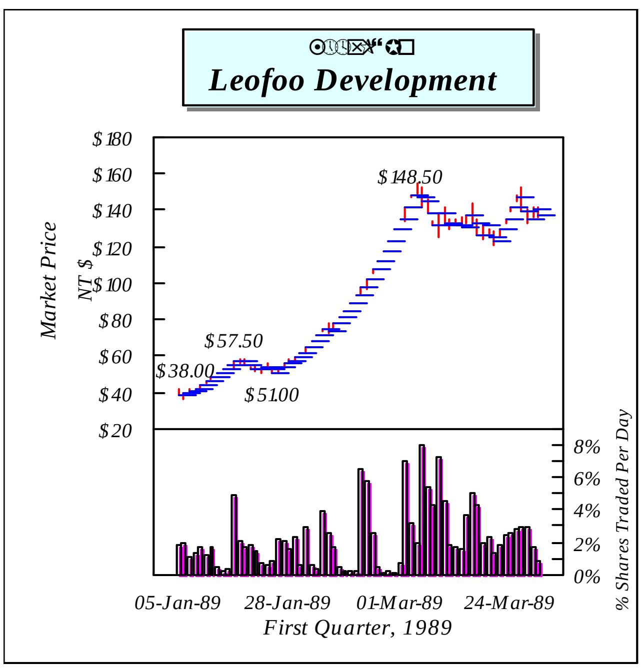


Hsin Chi's shares were trading below their NT$10.00 par value in January, and any intrinsic value they might have had was based only on the unlikely chance that the company would somehow emerge from its corpse-like state. As the shares were targeted for play by market manipulators about March 1, the price exploded upwards without any change in the hopeless condition of the underlying company. Over the next twenty-five trading sessions, Hsin Chi shares finished at their daily price limits (up or down 5% at that time) twenty-two times, and on thirteen of those days only an up-limit price was quoted for the whole trading session, which is to say that there were simply no sellers anywhere out there.

If a small investor was able to go along for the ride as Hsin Chi's shares were ramped, even without leverage, he could have earned 175% on his investment in a month completely unrestrained by the lack of any fundamental value in the underlying stock. Holding Hsin Chi for the entire first quarter yielded a return of 209%, or 46% *per month* on a compounded basis.

With returns like this available on intrinsically worthless stocks, it was no wonder that the majority of Taiwan investors focused on obtaining inside information on the market intentions of the big players, mostly available through rumors or the gutter press, rather than paying attention to the fundamental value of a corporation as a generator of future income streams.

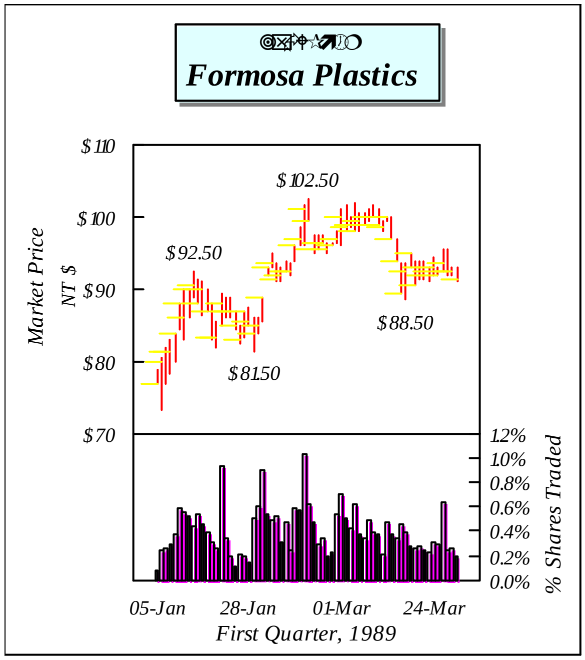
Hot stocks were not confined to corporate shells that existed only as poker chips to be valued by the volatile emotions of the crowd. Real, income generating companies could qualify too, provided that they had low market capitalizations, thin floats of shares available for trading, and, if possible, a good story or an auspicious name.



Leofoo Development Corporation went public in late 1988 and came into play a bit earlier than Hsin Chi. Based on normal investment criteria, Leofoo was an unlikely candidate for a wide following in the stock market, but it did meet the criteria for easy manipulation. Leofoo's two main assets were a dreary 238 room hotel in Taipei, named the Inn of the Sixth Happiness, and an unlikely wild animal park in central Taiwan where the occasional tourist would be mangled by a moth-eaten lion driven berserk by the unaccustomed sub-tropical heat and humidity.

Leofoo rallied 51% to NT$57.50 per share in the first two weeks of January and then fell back to NT$51.00 by January 25. Over the next twenty-five trading sessions, Leofoo rose, almost without interruption, to NT$148.50 on March 3. During this spike in the company's stock price, Leofoo was up-limit nineteen times, and twelve of those times only the up-limit price was quoted for the whole trading session. If a small investor had information on the plans of the market manipulators, he could have made 191% on his money in a little over one month without margin. Even if he waited to jump on the band wagon well after the market trend was established, big, fast, and easy money was there for the taking, and holding Leofoo for the entire quarter yielded an impressive 243%, or 51% *per month*, compounded.

Of course, there are also many blue chip companies in Taiwan with growing earnings, strong balance sheets, and forward looking management. Among these is Formosa Plastics Corp., led by billionaire Y.C. Wang and one of the world class, highly respected companies traded on the Taiwan Stock Exchange.



Here we see an entirely different picture. Formosa Plastics gained a more sober 18.8% during the quarter with its strongest rally between late January and mid-February when it gained 21.7% and was up limit twice in fifteen trading sessions. Holding Formosa Plastics an yielded un-thrilling 12.2% for the quarter, far less than the 44.4% rise in the TSE index, which was ratcheted upwards by the steroid-like effects of the speculative shares.

These three stocks were not isolated examples. In strong bull markets, small speculative stocks and corporate shells with no underlying value had generally outperformed the index and the blue chips mainly due to the ease with which they could be manipulated by the market players. In a booming market like that of the first quarter of 1989, the generally blue chip class A shares were up 39.5%, while the more speculative class B shares were up nearly twice as much at 74.8% and the objectively valueless full delivery shares were up by a similar amount at 71.3%. Like the tulip mania in 17th century Holland[13], these results seemed to detach any concept of economic value from the market price of a stock, and, once detached from this anchor to reality, no price and no amount of money seemed out of reach to those with the ability and will to play the game.

Many market players clearly thought that the best part of the game was that even with this tremendous upside potential there seemed to be almost guaranteed downside protection provided by the government. The ruling Kuomintang party had used the prosperity of the stock market in its advertising for the recent election campaign where their favored slogan was "Big Profits and Great Prosperity," and many interpreted this as some kind of implied guarantee against market losses. Even the newly legalized, opposition Democratic Progressive Party seemed to want to get into the act, and one of its leaders, Ju Gao-jeng, had just predicted that the market would hit 15,000 by June.[14] Why not? As he pointed out, there was so much money around, and it just had no where else to go.

Even if this rare political consensus on the so called "never ending bull market" should somehow fail, angry investors could simply take to the streets, and surround the Finance Ministry and the Minister's residence in protest if the market fell. Then the government would have to give in and take steps to revive the market as it had done several times over the past few years. Since the brouhaha caused by the market crash which followed the imposition of the capital gains tax, the government had been very careful to avoid blame for any further market

[13] Mackay, Charles, Extraordinary Popular Delusions and the Madness of Crowds, Richard Bentley, London, 1841.

[14] "Stock Market Index Seen To Hit 15,000 by June," The China Post, February 2, 1990.

corrections. Most officials tried to avoid any comment at all about the level or future direction of the market. Exceptions to this rule could be hazardous to the health, political or otherwise.

The policy of not commenting on the insane run-up of the market and the dangers that the economy might face as a result must have been galling to many of Taiwan's prudent financial officials and led to some convoluted verbal gymnastics at times. For example, shortly after the market broke the 10,000 level, charming but stern Finance Minister Shirley Kuo was surprised by a group of reporters who asked her about the stock market as she journeyed outside Taipei to make a ceremonial visit to the tombs of the late President Chiang Kai-shek and his son and successor Chiang Ching-kuo. She hastily replied with considerable understatement, "At 10,000, the market isn't low," and continued on her way. Quickly realizing that such a statement coming from her could cause a violent downward reaction in the market and lead to claims that the resulting losses were the government's responsibility, she leaped back toward the reporters and added, "Then again, it isn't high either!"[15] Even after hedging her bets in this way, her Delphic pronouncement was presented as one of the next day's major news stories.

Stock trading in Taiwan had rapidly become a national mania and few seemed to doubt that it had the potential to make everyone rich. Every day, the country's two million or so small time investors, one-tenth of the country's population, played the market with as many as 500,000 to

[15] "郭婉容愈來愈離譜," 財訊月刊, 1989年, 8月.

600,000 braving the island's traffic clogged streets to buy and sell on the trading floors of their favorite brokerage houses. The more modest of these market players - housewives, taxi drivers, college students, dancehall hostesses, teachers, Buddhist monks, and retired soldiers - thronged to the brokers' dingy, linoleum floored main trading rooms, occasionally taking a break to sit on molded plastic chairs amidst clouds of stale cigarette smoke and hundreds of flashing screens displaying current market quotes. If the stressed-out customers of one brokerage needed a break from the general chaos of hundreds of people pursuing fast money, they could retire one floor down to the broker-operated Wall Street Restaurant for a snack and never miss a market turn thanks to the computerized market screens and telephones imbedded in each of the tables.

Traders on a somewhat larger scale, whose monthly trading exceeded $3 million or $4 million depending on the brokerage, could trade in a quieter atmosphere at their own personal computer work station provided by their broker. These screens offered highly sophisticated software and graphics, allowing a trader to chart his stock against the market trend and to access a huge variety of technical market information.

Better still were the private VIP rooms available to the brokers' most profitable customers who traded upwards of $400 million per month. These VIP rooms were decorated in Chinese, Japanese, or what seemed to be Federico Fellini-inspired western styles, were stocked with expensive brands of whisky and brandy, and were equipped with thirty or forty screens showing current stock quotes. For really big traders, one brokerage maintained a VIP room furnished with expensive antiques and modeled on a Ching dynasty imperial throne room.

In the extreme case, a single market player accounted for over $12 billion in stock trades during 1989, consisting of 65,945 separate sales orders worth just over $6 billion and 60,796 purchase orders worth only fractionally less. When Finance Minister Shirley Kuo reported this astounding record to the Central Standing Committee of the Kuomintang she brought along the one meter thick computer printout of this player's annual trading records for proof, fearing that she might not be believed.[16]

The mania reached the point where many government offices went unmanned during stock exchange trading hours, and agencies such as the Department of Public Housing, the Labor Insurance Bureau, and the Taipei Environmental Protection Department ceased to function until after the market closed at noon and their employees came back to work.[17] Students at the elite National Taiwan University began to routinely cut morning classes;[18] primary school teachers quizzed their students to see what stocks their parents were buying; taxi drivers refused fares to play the market, and young office assistants, known as "tea girls" or "little sisters," deserted their jobs to trade shares on the stock exchange.[19]

High school girls desperate to accumulate savings to throw into the market while the party lasted turned to part-time prostitution and, like speculators at the Chicago

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[16] "Another Record Broken on Local Stock Market," The China Post, January 25, 1990.

[17] "Part-Time Stock Players Hamper Government Efficiency," The China Post, August 14, 1989.

[18] "Students Skip Class to Play the Stocks," The China Post, August 22, 1989.

[19] "股票全民化, 夫子學生同樂, 賺錢愉快, 小妹小弟難求, 工商日報, 1989 年 5月 30日.

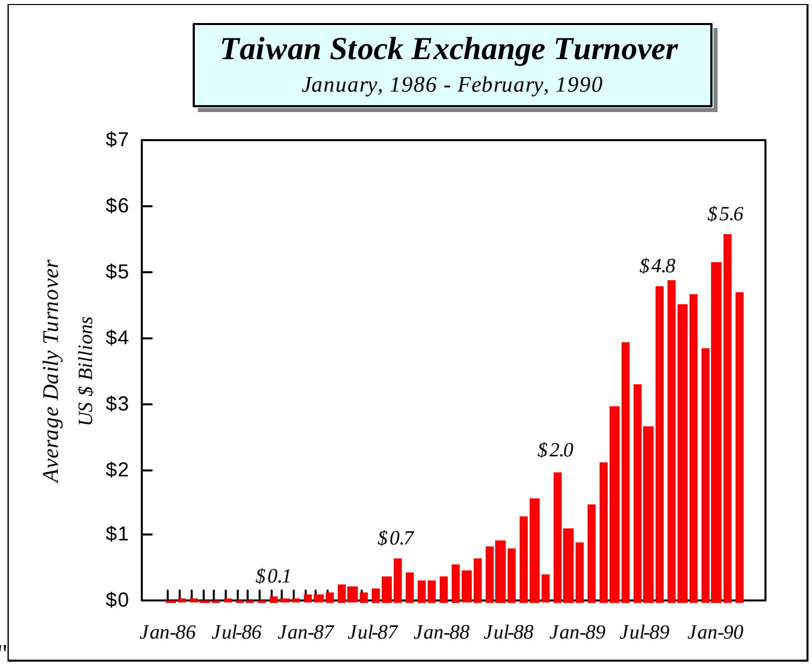
Board of Trade, negotiated the pricing of their transactions by flashing hand signals with prospective clients in fast-food restaurants and on street corners. While the more conservative elements of society disapproved of these slight deviations from strict Confucian morality, more street wise market players lauded the initiative of these young self-starters, quoting the Chinese proverb, "Laugh at the poor, but don't laugh at prostitutes. (笑貧不笑娼)"[20]

The collective actions of these individual investors, who accounted for 90% of trading in the market, had led to astounding increases in market turnover on the Taiwan Stock Exchange. Daily trading in the market's 181 listed companies had reached a speculative frenzy which was unexplainable and unfathomable in the rational world of economics and only understood in the realm of the psychology of the crowd.

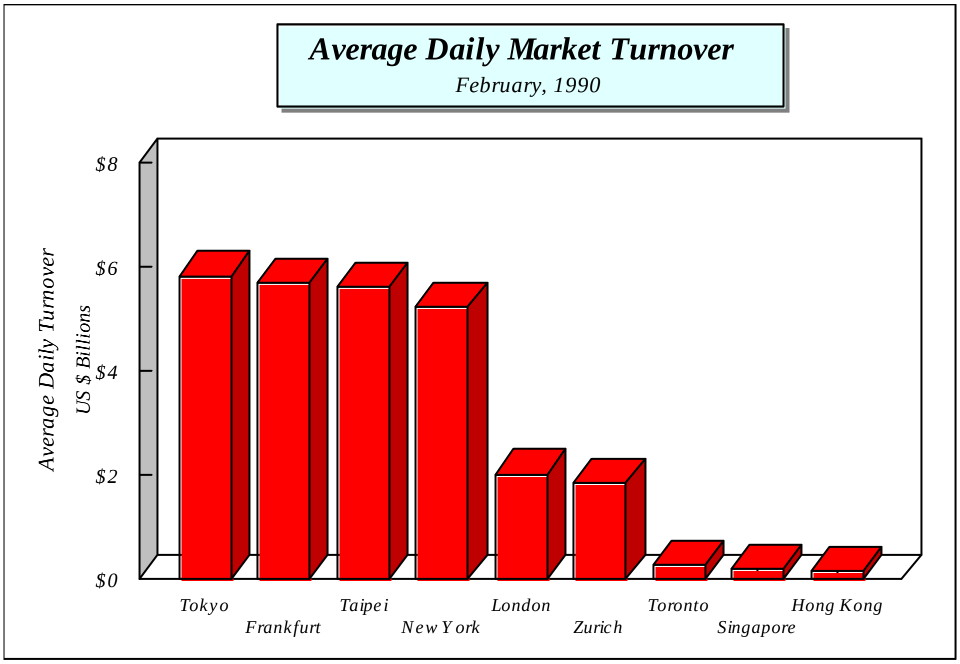
In the last quarter of 1989, total trading on the TSE had reached $306 billion, more than the total amount traded in the entire previous year. Average trading in any recent month exceeded all stock trading in 1987, and trading on a big day, which could exceed $7.6 billion[21], was greater than the sum total of all stock trades in 1985. At the peak of the crescendo, shares with a dollar value equal to all the shares traded in 1970 changed hands in the first ten minutes of the morning trading session. On peak days, trading on the TSE could exceed the *combined* turnover of the Tokyo and New York stock exchanges.

[20] "Promise of Quick Money Lures Children into Prostitution," The China Post, July 9, 1989.

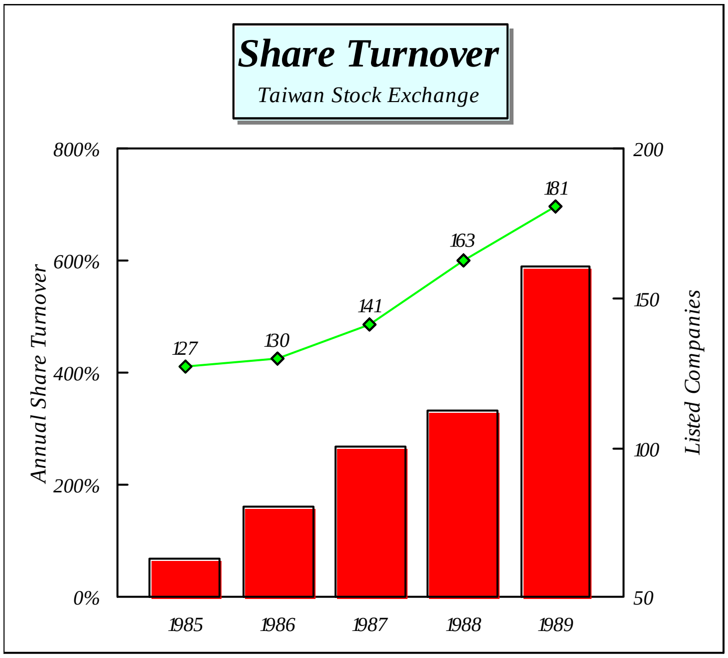
[21] An amount roughly equal to 5% of the country's annual gross national product.



At this level, *Taiwan's stock market was a black hole in the universe of international finance*. It was excluded from all major international market indices, was unmentioned in the statistical tables of the *Wall Street Journal*, and was composed of companies of which few American or European investors had ever heard, but in its three hour daily and two hour Saturday trading sessions it was handling a level of stock trading roughly equal to those found in the world's economic and financial superpowers.



The fact that this level of trading was taking place in the shares of the relatively small number of companies listed on the Taiwan Stock Exchange made these statistics even more amazing. In 1989, on average, every share of every company listed in Taiwan had changed hands just under six times, based on a straightforward calculation, but taking a closer look at the numbers produces an even more surprising result and illustrates the extreme short-term focus of Taiwan's stock market.



When listing on the Taiwan Stock Exchange, a company generally needs to sell only 5% to 10% of its outstanding shares to the public, and a large percentage of the shares of listed companies remain in the hands of founding families or in cross holdings with related group companies[22]. The government, at both the national and provincial levels, and the ruling Kuomintang party also control huge blocks of listed stocks on a permanent basis. These permanent family, group, and government holdings were estimated to comprise 70% of all stock in TSE listed companies, and if one removes these holdings from the inventory of shares available for trading, every available share on the exchange changed hands closer to twenty times in 1989. This means that *every single share of stock that was available to trade in Taiwan changed hands approximately every 15 days*. A further indication of the extreme short term focus of the market was data showing

[22] Sometimes these groups, or "***bang***" (幫), were based on a common geographic location in Taiwan, as in the Tainan "***bang***," or on a common area in mainland China from which the founding families hailed, as in the Shantung "***bang***."

that approximately 20% of total trading represented illegal *wash sales* in which purchasers of securities bought and sold a given share on the same trading day and never took delivery of the underlying stock certificates.[23]

The lower portion of the charts on pages 8,10, and 11 show the percentage of shares in Hsin Chi Woolen Mills, Leofoo Development, and Formosa Plastics traded per day. Hsin Chi had up to 15% of its total shares turning over on a big day, and Leofoo had 8% turnover of its shares in a single trading session. The corresponding daily turnover for a blue chip like Formosa Plastics was much lower with a more normal 1% changing hands on an active day.

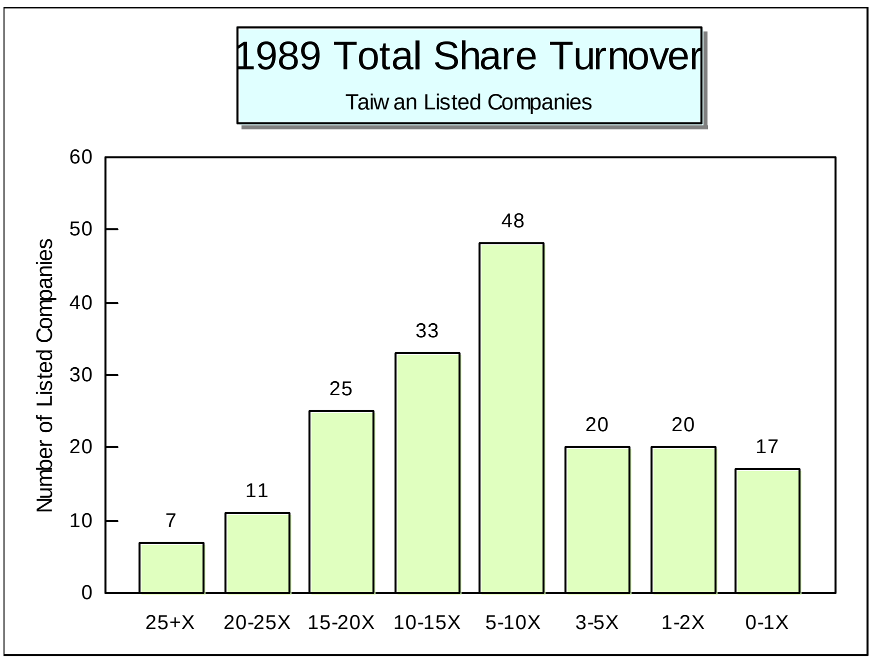
By contrast, turnover of shares on the New York Stock Exchange was often 20% to 30% per year in the 1970's, increasing to 50% per year in the early eighties and peaking at just under 100% (i.e., one time per year) just before the 1987 market crash. After the crash, the annual turnover level in New York stayed near 40% for several years and now has risen to 75%, so that shares, on average, now turn over about once in 1 1/3 years[24]. Unlike Taiwan, there are no large government, bank, or political party holdings in the market, and family and corporate cross holdings are relatively infrequent. Therefore, turnover of total shares and of tradable shares is generally about the same.

In the cases of some individual shares traded in Taiwan, the comparisons are even more staggering. Cheng Hong Chemical had its total shares outstanding turn over

[23] Traders generally sold shares first and bought them back later if they expected the market to fall and bought first and sold later in the day if they expected the market to rise.

[24] Emerging Market Indicators," The Economist, May 4, 1996.

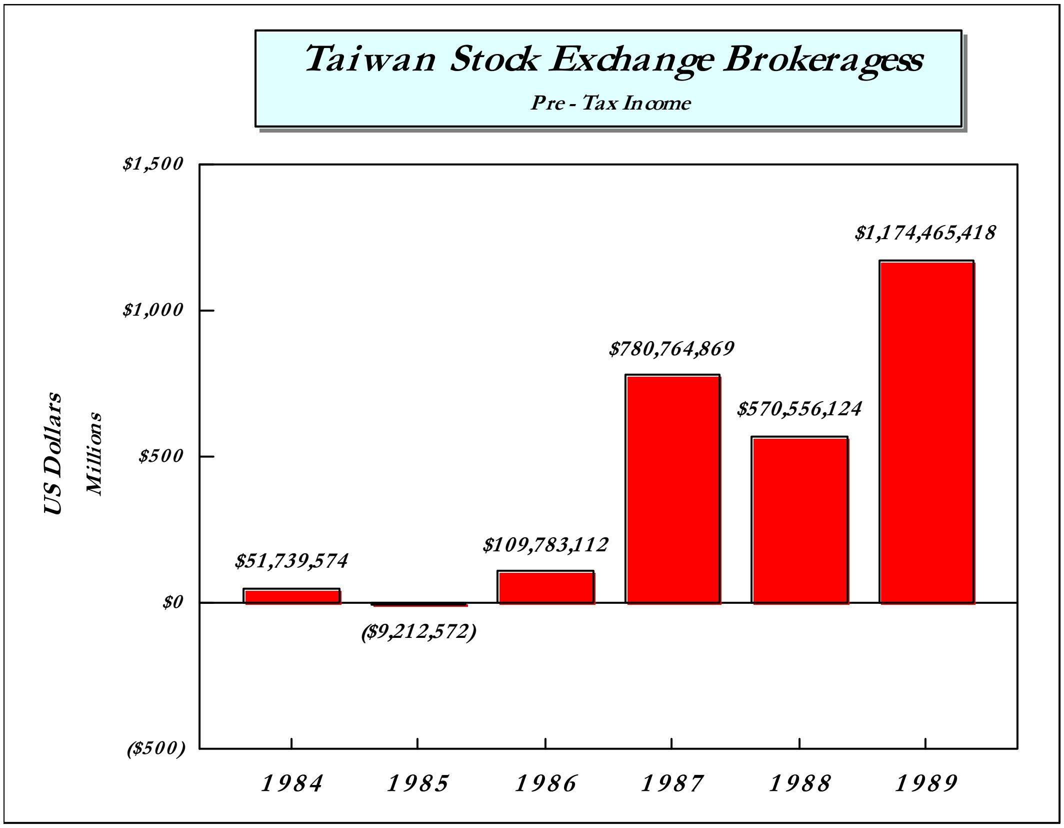
more than thirty-three times in 1989 and Ko Sheng Enterprises was close behind at nearly thirty-one times. There were seven companies whose total shares turned over more than twenty-five times, all of which were small and relatively poorly capitalized, but several of which were basically sound companies that just happened to come into play. The following chart shows a frequency distribution of the 181 TSE listed shares sorted by total 1989 share turnover. Using only shares actually available for trading would, of course, make the numbers even more extreme.



For comparative purposes, IBM's total shares turned over 0.7 times in 1990 and virtually all shares outstanding are tradable. The Limited's total shares turned over 0.5 times, but with 36% of all shares closely held, tradable shares turned over 0.8 times. Microsoft presents a more extreme case: total shares turned over 2.0 times, and, with 60% of total shares closely held, tradable shares turned over 4.9 times. Even Microsoft, however, traded somewhat sluggishly by Taiwan standards.

The avalanche of stock trading in Taiwan was done through the country's rapidly expanding group of brokerages, recently freed of regulations which had frozen new entry into the market for the last fifteen years. The twenty-eight TSE member firms that existed prior to deregulation were a mixed lot, including the trust departments of the government controlled banks and an assortment of vaguely disreputable hustlers, who seemed to operate on the fringes of the legitimate business community and who sometimes found themselves on the wrong side of the law.

Prior to deregulation, the industry was thinly capitalized, overhead was kept to a minimum, and there were wide swings from huge profits to major losses. Since the beginning of the great bull run, however, brokerage profits had skyrocketed as shown in the chart below:



Excluding the results of the bank trust departments, consolidated brokerage returns on equity swung from 225% in 1984 to -62% in 1985 and then rose precipitously to 352% and 491% in 1986 and 1987, respectively. Following deregulation of the industry in mid-1988, returns on equity declined due to the heavy capital requirements which were imposed, but it still seemed that every local business group, from major industrial conglomerates down to chains of tea shops and seafood restaurants, wanted to play the game and get their share of the windfall profits.[25] The names of these new brokerages provide a hint of the spirit of the times. Both the original Chinese names and their official English translations infuse the reader with a

[25] For a while, it looked like the increase in the number of brokerages would spiral toward infinity, but, interestingly, the expansion was checked by zoning laws which basically required new brokerages to meet building standards which would probably have been sufficient for surviving a thermo-nuclear blast.

sense of the *gravitas* of these new pillars of the financial community, and a sampling, thematically grouped, is presented in the Appendix to this chapter.

Taiwan's politicians rushed in to become major shareholders and top officers in the new brokerages, as unrestrained by quibbles about conflicts of interest as they were in their behavior on the floor of the Legislative Yuan, where fist fights, overturned tables, and squirt gun battles sometimes made the legislative process look like a scene out of "Animal House." Following the elections in late 1989, at least twenty members of the legislature served as Chairmen or Presidents of the local brokerages, while many others maintained significant shareholdings[26], and these market players formed the largest interest group within the legislature. As legislators, Taiwan's Soviet-inspired constitution[27] gave them the power to call the premier, cabinet ministers, and other high government officials for questioning before the chamber and the power to approve cabinet budgets. These powers, of course, also potentially gave them considerable influence over the SEC and other regulators trying to bring some semblance of standards to the market.[28]

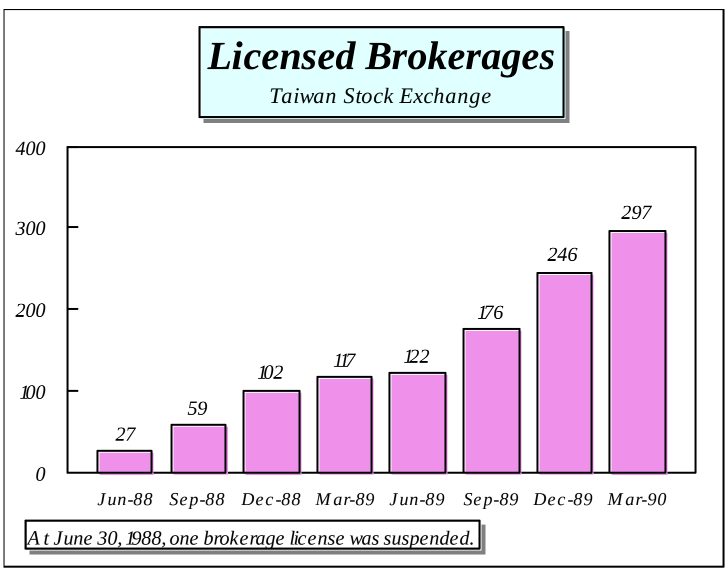
As the new brokerages began operations, Taipei and Kaohsiung were first blanketed with new brokerages, and brokers next filled the secondary cities of Taichung, Tainan, Chiayi, Hsinchu, and Changhwa. In search of

[26] "News Analysis: 'Stock Firm' Lawmakers Threaten Healthy Market Growth," The China Post, December 19, 1989.

[27] Reflecting an earlier period of cooperation between the ***Kuomintang*** and the U.S.S.R., one somewhat surprisingly finds Soviet influence in the constitution, the structure of the party, and the organization of the armed forces. Former President Chiang Ching-kuo was trained in Russia and had a Russian wife.

[28] "Becoming a Legislator May Be Best Long Term Investment," The China Post, March 24, 1989.

untapped new markets the brokers then moved to gritty Taipei suburbs and factory towns like Sanchung, Panchiao, Hsintien, Chungho, Yungho, Taoyuan, and Chungli. As these cities filled up to and beyond the saturation point, the brokers set up shop in obscure coastal cities like the former treaty port of Tansui, Lugang, Beigang, Hualien, Ilan, and the aboriginal outpost of Taitung. Finally, even the most obscure country villages like Shalu, Fuhsing, Chubei, Huwei, Wuchi, and Huaton had one or more brokerage to cater to farmers and housewives who had little or no idea what a share of stock represented. Always looking for new market niches, brokers established offices targeted at housewives, doctors, farmers, students at National Taiwan University, and the patrons of a well known hot springs resort.



Even with fixed commissions set at an extremely low 0.15% per trade, the brokerage business had produced stunning returns in the years prior to deregulation, but new rules set by the SEC in return for freedom of entry into the business required heavy capitalization and created much higher overhead expenses and break-even levels. Total capitalization of the non-bank brokerages, which had only totaled US$441 million on the eve of regulation, had risen exponentially to US$5 billion in February of 1990. Survival in the new environment, where straightforward price competition was illegal, depended on luring enough customers in to trade stocks, and this was accomplished by heavy advertising, luxurious decoration of the trading rooms allotted to the most profitable customers, lavish entertainment, the availability of illegal margin financing facilities, and, according to market rumor, commission kickbacks for really big players.

The huge increase in licensed brokerages stretched the already thin ranks of qualified employees; salaries were bid up out of sight, and it become very difficult to recruit senior, experienced staff. Overall about 60,000 new jobs were created in the brokerage industry with little time to allow for systematic training and with inevitable lapses in quality control. One new brokerage in Taichung bragged that its recently hired President had many years of experience at a well established brokerage in Taipei. A quick call to his former employer revealed, however, that this new CEO had served as a janitor in his previous position and had simply leveraged himself up in the sellers' market for experienced employees.

The sudden demand for additional office space to house the new brokerages put additional strains on Taipei's already tight property market. In aggregate, the ever expanding brokerages sucked up eight million square feet of office space from the market and contributed to the rent spiral that sent many commercial and industrial firms fleeing from the city.[29]

As one might expect, the print and television ads placed by the brokers stressed the easy wealth available in the market, and many featured gold ingots and coins, fine jade, or other traditional Chinese symbols of wealth. Other ads showed gold coins falling from the sky while frantic mortals held up baskets to collect their share of this manna from heaven. One imaginative advertisement linked a new brokerage to immanent and long dead Chinese scholars and literary figures Hu Shih and Lin Yu-tang. Many ads treated this new and easy wealth as a natural birthright, there for the taking if one just played the game.

Large traders were well entertained by the sales staff assigned to their accounts, and, with the money rolling in, expense seemed to be no object. To celebrate the reopening of Madam Boom-Boom's newly expanded and redecorated nightclub, one broker in attendance cavalierly ordered one-hundred bottles of XO brandy to be sent to the tables or private rooms occupied by his customers as they engaged in pre-coital conversation with Madam Boom-Boom's corps of young debutantes. At $320 per bottle, this small gesture cost more that the average yearly income of a typical Taiwanese family. Another broker was entertaining a group of clients in Taichung's most famous nightclub and "bought out" an even one hundred hostesses at $160 a head for the amusement of the group. He later noted that ads in the

[29] Chan, Danny, "How Long Can the Stock Market Party Last," Business Taiwan, December 11-17, 1989.

local press were soon forgotten, but a grand gesture like this would be talked about for years.

The flamboyance displayed by many members of the brokerage fraternity did have its more invidious aspects. These high profile market players frequently became the targets of kidnappers and extortionists who scented easy money. The Chairman of one brokerage was kidnapped from his office by gangsters who demanded a large ransom from the hapless executive's family. Another big player received a severed dog's head, a symbolic death threat, to remind him of the demands made on him by local gang members and of the consequences of refusal or even delay.[30] Other securities firms received bomb threats which would be carried through if the firms did not support the market prices of certain listed stocks.[31] Perhaps not surprisingly, bullet-proof vests became a favored accessory among the brokerage community and were the best selling items at Taipei's 1989 Fashion Week Exhibition.[32]

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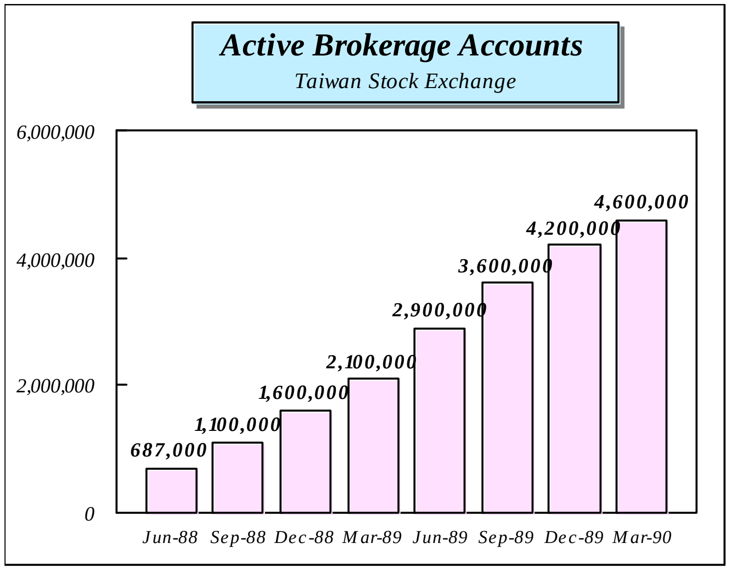
[30] "Securities Firm Head Kidnapped at Gunpoint by Three Gangsters," The China Post, November 18, 1989.

[31] "Firms Receive Threats as Share Prices Tumble," The China Post, February 24, 1989.

[32] "Bullet-Proof Vests Attract Buyers," The China Post, November 18, 1989.



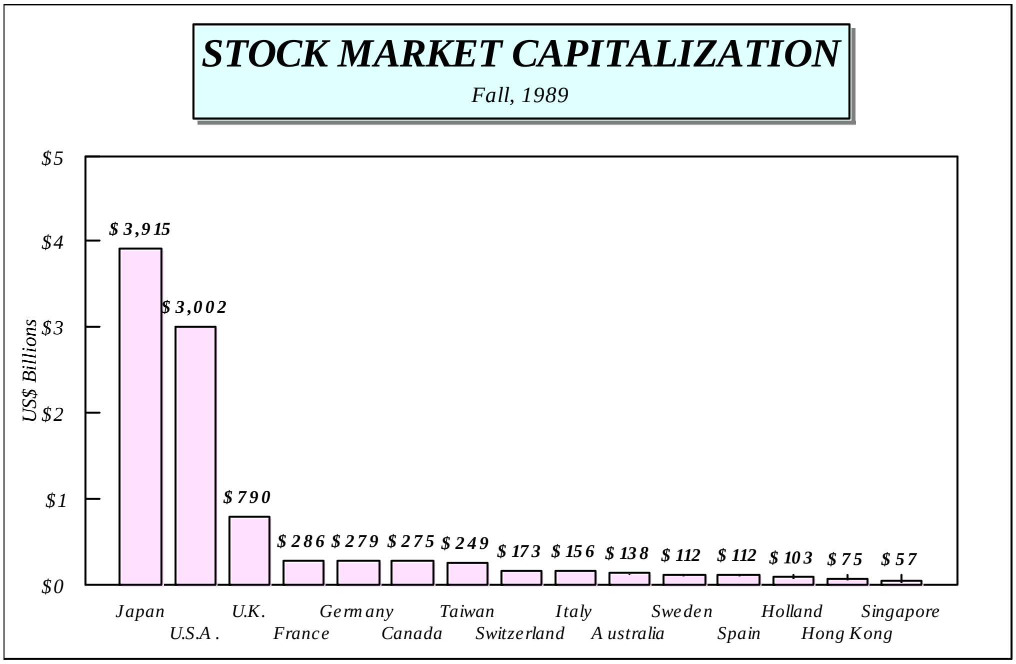
The results of these marketing efforts were impressive. When the ban on new brokerage was lifted in the summer of 1988, the market was already drawing investors in unprecedented numbers, and active brokerage accounts had reached 687,000. As the new brokerages made investing more convenient and better understood as a source of easy wealth, this number doubled by autumn, doubled again by the next spring, and doubled yet again by the following winter. By the end of 1990's first quarter active brokerage accounts reached 4.6 million in a country with a population of 20 million. Even adjusting for the numerous dummy accounts within this total and again adjusting for single accounts used by multiple investors, it was estimated that one in every three adults on the island was actively playing the market and that virtually every family group was involved in the game.

The much discussed dummy accounts took two general forms. "Surrogate" accounts are set up under the name of a local resident, with or without his or her knowledge, and are generally used to avoid tax. The more imaginative "ghost" accounts bear no name but are used to carry on stock transactions anyway. These "ghost" accounts provide the opportunity of conducting illegal trades without inconveniencing anyone in particular.[33]

Although the shares traded by these hoards of new speculators were treated as mere poker chips with little regard for underlying corporate earnings power and productive assets, they actually did, of course, represent equity ownership in, for the most part, active companies selling real products and services in competitive local and international markets. In theory, the total value of a company's shares was the market's cool, objective best guess at the present value of the future cash flows that would be paid to the shareholders, presumably in the form of dividends. Going a step farther, summing up the value of all the shares traded on the exchange has some relation to a country's total industrial and commercial strength and competitiveness.

Looking at the total capitalization of the Taiwan market in relation to the market capitalizations of the major industrial countries and to other newly industrialized countries shows the extent to which the hormonally imbalanced market in Taiwan equities exaggerated the country's importance on the world stage.

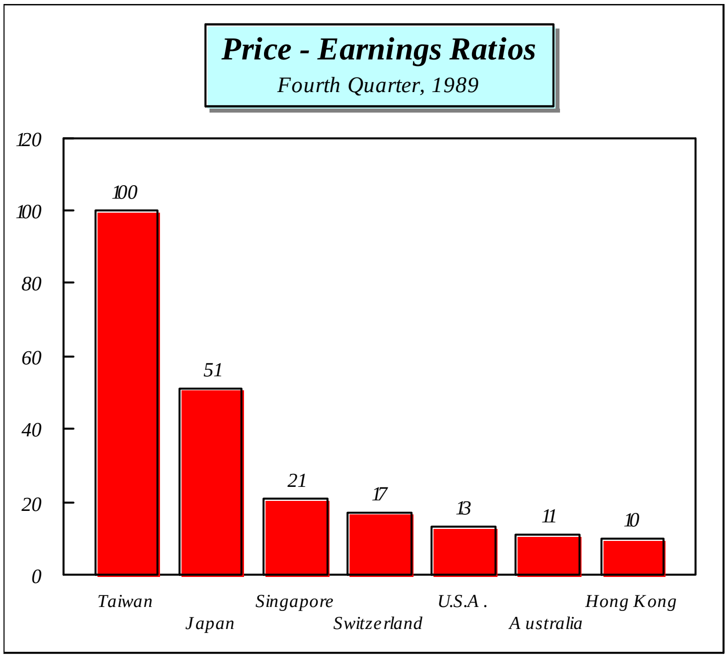
[33] "876 'Ghost' Accounts Found Floating on TSE," The China Post, August 10, 1990.



As these figures show, the obscure Taiwan stock market, whose results were ignored by almost all international investors and which went largely unreported in the international media, dwarfed the markets of its peer group, had a larger market capitalization than Switzerland, and was within spitting distance of the total size of the mighty German market.

In terms of the most fundamental yardstick of equity valuation, the price to earnings ratio, Taiwan was in a class by itself. By the fall of 1989, on the average, *investors were willing to pay one hundred times annual earnings for a share of stock*[34], roughly double to the average level of the Japanese market which was then nearing the peak of its own overvaluation. Again, a comparison of the price to earnings ratios across international markets is instructive, and the Taiwan market stands out in its stupendous overvaluation.

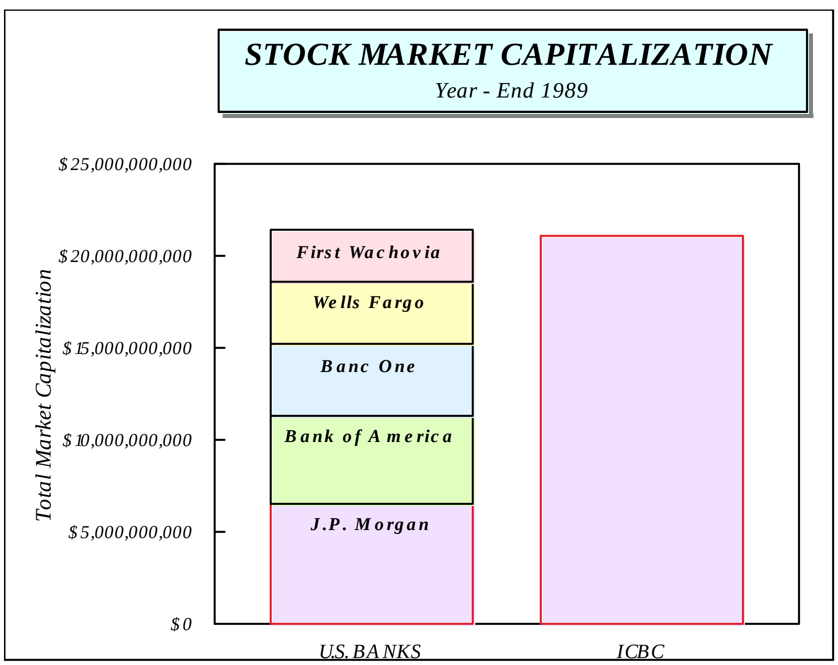
[34] This figure increased to 160 times earnings if one used only operating earnings in calculating the price/earnings ratio. This excluded such other earnings as income from real estate and stock market operations.



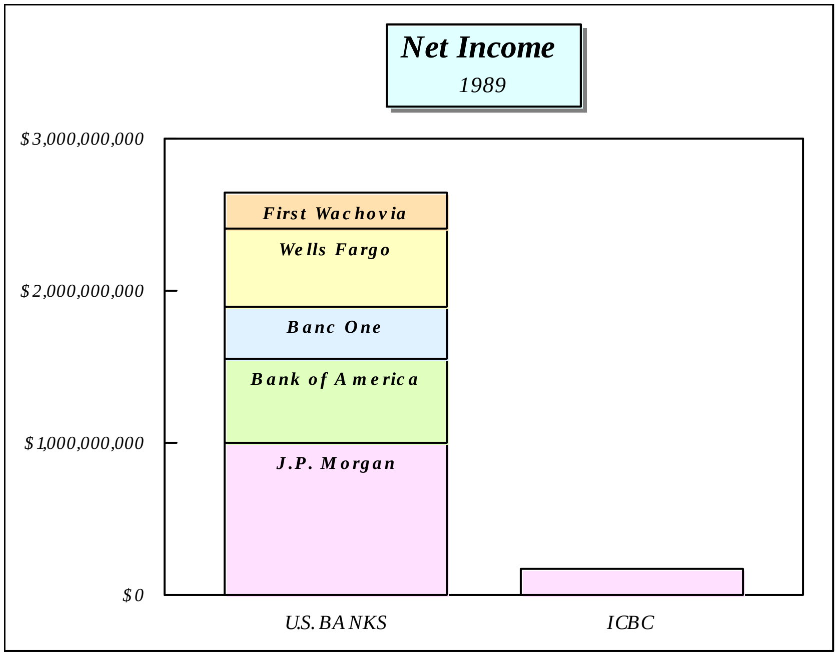
For some reason, a dollar's worth of corporate earnings in Taiwan was presumed to be worth twice as much as a dollar earned in Japan, nearly five times as much as a dollar earned in Singapore, and more than seven and a half times as much as a dollar earned in the United States. Such results could only be theoretically justified if corporate earnings in Taiwan were of high quality and were growing at an extremely rapid, but sustainable, rate making them the national equivalent of a well-financed, hot growth stock. Although Taiwan's economic growth and corporate earnings growth, on average, exceeded growth rates in more mature economies, the market as a whole was far from meeting these theoretical constraints.

The stock market's valuation of individual corporations traded on the TSE was even more startling. The International Commercial Bank of China, the Kuomintang-controlled remnant of the old mainland Bank of China, is a well managed and highly credit worthy, blue chip institution, not a hot, new, high-tech growth company.

Through the magic of the bubble market's stratospheric valuation, however, ICBC had, by default, become a world class financial ultra-heavyweight. With the vast majority of its shares tied up in long-term holdings and, thus a relatively limited share float, and a heavy weighting in the TSE index, ICBC was a stock market favorite and perceived by many as a high quality, conservative investment. By year-end 1989, ICBC had a total market capitalization of the equivalent of just over US$21 billion, which made it equivalent to the *combined* market capitalizations of J.P. Morgan Corp., Bank America Corp., Banc One Corp., Wells Fargo Corp., and First Wachovia Corp., the cream of the American Banking system.



Earnings, however, were another story, and ICBC's very respectable 1989 net income of US$171 million, swollen from stock market gains and the earnings of the bank's brokerage house, was only equal to half of Banc One's earnings alone.



Taipei Business Bank, an obscure institution lending exclusively to small, local companies in Taipei and Ilan counties only in local currency, traded at 358 times earnings. Its market capitalization of $8.6 billion exceeded that of J.P. Morgan Corp., with State Street Boston Corp. and Mellon Bank Corp. thrown in as loose change. Taipei Business Bank's 1989 earnings of $60 million were swollen with gains from market speculation, but State Street's earnings alone were half again as large.

Cathay Life Insurance, selling at 153 times earnings, was capitalized at US$23 billion, exceeding the combined market capitalizations of the 14 American life insurance companies covered by the *Value Line Investment Survey* plus total market values of diversified insurers Aetna Life & Casualty and Kemper Corp. Cathay Life's earnings, however, were about half of Aetna's alone.

At its peak value, Leofoo Development had a market capitalization of about $830 million, or more than the total combined values of the Plaza Hotel in New York, plus the Mandarin Oriental Hotel in Hong Kong and the Oriental Hotel in Bangkok (which are routinely rated among the world's top hotels), plus the entire 204 unit, 16,000 room La Quinta Motor Inn chain.

Every first year MBA student learns the concept of valuing securities using the dividend discount model. If one already knows the market's valuation of the future stream of income to be produced by the stock in question, he can easily back-out the implied growth rate the market is using in its valuation process. Applying this concept to Taipei Business Bank reveals the astounding 209% annual growth rate that the market price implied. At this obviously unsustainable rate of growth, *the GNP of the entire world* would be running through the annual accounts of this sleepy institution in a relatively short period of time[35].

At any point in late 1989 or early 1990, an observer with access to any yardsticks of comparative values across international markets (e.g., *The Asian Wall Street Journal*, etc.) did not need to be Albert Einstein to realize that something was drastically wrong.

A minority of foreign and Chinese observers saw the runaway bull market as a temporary aberration which could lead to a devastating crash. Among them, Marc Faber, the Hong Kong-based investment analyst often known as "Dr. Doom," wrote to his clients in mid-1989, " We feel that the

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[35] According to my calculations, this process would take about thirteen years if one were willing to accept these assumptions.

Taiwan market is currently significantly over-priced...In many ways, the Taiwan boom is comparable to the South Sea Bubble... What event will trigger the decline we do not know, but at the current level of valuation the margin for error has become extremely thin."[36] In a follow-up report near the end of the year, he again wrote, "I have argued that a crash in the [Taiwan] market was imminent... I would like to emphasize that the excesses which exist today in the financial market of Taiwan far exceed [those in] the 1929 stock market boom in America."[37]

Chang Chi-cheng, the scholarly and usually very reticent Governor of the Central Bank and former Minister of Finance, stepped out-of-character and called the stock market an "ungovernable, man eating casino.”[38]

My own year-end letter to shareholders of The R.O.C.-Taiwan Fund characterized the market as "speculative and volatile," and I concluded my review by noting, "While the Taiwan market appears to have been unfazed by two major settlement defaults and the apparent collapse of the Hung Yuan underground investment company, the largest such institution and a major market player, we believe that the down side risks continue to out weigh the upside potential of the market at the present time." I also increased the cash position in the fund to 25% to insulate the shareholders against what I viewed as the excessive risks in the market."[39]

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[36] Faber, Marc, "The Taiwan Casino," Drexel Burnam Lambert, Hong Kong, June 26, 1989.

[37] Faber, Marc, "Follow up on the Taiwan Casino," Drexel Burnam Lambert, Hong Kong, December 4, 1989.

[38]“張繼正痛斥：股市是吃人的市場,” 工商時報，1989年5月19日。

[39] Champion, Steven R., "Year-End Report - 1989," The R.O.C.-Taiwan Fund, Taipei, December 31, 1989.

Such views were, however, in sharp contrast to the prevailing market wisdom that Taiwan's bull market had plenty of room to keep running. While this was seldom presented in a sustained, coherent way, the bull argument, accepted by the overwhelming majority of local investors and by many uncritical international observers as well, ran roughly as follows:

First of all, Taiwan was a "liquidity driven" market. The money supply had ballooned over the past few years due to the high savings rate, the trade surplus, and the repatriation of hot money, and there were very few investment outlets for these funds other than the stock and property markets. There was very little possibility of this changing any time soon, and, similar to one version of the "big bang" school of cosmology, there was no reason to believe that the expansion would ever be reversed.

Second, Taiwan companies had huge holdings of grossly undervalued assets on their balance sheets, mostly land and corporate cross holdings of stocks. If these investments were written up to current market value, Taiwan shares wouldn't have looked so overvalued.

Third, the big players would always support the market because they could be ruined by a market crash.

Fourth, Taiwan is very similar to Japan, and foreigners had been predicting a crash in Tokyo for years, but the market had just kept rising.

Finally, the government simply wouldn't let the market crash because it feared an investor backlash at the polls. Such a reaction could upset the delicate balance being maintained between the Kuomintang and the opposition.

Besides, the ruling party was heavily into the securities business itself with holdings in an integrated brokerage house, indirect holdings in two of the big funds management companies, and a finance company which was the monopoly provider of legal margin financing. Party officials also had personal interests in the brokerages and many played the market. Clearly, the ruling party had too much to lose to allow a market collapse.

Many of the theoretically more dispassionate foreign brokers covering the Taipei market found this logic persuasive enough to ignore the obvious red flags being waved by the absurd market valuations. One such firm, a corporate descendant of one of the British "hongs" that had prospered by selling opium along the China coast in the previous century and which had deployed some of its now very respectable funds into the brokerage business, burbled at the very peak of the market that "prospects for February look good." Another firm with a similar lineage bellowed, "Our view in favor of a bullish 1990 first quarter remains unchanged."

Even about-to-be-minted MBA's from America's top business schools could get caught up in the enthusiasm. In February, I gave an hour-long presentation to a class of second year graduate students outlining most of the market facts noted in this chapter. To make things more interesting, I offered a prize for the best prediction of the level of Taiwan's market index three months later. After having spent the last year and a half learning about efficient markets and sophisticated analytical techniques, this group of some of the country's brightest scholars voted 2 to 1 that the market would keep going up with predictions ranging up to the 18,600 level[40].

As the year of the horse began, Taiwan seemed suspended between two diametrically opposed views of the market. Holders of one view maintained that this market was different and had an internal logic of its own which allowed it to defy laws applicable elsewhere. The others, a minority, felt that normal financial relationships must sooner or later prevail and, like the law of gravity, bring this high-flying market back to earth. Many players in the Taiwan economy, great and small, had huge vested interests in the outcome of this argument, and their decisions in dealing with this dilemma would affect their professional and personal lives.

[40] The prediction of 18,600 on the TSE index by the end of May implied that the market would steam ahead at a 238% annual rate during the quarter.