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Interest Rates as an Anti-inflationary
Instrument in Taiwan

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Interest Rates as an Anti-inflationary Instrument in Taiwan

In establishing the seat of government of Nationalist China on Taiwan after the withdrawal from the mainland in 1949, the Chinese found themselves confronted with the same type of inflationary problem that had beset them on the mainland. Money supply and prices were skyrocketing. It was realized that the inflation had been an important factor in the defeat on the mainland. The decision was made to stabilize Taiwan's money and avoid a repetition of the errors that had been committed in the past.

One of the very courageous decisions that was taken by the Government was the introduction of extraordinarily high rates of interest payable on time deposits held in banks. These were known as preferential interest deposits. The system was inaugurated in March 1950. Certificates of deposit were issued for deposits with one-, two- and three-month maturities. Later as confidence increased, six-month and one-year certificates were introduced (in April 1952 and April 1953, respectively). In the earlier years, the bulk of the deposits were in the one-month category.

The rate of interest offered on the one-month certificates in March 1950, was 7 per cent a month, which compounded monthly comes to 125 per cent per annum!

Even under the inflationary conditions then prevailing, this was an attractive rate for savers, and time deposits in the banking system quickly rose from NT \$2 million early in 1950 to NT \$37 million by August, which was a little less than 5 per cent of net money supply. ^{1/}

The price increase was temporarily halted, with the wholesale price index actually declining between May and July of 1950. The government, no doubt encouraged by this success, reduced the rate of interest payable on one-month deposits very sharply in July 1950 by half to 3.5 per cent a month. This brought a halt to the rapid increase in time deposits and the total fell slightly. In spite of this, the government made a further cut in the interest rate in October to 3.0 per cent a month on one-month deposits. This, combined with the sharp rise in prices that had resumed in August, prompted

^{1/} Besides preferential time deposits, the data also include relatively small sums for lottery and ordinary time deposits.

many depositors to withdraw their deposits. Total preferential interest rate deposits fell to only NT \$21 million in January 1951. In March 1951, the one-month rate was put back up to 4.2 per cent a month (64 per cent per annum, when compounded monthly). The rate was held at this level for the next 13 months.

The volume of preferential interest rate deposits rose spectacularly during 1951, rising to more than NT \$160 million by September, or over 17 per cent of net money supply. The increase lost steam in the final quarter of the year, but it resumed in January 1952. By April 1953, the total was up to NT \$350 million, 38 per cent of net money supply. At that point the government felt that confidence was strong enough to warrant introducing 6-month deposit certificates at a rate of 4.2 per cent a month. At the same time it began a series of steady reductions in the rate of interest paid on deposits. The approach was more cautious than it had been in 1950 when the rate reductions had been so large as to seriously reduce the willingness of savers to roll their certificates over. The reductions were made by approximately one-half percentage point at a time at two-month intervals (there was one reduction at a one-month interval). When the rate was down to 3.0 per cent a month, the rise in deposits was halted. However, money supply and prices had been held quite stable, and the interest rates were pushed down to 2.0 per cent a month in the last quarter of 1952. This was accompanied by a pronounced dip in time deposits, a rise in money supply and a renewed uptrend in prices.

The reduction of interest rates was halted for several months, and the time deposits again began to rise, although the increase was at a more moderate rate than it had been a year earlier. In April 1953, the state of confidence appeared to justify the introduction of one-year deposit certificates at a rate of 3.0 per cent a month. The rise in deposits continued, with an especially strong growth in the one-month maturities. The total rose to NT \$650 million by July 1953, nearly 50 per cent of net money supply. At this point the authorities decided that it would be safe to cut the interest rate back again. Rates were reduced twice in the second half of 1953, bringing the one-month rate down from 2 per cent to 1.2 per cent, the three-month rate from 2.15 per cent to 1.3 per cent, the six-month rate from 2.3 per cent to 1.5 per cent, and the yearly from 3 per cent to 2 per cent.

This led to a sharp switch to the longer maturity deposits, especially the six-month category. In June 1953, 75 per cent of the deposits were in the one- and three-month categories, but by December of that year the six-month and one-year deposits accounted for nearly half of a somewhat reduced total.

Growth of the deposits resumed in 1954, with the six-month category showing the most popularity. This permitted another reduction in interest rates in July 1954, which again slowed down the growth in deposit volume for several months. The growth accelerated in 1955, the total deposits rising to NT \$876 million ^{1/} in September, or 32 per cent of net money supply.

The growth was such that in late 1955 and early 1956, the authorities became concerned that the growing deposits were a potential source of increased liquidity, even though 58 per cent of the total carried a maturity of six months or one year at the end of 1955. It was thought that even in the case of the longer-term deposits the privilege of borrowing, and using the deposit as collateral, gave all of the deposits a high potential liquidity. Therefore, in March 1956 the rates were adjusted to make the shorter-term deposits relatively less attractive and to offer a higher rate of return to those who were willing to forego the privilege of borrowing against the longer-term deposits. The rate on one-month deposits was cut by 15 per cent, on three-month deposits by 9 per cent, and premiums of 15.4 per cent and a 12.5 per cent were offered on the rates for the six-month and one-year deposits, respectively, if the depositor was willing to forego the borrowing privilege. In June the option was removed and all the deposits were declared ineligible for use as collateral for loans.

The result of this change was that a substantial number of depositors switched from the one-month to the better paying three-month deposits, and from six-month to one-year deposits. By the end of 1956, 26.9 per cent of the deposits were for one year. However, too many people evidently found the premium inadequate compensation for the loss of liquidity. There was a very large drop in the number of six-month deposits, formerly the most popular category. The result was an overall decline in total preferential interest deposits, and 1956 was the first year in which the deposits failed to show a year-end to year-end rise.

The fears that prompted this move do not appear to have been well grounded. Although the preferential interest rate deposits were certainly responsive to interest rate changes, they did not show unusual volatility and past trends appear to demonstrate that the best insurance against their liquidation would be to maintain their attractiveness as investments. This might at times require the adoption of a somewhat more flexible policy on interest rates.

^{1/} This, and subsequent data, include the preferential time deposits only.

Two-year preferential deposits were introduced in July 1957. At the same time, the rates on deposits were generally lowered. The same interest rate was established for the two-year deposits (1.8 per cent monthly) as had previously been paid on the one-year deposits. The rate on the one-year deposits was reduced to 1.35 per cent monthly. Nevertheless, the one-year deposits became the most popular category, as the one-month deposits were discontinued and three-month deposits, which now paid only .85 per cent a month, lost favor. The volume of one-year deposits more than doubled in 1958. Six-month deposits also increased substantially, approximately doubling between mid-1957 and the end of 1958. By the end of 1958, preferential interest deposits totaled NT \$1,508 million, or 29 per cent of net money supply. Half of the total was in one-year deposits and one-third in six-month deposits. The interest rates were 1.65 per cent a month on the former, and 1.35 per cent a month on the latter. The three-month and two-year deposits, which paid 0.85 per cent and 1.8 per cent, respectively, accounted for the remaining 17 per cent of the deposits. All preferential interest rate time deposits were terminated at the end of 1958 in favor of regular time deposits.

These results showed what could be accomplished with an astute and bold use of interest rate policy. The savers were at first induced to put their money into banks at what seemed to be outrageously high interest rates for very short maturities. Actually, the real return on the savings was not so outrageous at the time. Given the rate of inflation in 1951 of 52 per cent a year, the real return on a one-month preferential interest rate deposit was only 12 per cent a year, even though the nominal interest rate was 64 per cent. As inflation was brought under control, partly through the absorption of liquidity through the preferential interest rate deposits, the savers were actually able to obtain a higher real return even though the nominal rate of interest was lowered. For example, with prices rising only 3 per cent, the real return to the saver on a one-year deposit in 1958 was about 17 per cent. As the depositors were accustomed to the savings habit and learned to appreciate the great benefits of compound interest, it was possible to greatly reduce the nominal rates of interest as well as stretch out the average maturities of the deposits. This was undoubtedly of major importance in normalizing the economic and financial picture in a country where the inflationary psychology had become so deeply ingrained that many observers doubted that it could ever be eradicated.

The preferential interest rate policy was not the only factor in bringing about greater monetary stability in Taiwan, but it was clearly very effective in drying up the excessive liquidity created by the unbalanced budgets of the early 1950's. Part of the success of the system may have been due to the fact that the Bank of

Taiwan undertook to guarantee the commercial banks against any loss from paying these extraordinarily high rates. A system of redeposit with the Bank of Taiwan was instituted. A large part of the deposits were actually redeposited with the Bank of Taiwan, which paid the depositing banks interest equal to, or above, what the banks were required to pay. This feature was important after 1951. Redeposits with the Bank of Taiwan rose from NT \$6 million in March 1951 to NT \$129 million in September. By the following August they were as high as NT \$329 million. This was because the demand for loan funds was not strong enough after 1951 to absorb all the funds that were pouring into the banks at the special high rates.

The Bank of Taiwan lost money on these deposits, but the losses were offset by its earnings from U.S. counterpart funds that were kept on deposit with the Bank of Taiwan. In any case, the price appears to have been low in terms of the success in combating inflation.

Taiwan has continued to follow a policy of using interest rates realistically. Since the economy has enjoyed a substantial measure of price stability, it has been possible to bring deposit rates down still lower. However, in 1959 Taiwan pioneered again in the interest rate field by issuing high interest rate government bonds. Bonds with maturities of 12 to 30 months were issued at rates varying from 9 to 18 per cent. Interest on the 18 per cent bonds, which were sold only to the non-bank public, was paid quarterly and was exempt from income taxes. Commercial firms were also encouraged to raise needed capital through the issuance of bonds bearing attractive rates. For example, in 1958-59, substantial amounts of bonds were successfully placed by business firms in the private capital market. About three-fourths of these issues were guaranteed by the Government. They carried a two-year maturity and an interest rate of 20 per cent. The non-guaranteed bonds also had a two-year maturity, but carried a rate of 26.4 per cent. At the time, secured and unsecured bank loans were being made at 19.8 and 22.3 per cent, respectively, while private money lenders charged 36-40 per cent per annum.

The Taiwan experience demonstrates that it is feasible to use interest rates to fight inflation without provoking a depression. The big problem seems to be to overcome the conventional attitudes that interest rates in excess of, say, 6 per cent a year are intrinsically evil, even though it may be easily demonstrable that in real terms a rate double that figure might actually be negative. There was considerable opposition to the high interest rate policy in Taiwan, some of it coming from U.S. advisers, who expressed the fear that the large amount of money being absorbed by time deposits would at some time be suddenly loosed and overwhelm the economy in an inflationary flood.

Fortunately, the Chinese have kept this from happening by not letting inflationary psychology take hold. Moreover, they have learned that even when conditions are at the worst, there is some price, in terms of the interest rate, that will persuade people to save.

The lessons of the Chinese experience have been studied by Korea, and that country has recently broken away from the policy of imposing unrealistic interest rate ceilings on savings. The results so far appear to confirm the workability of this policy as an anti-inflationary device.

TAIWAN: SELECTED ECONOMIC DATA

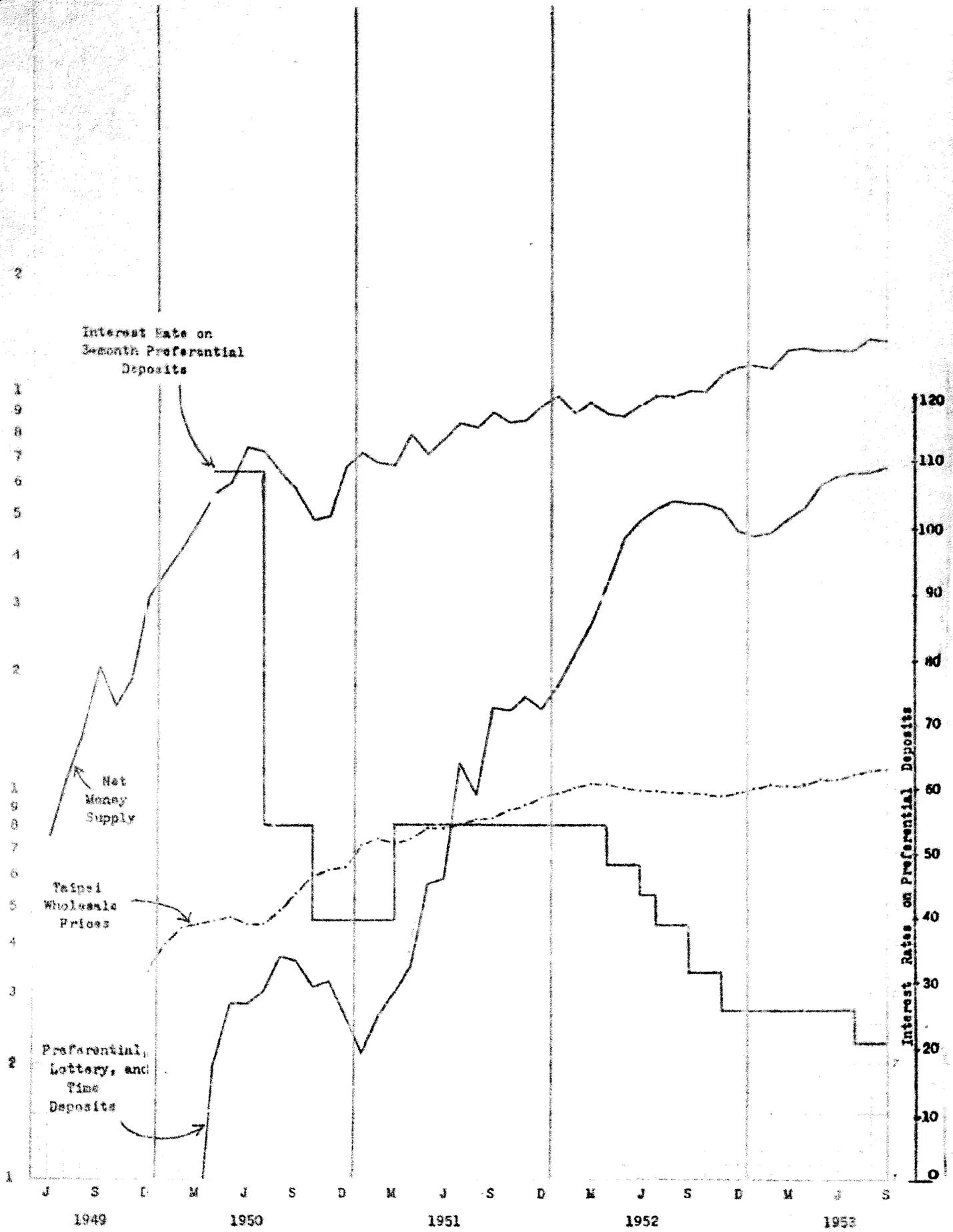


Table 1

Taiwan: Selected Economic Data

<u>Period</u>	<u>Net Money Supply (millions of NT\$)</u>	<u>Preferential, Lottery and Time Deposits (millions of NT\$)</u>	<u>Taipei Wholesale Prices 1952=100</u>	<u>Interest Rate on 3- Month Preferential Deposits at End of Month (per cent per month)</u>
<u>1949</u>				
June	76			
July	104			
August	139	1		
Sept.	209	2		
Oct.	163	2		
Nov.	192	3		
Dec.	312	6	34	
<u>1950</u>				
Jan.	364	2	40	
Feb.	416	2	44	
March	487	6	45	
April	569	20	46	9.0
May	606	28	47	9.0
June	750	28	45	9.0
July	733	30	45	4.5
August	644	37	49	4.5
Sept.	585	36	54	4.5
Oct.	496	31	60	3.3
Nov.	501	32	62	3.3
Dec.	666	26	63	3.3
<u>1951</u>				
Jan.	733	21	72	3.3
Feb.	685	26	75	3.3
March	680	30	73	4.5
April	818	40	75	4.5
May	723	57	80	4.5
June	793	59	80	4.5
July	872	118	82	4.5
August	853	97	84	4.5
Sept.	934	164	85	4.5
Oct.	880	161	89	4.5
Nov.	885	174	92	4.5
Dec.	966	163	96	4.5

Table 1 (continued)

<u>Period</u>	<u>Net Money Supply (millions of NT\$)</u>	<u>Preferential, Lottery and Time Deposits (millions of NT\$)</u>	<u>Taipei Wholesale Prices 1952=100</u>	<u>Interest Rate on 3- month Preferential Deposits at End of Month (per cent per month)</u>
<u>1952</u>				
Jan.	1,020	187	98	4.5
Feb.	937	229	101	4.5
March	989	271	104	4.5
April	927	348	104	4.0
May	917	447	102	4.0
June	974	494	100	3.6
July	1,022	526	100	3.2
August	1,022	552	99	3.2
Sept.	1,076	541	99	2.6
Oct.	1,075	541	98	2.6
Nov.	1,184	525	97	2.15
Dec.	1,221	467	99	2.15
<u>1953</u>				
Jan.	1,235	453	101	2.15
Feb.	1,224	462	104	2.15
March	1,359	499	103	2.15
April	1,391	530	104	2.15
May	1,346	603	108	2.15
June	1,356	640	108	2.15
July	1,355	649	110	1.7
August	1,455	652	112	1.7
Sept.	1,437	671	113	1.7
Oct.	1,402	658	114	1.3
Nov.	1,526	607	114	1.3
Dec.	1,575	599	115	1.3
<u>1954</u>				
Jan.	1,668	585	115	1.3
Feb.	1,604	626	115	1.3
March	1,592	667	114	1.3
April	1,601	692	115	1.3
May	1,641	715	115	1.3
June	1,779	747	110	1.3
July	1,788	745	108	1.1
August	1,854	759	109	1.1
Sept.	1,860	782	108	1.1
Oct.	1,849	760	108	1.1
Nov.	1,921	751	108	1.1
Dec.	2,016	765	112	1.1

Table 1 (continued)

<u>Period</u>	<u>Net Money Supply</u> (millions of NT\$)	<u>Preferential, Lottery and Time Deposits</u> (millions of NT\$)	<u>Taipei Wholesale Prices</u> 1952=100	<u>Interest Rate on 3-month Preferential Deposits</u> at End of Month (per cent per month)
<u>1955</u>				
Jan.	2,143	759	115	1.1
Feb.	2,144	790	119	1.1
March	2,196	816	121	1.1
April	2,227	842	122	1.1
May	2,251	859	124	1.1
June	2,363	883	122	1.1
July	2,411	910	123	1.1
August	2,607	926	127	1.1
Sept.	2,741	924	130	1.1
Oct.	2,677	925	134	1.1
Nov.	2,603	837	143	1.1
Dec.	2,573	860	144	1.1
<u>1956</u>				
Jan.	2,615	808	140	1.1
Feb.	2,628	813	140	1.1
March	2,616	832	140	1.0
April	2,573	797	142	1.0
May	2,658	775	142	1.0
June	2,682	747	141	1.0
July	2,775	766	140	1.0
August	2,809	804	140	1.0
Sept.	2,959	800	143	1.0
Oct.	2,993	838	148	1.0
Nov.	3,114	837	151	1.0
Dec.	3,124	848	152	1.0
<u>1957</u>				
Jan.	3,562	833	152	1.0
Feb.	3,202	908	154	1.0
March	3,261	970	154	1.0
April	3,304	1,001	154	1.0
May	3,541	1,019	153	1.0
June	3,402	1,060	153	1.0
July	3,553	1,059	152	0.85
August	3,611	1,081	152	0.85
Sept.	3,646	1,112	154	0.85
Oct.	3,603	1,136	155	0.85
Nov.	3,689	1,123	155	0.85
Dec.	3,762	1,161	154	0.85

Table 1 (continued)

<u>Period</u>	<u>Net Money Supply (millions of NT\$)</u>	<u>Preferential, Lottery and Time Deposits (millions of NT\$)</u>	<u>Taipei Wholesale Prices 1952=100</u>	<u>Interest Rate on 3- month Preferential Deposits at End of Month (per cent per month)</u>
<u>1958</u>				
Jan.	3,674	1,175	155	0.85
Feb.	3,924	1,225	155	0.85
March	3,875	1,331	155	0.85
April	3,760	1,336	155	0.85
May	3,791	1,345	156	0.85
June	3,918	1,404	154	0.85
July	3,979	1,522	153	0.85
August	4,209	1,618	153	0.85
Sept.	4,544	1,797	154	0.85
Oct.	4,450	1,894	157	0.85
Nov.	4,634	1,994	159	0.85
Dec.	5,129	2,114	163	0.85
<u>1959</u>				
Jan.	5,202	1,747	164	Discontinued
Feb.	5,042	1,763	165	
March	5,055	1,784	167	
April	5,081	1,728	166	
May	5,157	1,829	165	
June	5,169	1,786	168	
July	5,026	1,591	170	
August	5,208	1,486	174	
Sept.	5,160	1,398	177	
Oct.	5,170	1,445	180	
Nov.	5,193	1,394	182	
Dec.	5,570	1,339	181	

Sources: Taiwan Financial Statistics Monthly, Bank of Taiwan, Taipei, and various reports of the U.S. International Cooperation Administration, Taipei.

Table 2

Taiwan: Preferential Interest Rate Time Deposits

	<u>One-month</u> <u>Mill. NT\$</u> %/Mo.	<u>Three-month</u> <u>Mill. NT\$</u> %/Mo.	<u>Six-month</u> <u>Mill. NT\$</u> %/Mo.	<u>One-year</u> <u>Mill. NT\$</u> %/Mo.	<u>Two-year</u> <u>Mill. NT\$</u> %/Mo.	<u>Total</u> <u>Mill. NT\$</u>
May 1952	266 3.8	62 4.0	16 4.2	-- --	-- --	437
Dec. 1952	261 2.0	95 2.15	101 2.3	-- --	-- --	457
Mar. 1953	288 2.0	88 2.15	115 2.3	-- --	-- --	492
June	368 2.0	101 2.15	137 2.3	23 3.0	-- --	628
Sept.	297 1.5	111 1.7	199 2.0	50 2.5	-- --	657
Dec.	204 1.2	90 1.3	228 1.5	63 2.0	-- --	585
Mar. 1954	230 1.2	92 1.3	258 1.5	72 2.0	-- --	652
June	261 1.2	102 1.3	286 1.5	80 2.0	-- --	730
Sept.	252 1.0	110 1.1	307 1.3	83 1.6	-- --	752
Dec.	235 1.0	95 1.1	321 1.3	83 1.6	-- --	734
Mar. 1955	234 1.0	98 1.1	364 1.3	86 1.6	-- --	783
June	238 1.0	116 1.1	403 1.3	79 1.6	-- --	835
Sept.	228 1.0	140 1.1	448 1.3	60 1.6	-- --	876
Dec.	204 1.0	119 1.1	423 1.3	58 1.6	-- --	804
Mar. 1956	145 0.85 ^{1/}	109 1.0 ^{1/}	412 1.3 ^{1/}	87 1.6 ^{1/}	-- --	753
June	105 0.85 ^{1/}	126 1.0 ^{1/}	261 1.5 ^{2/}	163 1.8 ^{2/}	-- --	655
Sept.	106 0.85	209 1.0	209 1.5 ^{2/}	179 1.8 ^{2/}	-- --	704
Dec.	112 0.85	221 1.0	185 1.5	190 1.8	-- --	709
Mar. 1957	112 0.85	243 1.0	209 1.5	229 1.8	-- --	793
June	112 0.85	239 1.0	258 1.5	250 1.8	-- --	860
Sept.	9	229 0.85	229 1.35	319 1.65	14 1.8 ^{2/}	801
Dec.	3	183 0.85	261 1.35	332 1.65	31 1.8 ^{2/}	809

Table 2 (continued)

Taiwan: Preferential Interest Rate Time Deposits

	One-month		Three-month		Six-month		One-year		Two-year		Total Mill. NT\$
	Mill. NT\$	%/Mo.	Mill. NT\$	%/Mo.	Mill. NT\$	%/Mo.	Mill. NT\$	%/Mo.	Mill. NT\$	%/Mo.	
Mar. 1958	1		159	0.85	303	1.35	403	1.65	55	1.8	921
June	1		151	0.85	316	1.35	455	1.65	76	1.8	999
Sept.	0.5		162	0.85	416	1.35	611	1.65	81	1.8	1,271
Dec.	0.3		162	0.85	503	1.35	752	1.65	91	1.8	1,508
Discontinued December 31, 1958											
Mar. 1959	0.2		30		277		544				850
June	0.1		9		17		414				441
Sept.	0.1		5		3		200				208
Dec.	0.1		4		1		13				18
Mar. 1960	0.1		3		0.4		3		--		7
June	0.1		3		0.3		2		--		4
Sept.	0.1		1		0.2		0.1		--		3
Dec.	--		1		0.2		0.1		--		1

1/ With loan feature.

2/ Without loan feature.

Source: Taiwan Financial Statistics Monthly, Bank of Taiwan, Taipei.