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## Chapter 1 Overview

Since the Central Bank of China (CBC) was founded in 1924, it has gone through various forms of restructuring. In 1949, the civil war in China necessitated the CBC's move to Taiwan and temporary closure. It resumed its operation in 1961 and has been under the jurisdiction of the Executive Yuan (Cabinet) since 1979. Over the past forty years in Taiwan, the top priority of its policy objectives has changed from promoting economic development to carrying out financial reforms and maintaining price and financial stability. This chapter introduces the CBC's roles and responsibilities with separate sections on background, operational objectives, organization, and major operations.

### Section 1 Background

The CBC was founded in Guangzhou, China in 1924 and began operating as a national central bank four years later. In 1949, following the move of the central government, the CBC relocated from China to Taiwan but did not resume operation until 1961. At that time, Taiwan experienced trade deficits and a shortage of foreign exchange. The government adopted an export expansion strategy to pursue high economic growth. The CBC kept real interest rates positive to encourage savings and allocated available financial resources via administrative efforts. It also provided export-loan accommodations to banks to promote export.

During the 1970s when the world suffered oil crises, Taiwan faced stagflation. To keep inflation in check, the CBC increased interest rates, adopted selective credit controls and restricted capital inflows. In addition to maintaining price stability, the CBC also accommodated bank loans for financing public infrastructure projects to promote economic growth. As for financial reforms, the CBC together with the Ministry of Finance (MOF) established the money market in 1975. The CBC also replaced the fixed exchange rate regime with a managed float in 1978 and established the foreign exchange market in 1979. On the institutional side, the CBC entered a new era in 1979 when the revised *Central Bank of China Act* took effect. The CBC became under the jurisdiction of the Executive Yuan instead

of the Office of the President. The shift also made the CBC accountable to the Legislative Yuan (Congress).

In the 1980s, the CBC speeded up financial liberalization and internationalization. Interest rate deregulation, which began in 1980, was completed in 1989. Foreign exchange controls on current and capital account transactions began to be relaxed in 1987. The Taipei Foreign Currency Call-loan Market was established in 1989. Along with rapid financial developments, Taiwan's trade surplus also rapidly increased. The huge trade surplus together with a surge of capital inflows resulted in appreciation pressure on the New Taiwan dollar (the NT dollar) and excess liquidity in the financial system. In response, the CBC adopted a policy of gradual appreciation to enable exporters to adjust to the impact of a rising NT dollar. It also stemmed asset price inflation by increasing the discount rate, raising reserve requirements, issuing negotiable certificates of deposit, and exercising selective credit controls.

In the 1990s and early 2000s, a sluggish housing market, cross-strait tensions, the Asian financial crisis, and the bursting of the global IT bubble were major challenges to Taiwan's financial stability. The CBC responded by using market-oriented policy instruments, such as open market operations. The CBC also reformed the reserve requirement system to increase the competitiveness of banks, modernized payment systems, furthered the deregulation of capital account transactions, introduced book-entry government securities, and issued a new series of NT dollar bills and coins. In addition, to enhance its independence, the CBC proposed an amendment to the *Central Bank of China Act* in June 2002. The draft amendment has been approved by the Executive Yuan and is currently under review at the Legislative Yuan.

## **Section 2 Operational Objectives**

The CBC's operational objectives as stipulated in the *Central Bank of China Act* include: to promote financial stability, to guide sound banking operations, to maintain the stability of the internal and external value of the currency, and to foster economic development within the scope of the aforementioned objectives.

### ***1. To Promote Financial Stability***

The promotion of financial stability contains two aspects: first, to prevent large

fluctuations in financial asset prices, and second, to prevent systemic risk by providing necessary liquidity. Regarding the first aspect, large fluctuations in financial asset prices could affect market confidence and subsequently trade, consumption, investment, and other economic activities. To maintain financial stability, the CBC closely monitors international and domestic economic developments, and adopts response measures when necessary.

In terms of systemic risk, when a financial institution fails to manage risk properly, not only is its own business endangered, but others may also be adversely affected. The contagion effect could threaten overall financial stability. The CBC, as the lender of last resort, can provide the necessary liquidity to prevent systemic risk.

## *2. To Guide Sound Banking Operations*

Another responsibility of the CBC is to promote the soundness of banking operations by monitoring the performance and operations of banks and, when necessary, undertaking financial reforms. In recent years, financial deregulation and technological advancement have sped up the process of financial integration and innovation. Such changes have not only blurred the distinction among different types of financial institutions and among financial products but also increased the complexity of financial activities. Therefore, the CBC's task to strengthen the soundness of banking operations has become increasingly challenging.

## *3. To Maintain the Stability of the Internal and External Value of the Currency*

Maintaining the internal stability of the currency refers to maintaining price stability at home. Stable prices reduce economic uncertainty and help economic agents to plan and carry out economic activities such as production, consumption, saving and investment. Price stability is fundamental to maintaining sustainable economic growth.

The stability of the external value of the currency refers to the stability of the NT dollar exchange rate. Because the Taiwan economy is highly open and its ratio of external trade to GDP is relatively high by international standards, large swings in the NT dollar exchange rate may adversely affect economic and financial conditions. The CBC, therefore, regards managing large swings in the NT dollar

exchange rate as one of its operational objectives.

#### ***4. To Foster Economic Development***

In addition to achieving the three operational objectives mentioned above, the CBC may implement expansionary monetary policy to help stimulate economic growth during economic downturns. However, such a policy has only a transitory effect and, therefore, can not be depended upon to stimulate long-term economic growth.

Based on the *Central Bank of China Act*, the CBC pursues multiple operational objectives that may not be perfectly matched. Of these objectives, price and financial stability and sound banking operations are fundamental to sustaining long-term economic growth. Therefore, when formulating monetary policy, the CBC emphasizes these three objectives, and within their scope, helps to foster economic development.

### **Section 3 Organization**

According to the *Central Bank of China Act*, the executive body of the CBC consists of the Board of Directors, the Board of Supervisors, and the Governor and Deputy Governors. Their respective functions are policy formulation, supervision and implementation.

#### ***1. Board of Directors***

The CBC reaches policy decisions through panel discussion. The Board of Directors consists of eleven to fifteen members. They are nominated by the Executive Yuan and appointed by the President with at least one from each of the agricultural, industrial and commercial, and banking sectors among them. Five to seven directors form the Executive Board of Directors. The Governor of the CBC, the Minister of Finance, and the Minister of Economic Affairs serve as *ex officio* directors and executive directors without term limits unless they change positions. Other directors serve five-year terms and may be reappointed when their terms expire. The major functions of the Board of Directors are to make policy decisions and approve the CBC's operational plans. The Board meets quarterly in general and may hold interim meetings when events of significant

importance take place.

## 2. Board of Supervisors

The Board of Supervisors consists of five to seven members. They are also nominated by the Executive Yuan and appointed by the President. The Director General of the Budget, Accounting, and Statistics of the Executive Yuan is the *ex officio* supervisor. Other supervisors serve three-year terms and may be reappointed. The major functions of the Board of Supervisors are to examine the CBC's assets and liabilities and audit the CBC's accounts. The Board meets quarterly and may hold interim meetings when needed.

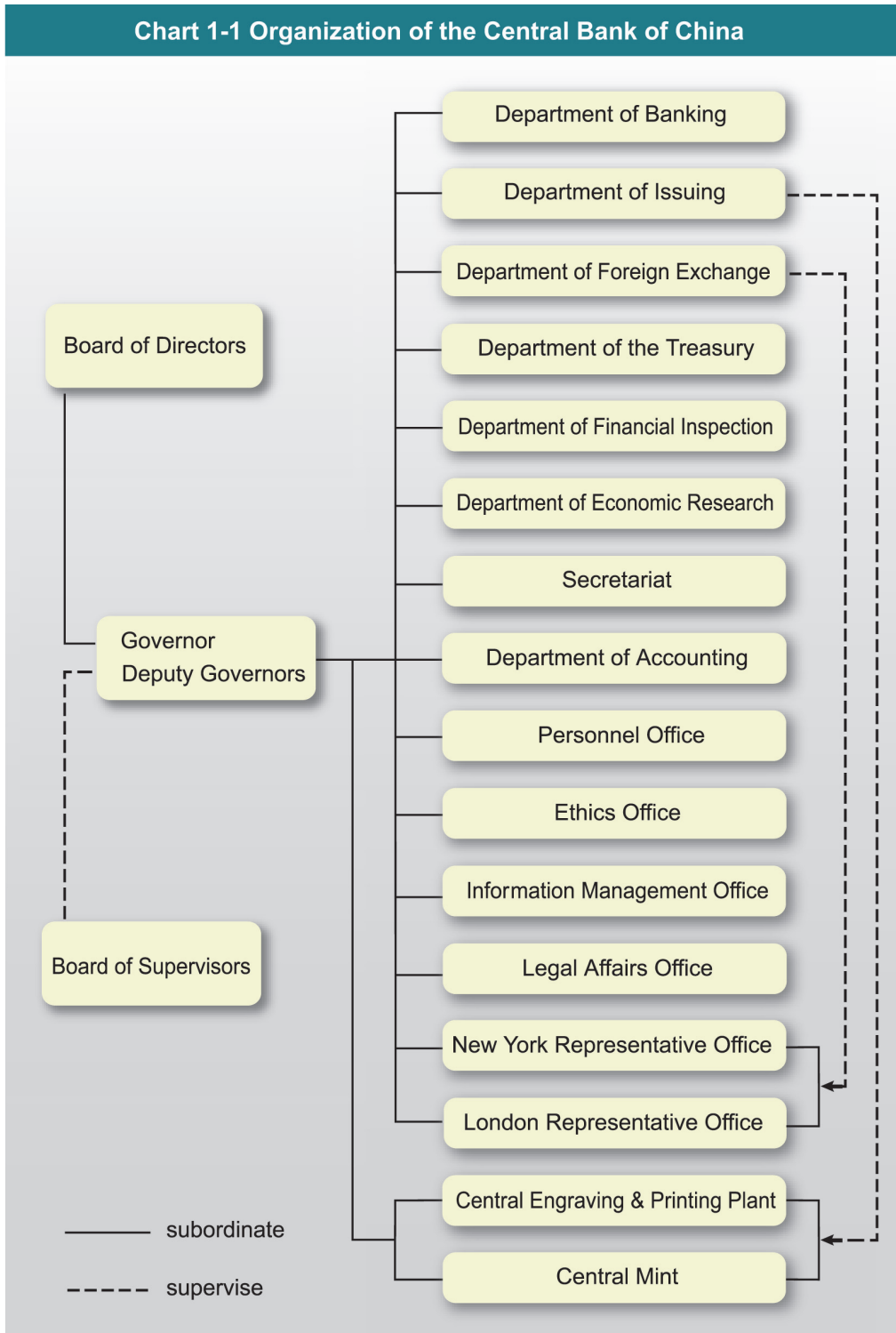
## 3. Governor and Deputy Governors

The Governor is chairman of the Boards of Directors and Executive Directors. The Governor represents the CBC and is responsible for handling internal affairs and executing resolutions passed by the Boards. Two Deputy Governors assist the Governor in handling the CBC's affairs. Each serves a five-year term and may be reappointed when the term expires.

The Governor and Deputy Governors oversee eight departments, four offices and two overseas representative offices. The Central Engraving & Printing Plant and the Central Mint, two affiliates of the CBC, print notes and mint coins, respectively. Chart 1-1 sums up the organizational structure of the CBC.

In practice, the Boards of Directors and Supervisors convene a joint meeting at the end of each quarter. Department heads of Banking, Foreign Exchange, and Economic Research at the CBC report matters related to monetary policy operations, foreign exchange operations, domestic and international economic conditions, respectively. The







Board of Directors then makes monetary policy decisions. Interim meetings and telephone consultations may take place when events of significant importance occur. After each meeting, the Governor hosts a press conference. Policy resolutions are made public in press releases and on the CBC's website.

## Section 4 Major Operations

The CBC's major operations include monetary policy operations, foreign exchange management, currency issuance, financial examination, the management of payment systems, and the fiscal agent of the government. It also participates in activities hosted by international financial organizations.

### *1. Monetary Policy Operations*

The CBC may use a variety of monetary policy instruments to ensure bank reserve positions are consistent with the aims of the CBC's monetary policy. Common instruments used are open market operations, reserve requirements, discount window lending, redeposits of financial institutions, and selective credit controls and accommodations.

#### (1) Open Market Operations

The CBC conducts open market operations virtually every business day. The CBC trades government securities with banks and thereby affects bank reserves and short-term interest rates. When excess liquidity surges as a result of capital inflows and trade surpluses, the CBC typically issues certificates of deposit to absorb excess liquidity from the banking sector. Conversely, when the banking sector experiences a temporary shortage of funds, the CBC usually purchases securities with repurchase agreements to temporarily increase the supply of reserves.

#### (2) Reserve Requirements

Central banks usually require banks to keep a certain amount of funds in reserve to meet unexpected withdrawals. The ratio of this fund to bank deposits affects banks' ability to extend credit. An increase in required reserve ratios is a restrictive action while a decrease an expansionary one.

Changes can also be made to adjust the structure of the reserve requirement system, and the potential impact on bank reserve positions can be offset by open market operations. The lowering of required reserve ratios in major industrialized countries in the 1990s is an example. Some even completely abolished the reserve requirement system. To increase financial efficiency, the CBC also realigned its reserve requirements to lower ratios in the mid-1990s.

### (3) Discount Window Lending

The CBC serves as the lender of last resort to accommodate banks that are experiencing reserve shortages or a temporary lack of funds. It may adjust the rates and terms of borrowing, credit lines, and the eligibility of bills for discount. These measures influence the cost and volume of borrowing by banks, thereby affecting reserve money and bank credit.

### (4) Other Policy Instruments

The redeposit system is another monetary policy instrument. The CBC may accept deposits from banks and the Postal Savings System to absorb excess liquidity in the banking sector. Based on changes in economic and financial conditions, the CBC may require banks to adjust the volume of their deposits with the CBC. An increase in redeposits will reduce the supply of bank reserves, and vice versa.

Under special circumstances, the CBC may enforce selective credit controls or selective accommodations. The purpose of imposing credit controls is not to influence the level of bank reserves, but to suppress speculative financial activities by constraining specific lending businesses. In addition, the CBC may also facilitate programs that grant favorable credit terms to certain borrowers such as the victims of the September 21, 1999 earthquake, who need funds to reconstruct homes.

## *2. Foreign Exchange Management*

The CBC's foreign exchange management includes the management of foreign exchange markets, capital movements, banks' foreign exchange business, and the CBC's foreign exchange reserves.

## (1) Managing Foreign Exchange Markets

Since 1979, Taiwan has adopted a managed floating exchange rate regime. In principle, the NT dollar exchange rate is determined by market supply and demand. The CBC may step in the market to stabilize the exchange rate when seasonal or irregular disruptions cause disorderly conditions in the market.

Since the outbreak of the Asian financial crisis in 1997, the CBC has strengthened the real-time reporting system for large-value foreign exchange transactions. This system allows the CBC to gather valuable information regarding market dynamics and to help improve the accuracy of foreign exchange statistics.

## (2) Managing Capital Movements

Since July 1987, the CBC has actively deregulated the foreign exchange controls on capital movements. Currently, capital flows not involving the NT dollars are completely liberalized. Those involving the conversion of NT dollars and relating to goods and services transactions, as well as direct investments and portfolio investments approved by the competent authorities, are also liberalized. However, for short-term capital movements that exceed the annual remittance limit on an accumulated basis, prior approval from the CBC is required.

## (3) Managing Banks' Foreign Exchange Business

The CBC has actively promoted financial liberalization and internationalization by authorizing more financial institutions to engage in foreign exchange related activities. It has allowed foreign exchange transactions between banks and customers to be made through the Internet in line with the development of online banking. It has also helped introduce financial derivatives to meet the private sector's need to hedge exchange rate risk and to expand the scope and scale of the Taipei Foreign Exchange Market. In addition, to improve the international competitiveness of Taiwan's banks and businesses, the CBC has helped to promote offshore banking units of domestic banks to become funding centers for overseas Taiwanese businesses.

#### (4) Managing Foreign Exchange Reserves

The CBC's management of its foreign exchange reserves centers on the principles of security, liquidity and profitability. The CBC invests a large portion of foreign exchange reserves in government securities issued by major industrialized countries and deposits a part of reserves with credit worthy foreign financial institutions. The CBC also takes promoting economic development and industrial upgrade into consideration when managing foreign exchange reserves. Therefore, some reserves are used as foreign currency accommodations for domestic businesses, deposits in overseas branches, subsidiaries and offshore banking units of domestic banks, and seed funds for the development of the Taipei Foreign Currency Call-loan Market.

### *3. Currency Issuance*

The national currency is issued by the CBC to provide a stable, reliable, and widely accepted medium of exchange for economic activities. The volume of issue mainly depends on the demand of the public. The public withdraw deposits from banks to meet their immediate needs for currency. Banks, to accommodate the needs of customers, release vault cash and draw against reserves stored at the CBC. When this need declines, banks dispose of and deposit excess currency in their reserve accounts.

The CBC makes public the specifications of notes and coins prior to their issuance. A brand new series of NT dollar bills was introduced sequentially between July 2000 and July 2002 in denominations of 1000, 500, 100, 200 and 2,000 dollars, one in each half-year period. Major changes in the new series include the denomination, size, illustration, and anti-counterfeiting features. The Central Engraving & Printing Plant prints notes and the Central Mint mints coins. The Bank of Taiwan, delegated by the CBC, circulates the currency.

### *4. Payment Systems Oversight*

The CBC oversees the payment systems. Taiwan's major payment systems include the CBC Interbank Funds-Transfer System (CIFS), the Central Government Securities-Settlement System (CGSS), the Nationwide Interbank

Remittance System operated by the Financial Information Service Co., Ltd. (FISC-NIRS), and the check clearing system operated by the Taiwan Clearing House (TCH).

The CIFS, which was established in 1995, settles interbank payments and payments between the CBC and local banks. Prior to September 2002, banks transferred funds through the CIFS system either on a Real-Time Gross Settlement (RTGS) basis or on a Designated-Time Net Settlement (DNS) basis. To minimize settlement risks and to comply with international standards, the CBC abolished the DNS and adopted a new RTGS system in September 2002. The CGSS, a book-entry system established in 1997, handles the issuance, transfer, and redemption of central government bonds and treasury bills. The FISC-NIRS offers bank customers interbank remittance and fund transfer services. The TCH clears checks and is responsible for keeping and handling records of dishonored checks. It also provides an inquiry service on check drawers' credit records to the public.

### *5. Fiscal Agent of the Government*

The CBC also serves as the fiscal agent of the government. It manages the national treasury's deposit account, central governmental agencies' deposit accounts, bills and securities, and the safekeeping of their other asset documents. Starting from February 1999, the CBC established the National Treasury Services Operational System, which links the CBC with the MOF and the delegated banks so that the collection and payment of funds for the national treasury's accounts can be handled more efficiently.

The CBC also undertakes the issuance and redemption of central government bonds and treasury bills. Since the establishment of the CGSS in 1997, central government bonds have all been issued in book-entry form. The issuance of book-entry treasury bills followed suit in October 2001.

### *6. Financial Examination*

Financial examinations help to improve the health of financial institutions. In addition, they help financial markets to efficiently carry out the transmission process of monetary policies.

The CBC, following the establishment of the Financial Supervisory Commission of the Executive Yuan in July 2004, has ceased to conduct general examinations of financial institutions. Nevertheless, it retains the right to conduct target examinations relevant to the implementation of monetary policy.

### *7. Participation in International Activities*

The CBC hosts conferences, provides training programs, and attends annual meetings organized by international organizations such as the Asian Development Bank (ADB), the Central American Bank for Economic Integration (CABEI), and the Conference of Governors of South East Asian Central Banks (SEACEN). In addition, the CBC maintains close working relationships with the Inter-American Development Bank (IDB), the European Bank for Reconstruction and Development (EBRD), and the Bank for International Settlements (BIS).