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**Democratisation and Financial Governance:
The Politics of Financial Reform in Taiwan
(1988-2008)**

Thesis submitted for the degree of Doctor of Philosophy

By

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August 2011

Declaration for PhD thesis

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The Politics of Financial Reform in Taiwan (1988-2008)**

Abstract

The global financial meltdown in 2008-2009 and its lasting negative impacts on most national economies have driven many to contemplate the importance of financial governance of the state. The fresh focus on the state's role in regulating the free financial market is in a big contrast to what many East Asian countries experienced in the wake of the regional financial debacle of 1997-1998. At that time, many of them were forced to deregulate their financial markets and the states were blamed for the crisis. The so-called East Asian model, in which the state played a leading role in delivering economic growth and strategically controlled the financial market, was heavily questioned. Now as the opinion pendulum swings back, can we reconfirm the model's relevance in the current global political economy?

In fact, the question is far from new. It had been hotly debated among policy makers and scholars for years even before the Asian financial crisis in the late 1990s. Also, it has caught more attention with the rise of China and the relatively better economic performance of other East Asian countries over the past decade. During those debates, Taiwan, as one of the paragons of the East Asian model, has been frequently mentioned. But, oddly, it has been cited as evidence for two opposite views: The

model is in decline or demise; the model is resilient in adaption. The mixed picture leads to this thesis to clarify the reality of the model's application in Taiwan over the recent two decades by examining how the state addressed financial governance and reform from 1988 to 2008.

The Taiwanese state has followed the global trend of financial liberalisation by actively pushing for financial reform since the late 1980s. It has been hoping to establish a new financial sector which is efficient and competitive. While certain progress has been made, two puzzles emerge. First, why did financial turmoil (i.e. run on banks, collapse of financial institutions and mounting bad loans) surge after the mid-1990s? Second, why did it become so hard for the state to pass and implement its new financial reforms? Through examining four key issues of financial reform from the late 1980s to 2008, I argue that rapid political democratisation since the end of martial law rule in 1987 was the key to these puzzles.

In a democratic era, the state's capacity in delivering effective financial governance was so significantly squeezed and challenged by newly rising forces and players that its typical state-dominant and top-down approach for financial reform often ran into difficulties. While this is closer to the "decline or demise" view of the East Asian model, the study in fact also finds that the Taiwanese state has been efficient in

quelling financial turbulences in recent years. It is because, in face of crises, the state's capacity is often recharged to a higher level than usual by a strong reform mandate from the public. Hence, while it is true that the East Asian model has been under enormous pressure to change or even crash, it might be too early to announce its end in Taiwan. Nevertheless, it is likely that a regulatory state or something in between is rising there.

In contrast to many existing works concentrating on how globalisation has shaped or constrained the East Asian model, this study highlights the importance of domestic politics in grasping the changing course of the model. Without denying the impacts of globalisation, it underlines how domestic politics during the periods of democratic transition and consolidation has affected economic governance in general and financial governance in particular of the state in Taiwan. Though it is risky to generalize too much from a single case, the study's findings provide a base for further comparative studies with other East Asian countries.

Author's Declaration

I declare that the work presented in this thesis is mine alone.

Leou Chia-feng

Acknowledgements

The thesis is a product of my long and winding journey of doctoral study. While there are ups and downs all along the way since I began the programme in 2002, I have never really felt regret about my initial decision to have the journey. To have studied abroad at SOAS in the UK has made a big difference to my career. It is not just about enhancing my knowledge regarding politics and economics through studying; it is also about exploring a new world by living there and travelling around as well as meeting people from various countries. Through constant observations and comparisons, I have learned to see things from different perspectives and realized what is so invaluable of my own country Taiwan and what is still missing to make it better. In a sense, the thesis crystallizes an essential part of my academic and overseas adventure in recent years. It aims to make an accurate diagnosis concerning democratisation and financial governance in Taiwan. Hopefully, it would be helpful to the debate on how to tackle Taiwan's political and economic development.

This thesis would not have been finished without the help and encouragement from a lot of people. My deepest appreciation firstly goes to my supervisor Dr. Dafydd Fell. His timely support in taking over the supervisory responsibility for my study in late 2006 soon calmed me down when I was in panic to learn that my original supervisor

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List of Abbreviations

AFA:	Agricultural Financial Act (農業金融法)
AMC:	Asset Management Companies (資產管理公司)
BOMA:	Bureau of Monetary Affairs (銀行局)
CBC:	Central Bank of China (中央銀行)
CCP:	Chinese Communist Party (中國共產黨/中共)
CDFFAs:	Credit Departments of Farmers' and Fishermen's Associations (農漁會信用部)
CDIC:	Central Deposit Insurance Corporation (中央存款保險公司)
CEC:	Central Election Commission (中央選舉委員會)
COA:	Council of Agriculture (農委會)
DPP:	Democratic Progressive Party (民主進步黨/民進黨)
EDAC:	Economic Development Advisory Conference (經發會)
FIMA:	Financial Institutions Merger Act (金融機構合併法)
FHCA:	Financial Holding Company Act (金融公司控股法)
FSC:	Financial Supervisory Commission (金融監督管理委員會)
KMT:	Kuomintang (中國國民黨/國民黨) or the Chinese Nationalist Party

MOF:	Ministry of Finance (財政部)
MOI:	Ministry of the Interior (內政部)
NP:	New Party (新黨)
NPLs	Non-performing loans (逾放款)
NDC:	National Development Conference (國發會)
PFP:	People First Party (親民黨)
PRC:	People's Republic of China (中華人民共和國)
ROC:	Republic of China (中華民國)
RTC:	Resolution Trust Corporation
TAFU:	Taiwan Agro-Fighters United (全國農漁會自救會)
TPA:	Taiwan Provincial Assembly (台灣省議會)
TPG:	Taiwan Provincial Government (台灣省政府)
TSU:	Taiwan Solidarity Union (台聯)

Note on Romanisation

In general, I have used the Wade-Giles system for Romanising names and terms associated with Taiwan, and the Hanyu Pinyin system for those associated with China. However, in some cases when well-known spellings (like using *Chiang Kai-shek* not *Chiang Chieh-shih*) have been used for a long time, or the original spellings are available (like using *Lee Teng-hui* not *Li Teng-hui*), I will just use their spellings as they have been. As there has been no unified Pinyin system in Taiwan, I believe this approach could mostly represent the reality of Romanisation of Chinese names and terms for a case study about Taiwan.

Chapter One

Introduction

Since the outbreak of the global financial crisis in 2008-2009, the call to increase government intervention in the financial system is gaining strong support around the world. For the East Asian nations, however, they have more mixed feelings about the issue than their counterparts in the West. It is quite ironic for them to see the resurged emphasis on the importance of the state's role in regulating and controlling the financial system. Just around 12 years ago, when most of them suffered in the Asian financial crisis of 1997-98, they were asked to do exactly the opposite – undertaking aggressive financial liberalisation and deregulation – under the enormous pressure of the International Monetary Fund (IMF), an international body for financial rescue dominated by the Western powers. Only by doing so, the IMF insisted, could they gain the rescue funds from it to save their economies from complete collapse. But now after more than a decade of aggressive financial liberalisation and deregulation, the East Asian countries are only startled to find that the supposedly much safer and more advanced financial sectors in the West have experienced earlier and bigger crashes in the latest global financial crisis than the rest of the world. As the given model of national financial governance is melting down, the East Asian model, where the state has been generally more active in interventions of the financial system,

seems to deserve a reassessment.

The East Asian model has been widely denounced by many as being in decline or demise since the Asian financial crisis in the late 1990s. Prior to the recent global financial crisis of 2008-2009, the model had been under heavy criticism. It had been blamed by some as the root cause behind the last regional financial meltdown. They argued that too much state intervention in the financial markets in East Asia had made their financial systems too rigid, weak, inefficient and uncompetitive. As a result, their economies were vulnerable to financial crises. To improve the health of their economies and financial sectors, the role of the state in the financial markets was required to be reduced to a less significant level so that “the invisible hand” could wield its magic to make financial markets and broader economies more efficient and robust. Now that “the invisible hand” has failed its job in the latest global financial crisis, does this imply a resurgence of the East Asian model as a way of economic governance in the global economy? Especially, over the past decade, the rise of China and the relatively better economic performance of other East Asian countries have seemed to provide more support for the claim.

1. Origins of the study

To do a study particularly focusing on Taiwan is a response to the debate on the

relevance and outlook of the East Asian model in the world economy. The debate has been undertaken between two main camps with two completely opposite views: the decline/demise view and the resilience/adaption view. While the former argues that the model's decline or demise is inevitable in the global economy, the latter contends that the model is resilient enough to adjust itself to the new challenges it confronting. What puzzles me most is the role that Taiwan has played in the debate. As one of the paragons of the East Asian model, Taiwan has often been both cited to support the model's decline/demise and resilience/adaption. How could the same country become the evidence to make two completely different views sustain at the same time?

A brief answer is: it has something to do with the mixed reputation that the Taiwanese state has in handling financial governance and crises. Following the global trend of economic deregulation and liberalisation, triggered by Reagan-Thatcher's aggressive push for reforms based on the doctrines of free market economy in the 1980s, the state in Taiwan has conducted large-scale financial reform since the late 1980s. Indeed, financial liberalisation or reform has been one of the buzzwords for financial policy makers in Taiwan over the past two decades. Over the recent decade, the Taiwanese state, however, has shown very different faces to the world in terms of its reputation on financial governance in different financial crises. It impressed the world when Taiwan was relatively unscathed amid the Asian financial crisis of 1997-98. But soon

it was under heavy criticisms as a non-performing loan (NPL)¹ crisis was looming between 1999 and 2002. Then to the great surprise of the observers, it efficiently defused the NPL crisis in 2004. Nonetheless, it soon failed again in its attempt to consolidate the banking industry from 2005 to 2007. In short, the mixed performances that the Taiwanese state has demonstrated have further raised my interest on how it has addressed financial reform since the genesis of its large-scale financial liberalisation.

Another drive to do the study stemmed from my initial attention to the issue of financial liberalisation among the East Asian countries after the outbreak of the regional financial meltdown in 1997-98. As many critics have attributed the crisis in a significant part to the mishandling of financial liberalisation prior to the crisis by the governments in the region for years, I was curious about the process of how and why the governments failed to handle the issue. Especially, as many of the governments were credited with their capacity and performance in controlling financial markets and delivering remarkable and sustained economic growth in the 1980s and early 1990s, why did they suddenly lose their competence?

1 NPLs indicate those loans that are in default or close to being in default. Normally, when loans are in default for three months, they become non-performing. But this can depend on the contract terms.

2. The questions in the context of Taiwan

When I started to work on how the Taiwanese state has handled financial reform since the late 1980s, two questions regarding its financial governance occurred to me. Firstly, why has there been a surge of incidents of financial disorder since the early 1990s? To be more specific, the sudden increase of bank runs and financial crises over the past two decades are unprecedented. On the one hand, the frequency of runs on banks is the highest in Taiwan's financial history. Studies have shown that between 1991 and 2001, 83 bank-runs occurred in Taiwan and most of them emerged in the second half of the 1990s.² On the other hand, the occurrence of financial crises over the past years also reached record highs. In just 10 years, three alarming financial crises hit Taiwan. The first one came as Taiwan was dragged into the regional financial meltdown in East Asia in 1997-98. The second emerged in late 1998 as a series of incidents of financial difficulty broke out among a large number of listed companies, resulting in a panic in financial markets. The third, the NPL crisis, began to take shape right after the previous one. As the government did not really address the earlier crisis, NPLs accumulated fast in the banking sector and thus threatened to cripple Taiwan's financial system and economy from 2001 to 2003. Given that the state has consciously pushed for large-scale financial reform for several years since

² Lin, "Taiwan Jiuling Niandai De Jinrong Jidui Hebing Yu Jinrong Zhixu" [bank-runs, bank mergers and financial order on Taiwan in the 1990s].

the late 1980s, the surge of financial disorders is not only ironic but also difficult to understand.

Secondly, why have most of the main measures of financial reform initiated by the government either been seriously delayed, altered, or sometimes even forced to terminate halfway? Various measures of financial reform, based on the proclaimed principle of “internationalisation” and “liberalisation,” have been taken since the late 1980s. Among them, “privatise state-owned banks,” “build Taiwan as a regional financial centre,” “allow new private banks to be established,” “encourage merger and acquisition among financial institutions,” “strengthen financial oversight” are all well-known examples. Unfortunately, not many of them were fully realized. Delays, alterations or even terminations of reform projects have become more common than before the 1990s. As the Taiwanese state had traditionally had a reputation for being powerful and conservative in managing the financial system with its regular interventions and significant shareholdings in major financial institutions, its recent inability to carry out measures of financial reform creates another puzzle.

Thus, I contend that the key to making sense of how the state in Taiwan has handled financial reform is to offer vital answers to the two questions above. To put it in another way, if one could explain what has accounted for the surge of financial

turmoil in Taiwan and what has contributed to the slowness or ineffectiveness of financial reform in Taiwan since the early 1990s, then one would have a better assessment of the East Asian model in Taiwan, and consequently make a more substantial contribution to the debate on the future of the model.

3. The argument

The surge of financial turmoil and the constant failure of reaching planned targets of financial reform are all signs of an obvious fact --- the Taiwanese government's mission to engineer a new financial sector which is both efficient and competitive since the late 1980s has failed. On top of that, behind the failed mission is an inconvenient truth about the Taiwanese state: its capacity in delivering sound governance over the financial sector has simply been in decline over the past two decades. But, a further question would be: What has accounted for the shrinking capacity of the state in bringing a more stable, efficient and competitive financial sector? That is, what has happened to the state in just a few years after Taiwan's financial Big Bang³ beginning in the late 1980s, especially considering the relatively strong financial governance of the state in the past?

³ The term was initially referred to the liberalization in 1986 of the London Stock Exchange (LSE) and its following financial liberalisation measures adopted by the Conservative government in the UK in the 1980s. Later, when Japan pursued its financial reform in large scale in 1998, Japan applied the same term to the reform. Since Taiwan conducted a large-scale financial reform in 1989, I use the same term to describe it. See also Lee, "The development of Banking in Taiwan: the historical impact on future challenges."

It has no doubt that the causes behind the shrinking capacity of the state on financial governance are compound. For example, the shrinking might be because of the impact of financial globalisation which erodes the barriers of capital movement and thus makes state controls and interventions more difficult. It might be also due to the shift of geopolitics that initially was favourable to the existence of the developmental state. But in terms of impacts on the content and pace of financial reform, domestic politics, I argue, is much more dominant.

The state in Taiwan has been under growing constraints imposed by rapid political democratisation since its outset in the late 1980s. Since then, the old state-centred approach for policy making and implementation, a key feature of the East Asian model, has been so constantly and gravely challenged by newly rising political players and forces that it is not able to work as effectively as before. Consequently, the effectiveness of its economic governance including financial governance is seriously undermined.

The argument is built upon an important observation that Taiwan's financial liberalisation has been undertaken in a rapidly changing political context which has been greatly shaped by rapid democratisation. From 1988 to 2000, the first 12 years of large-scale financial liberalisation, we saw the rise in the influence of the opposition

parties, legislators, elected politicians, business groups, local governments and civil organizations on Taiwan's political stage. Though, in appearance, the KMT was still dominant in power, policies or measures for financial liberalisation were much less likely to be approved without the support of those new political forces in a new democratic era. From 2000 to 2008, as the first change of ruling parties since the end of the Second World War marked a new milestone of Taiwan's democratisation, divided government and polarized politics brought additional challenges for the state to undertake financial reform. In sum, as the political context underpinning the state has been significantly changed by democratisation, the state's autonomy and capacity are also under growing squeeze. Under such circumstances, it is no surprise that the state has run into difficulty in pushing through its agenda and plan for financial reform in a new democratic era.

4. Location of the thesis in the related studies

Certainly, such an argument does not come from nowhere. Firstly, at a fundamental level, the argument is inspired by the existing literature on the East Asian model. It is only from this literature that I could have a clear picture about how the model has worked, why it could make a difference in achieving remarkable economic growth in the past, what the favourable conditions are for its existence, and what its latest

challenges are. Applying these existing insights to the case of Taiwan is like to borrow a sophisticated and sharp lens to help examine the conditions of the model in Taiwan.

In fact, this thesis is dedicated to enriching the given research in this field.

Secondly, at a broader level, the argument is related to a lasting discussion on whether a democratic developmental state is possible in East Asia in today's global economy.

As many successful cases of the developmental state were all connected with authoritarian regimes in the past, some researchers ask whether these cases could still be sustained under democratic regimes. To put it in another way, they are asking: is the developmental state compatible with democracy?⁴ For a significant number of developmental states, democratisation is a critical test to their survival. Since Taiwan has been in similar situation since the late 1980s, this line of studies inspires me to make my argument in which democratisation is regarded as the key variable.

Finally, at a narrower level, my argument is also related to an ongoing discussion on how crony capitalism damaged the financial governance of those crisis-hit states in East Asia before they tumbled in the regional financial meltdown of 1997-98.

According to this line of literature, its focus is on how the previous iron triangle

⁴ White, "Constructing a Democratic Developmental State." Edigheji, *Constructing a Democratic Developmental State in South Africa: Potentials and Challenges*. Kim, "Limits of the authoritarian developmental state of South Korea." Evans, "Constructing the 21st century developmental state: potentialities and pitfalls." Chang, "How to 'do' a developmental state: political, organisational and human resource requirements for the developmental state." Huang, "Contested State and Competitive State: Managing the Economy in a Democratic Taiwan?"

among the state, business and banks slipped into an alliance which increased moral hazard and thus encouraged reckless lending and borrowing and jeopardised the soundness of financial oversight. Similarly, my emphasis on the negative impact of democratisation on the state's financial governance is to single out a twisted dimension in the process of Taiwan's moving into a consolidated democracy. I assert that democratisation has made crony capitalism less constrained in Taiwan and thus jeopardised the quality of financial governance of the state.

5. Plan of the thesis

To justify the argument and make my case, the rest of the thesis is arranged as follows. The next chapter will begin with a literature review on related studies in the fields just mentioned. It aims to locate my study in the given researches in detail and, most of all, build my own argument against this backdrop. It finally will be ended with a brief discussion of my methodology and research approach. Then, since the thesis is a case study about the politics of financial reform in Taiwan, there is a need to have a context chapter about Taiwan's general history, political development and financial evolution. With this chapter as a base, from Chapter Four to Seven are four individual case studies on the four most important policies or measures regarding financial reform or

governance over the past two decades in Taiwan.⁵ Chapter Four is about the reform to privatise and deregulate the state-owned banks. It analyzes why the reform was either seriously delayed or even simply halted. Chapter Five examines how the reform to lift the ban on the establishment of new private commercial banks led to financial chaos in the end. In other words, it traces the roots of financial turmoil resulting from the entry of new private commercial banks into the banking system. Together, Chapter Four and Five are cases to prove the decline of Taiwanese state on financial governance in terms of its inability to engineer the kind of new financial sector it had hoped to create. Furthermore, through these two chapters, we will see the clear impacts of political democratisation on the economic governance of the state. As the state is significantly penetrated by new political forces and players in a new democratic era, its autonomy has struggled to be maintained, thus undermining its capacity to carry out financial reform.

The same argument applies to how the looming NPL crisis was formed from the late 1990s to the early 2000s in Chapter Six and how the health of grassroots financial institutions deteriorated in Chapter Seven over the same period of time. However, two additional points are added into these two chapters. First, greater emphasis is laid on

⁵ The four cases are chosen due to either their relatively larger scale and scope of reform or their critical impacts on the financial, economic and social stability. In some of them, it could be because of both. Also, as indirect financing is still dominant in Taiwan, I only focus on issues of the banking sector.

the performance of the Democratic Progressive Party (DPP) government than in the two previous chapters as these two financial reform issues are mainly addressed by the DPP during its years in power for the first term from 2000 to 2004. Second, deliberate contrast is made between the two chapters as the DPP government succeeded in defusing the NPL crisis but failed to push through its reform on the grassroots financial institutions at the same time. This contrast is aimed to demonstrate two more claims. Firstly, it shows the conditions for the state to restore its efficiency and effectiveness of financial governance after 2000. The case of defusing the bad debt bomb in Chapter Six demonstrates that an overwhelming financial crisis is of great help to boost the mandate of the state to implement necessary reforms even if the state was constrained by divided government. Secondly, it attempts to make clear that the effects of the change of ruling parties on enhancing financial governance of the state are limited. The case of policy U-turn on reforming the grassroots financial institutions in Chapter Seven reveals more subtle aspects of the influence of domestic politics on the outcome of financial reform after 2000.

Finally, Chapter Eight is the conclusion of the thesis. It not only summarizes the main findings and their implications of the previous chapters but also offers policy suggestions to revamp the developmental state in Taiwan in a democratic era.

Moreover, it also identifies possible scenarios about the prospects of the

developmental state in Taiwan and East Asia. Then judging from the progress of this thesis and its limitations, I call for further comparative studies in the future. A brief discussion on what could be done to expand the research is addressed.

6. Expected contributions

While there are scores of studies on the effects of political democratisation on the state's economic governance or financial governance in Taiwan, the thesis, however, is the most comprehensive study so far on the politics of financial reform in Taiwan.

Unlike other studies which only focus on one particular issue at one particular period of time, the thesis covers the most important four issues regarding financial reform or governance since Taiwan's financial Big Bang in the late 1980s. By doing so, it will not only help us pay special attention to the long-term course of development regarding the developmental state in Taiwan, but also prevents us from jumping to the conclusion based on relatively insufficient material and evidence. Thus, the thesis is expected to provide a more accurate assessment of Taiwan's developmental state in terms of its financial governance.

Moreover, while the main argument of the thesis is obviously more in line with the demise view about the East Asian model, the study does not totally deny the possibility for the model to restore its effectiveness on financial governance. It notices

the importance of conditions which are favourable to the continuing function of the model. Therefore, the study is hoping to transfer the focus of the debate on the East Asian model from “the demise view vs. the adaption view” to “under what conditions the model could function effectively” in the current and future global economy.

Finally, it seeks to enrich the debate on the prospect of the East Asian model in the global economy by adding more observations and experiences from Taiwan. As Taiwan is one of the three core developmental states in East Asia, in addition to Japan and South Korea, a case study on its financial reform since the weakening of its previous authoritarian regime about 20 years ago will provide a more solid empirical base for further comparison and study with other countries of similar nature in the same region at the same period of time.

Chapter Two

The East Asian Model and the Taiwan Case

Since the thesis is aimed at addressing the relevancy of the East Asian model in the global economy through a case study on Taiwan's financial reform from 1988 to 2008, this chapter is intended to review six key questions about the academic background behind the thesis:

1. What is the East Asian model?
2. How has the model been assessed before and after the Asian financial crisis of 1997-1998?
3. What has happened to the East Asian model over the past two decades and what will it become?
4. What is the relationship between democracy and development in East Asia? Is a democratic developmental state possible in the region?
5. What is the special role of Taiwan in the debate of assessing the East Asian model?
6. How was the research conducted and built upon existing literature?

Accordingly, the rest of the chapter will be divided into six parts to elaborate the questions above.

1. What is the East Asian model?

The East Asian model, or the East Asian developmental state, is a state-led regime for economic governance and national development. But unlike a socialist state in which state control and central-planning are central to the economy, the regime embraces the market economy and actively engages in international trade. While the state actively gets involved in economic development through a variety of industrial policies in an attempt to help home industries outperform their rivals from other countries, it allows the market, “the invisible hand,” to play its role. The state only intervenes in those “target industries” which are regarded as strategically important for national competitiveness in the global economy. The state is strongly committed to fostering comparative advantages of home industries in particular and economic development in general. Its policy tools range from direct investment, transferring technology, providing cheap credit or credit guarantee to tax breaks for exports and imposing high tariffs and other trade or non-trade barriers for protecting emerging industries with competitive potential. As a result, the whole national economy can improve and grow fast, transforming a late comer in the world economy into a competitive player in just a few decades.

The state-led regime, or the developmental state as it has been widely referred to, has

been particularly popular in East Asia since the end of the Second World War. Its origin, actually, is from the West. According to the studies of Alexander Hamilton, Friedrich List and Alexander Gerschenkron, strategic interventions into the market by the state, aiming to facilitate industrial transformation and economic development, was quite common in backward economies in the West in the past.⁶ The strategy was adopted in those economies to protect infant industries at home with an eye on catching up with the advanced economies in the near future. George Washington's US, Bismarck's Germany, Meiji era Japan and the young Soviet Union are all typical cases.

But it was the remarkable economic growth of a number of East Asian economies over the decades after the Second World War that made practices of the state-led regime noticed worldwide and a more systematic research on the regime emerged. The first such case was Japan. To overcome its economic backwardness and catch up with the Western powers, Japan actively used a state-centred approach to engineer its rapid industrialisation since the Meiji Restoration in the late 19th century. The approach was reinstalled and reinforced shortly after the Second World War. In just three decades, Japan not only soon recovered from its ruin and defeat in the war but

⁶ See Hamilton, "Report on Manufactures." List, *National System of Political Economy, Book II, The Theory*. Gerschenkron, *Economic Backwardness in Historical Perspective*. Chang, *Kicking away the Ladder: Development Strategy in Historical Perspective*.

also became the second largest economy in the world.⁷ By effectively exploiting the Cold War context in which the US opened its market to sustain its alliances, the Japanese state successfully fostered its strategic industries and used its booming exports to significantly strengthen its economic power. Through the late 1970s to the early 1990s, Japan was widely regarded as the most successful story of economic development among the advanced economies. “Japan as number one”⁸ was once the most worrying trend to many people in the US, the biggest economy in the world.

The economic success of Japan attracted much scholarly attention. Among a large number of scholars, Chalmers Johnson’s study on the role of the Ministry of International Trade and Industry (MITI) in contributing to the Japanese Miracle is the most renowned.⁹ In Johnson’s view, the MITI was the pilot agency which directed the development of Japan’s economy. Equipped with highly capable technocrats and strong autonomy, the MITI could deliberate plans and strategies for economic development with an eye on the long term national interest. “The politicians reign and the bureaucrats rule” was a snapshot of how the MITI functioned in Japan’s political and economic system. Johnson coined the term “developmental state” to entail the economic growth mechanism in Japan and its particularly historical context.

⁷ China has replaced Japan as the second largest economy in 2010. Japan's economy was worth US\$5.474 trillion at the end of 2010 and China's economy was closer to US\$5.8 trillion in the same period.

⁸ Vogel, *Japan as number one: lessons for America*. It is believed that China has adopted similar state-led approach for its rapid rise over the past three decades.

⁹ Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975*.

After Johnson's book was published in 1982, the rapid economic growth in other newly industrial countries (NICs) in East Asia also began to attract global attention.¹⁰ Due to similar patterns of economic development and historical connection as well as geographic proximity, some researchers began to apply Johnson's research to those East Asian NICs. Among which, Taiwan and South Korea were most frequently studied and compared to Japan.¹¹ For example, Amsden's analysis on South Korea's industrial development strategy by deliberately "getting prices wrong" stressed the role of the state in making the strategy work.¹² Similarly, Wade's study on Taiwan's industrial transformation also highlighted the commanding position of the authoritarian KMT regime in engineering the process of economic take-off through a range of industrial policies.¹³ In short, the developmental state gradually emerged as a paradigm, both in practice and theory, for understanding and explaining "the *East Asian Miracle*"¹⁴ from the 1980s to the mid-1990s.¹⁵

In fact, the emergence of the new paradigm could be also seen as a counter critique of

¹⁰ These East Asian economies grew at an average rate of almost 10% per year.

¹¹ Weiss distinguishes the differences between the developmental states in Northeast Asia, including Japan, South Korea and Taiwan, and those in Southeast Asia, including Thailand, Malaysia and Indonesia. Though the latter group of countries also had rapid economic growth in the early 1990s, they are different from the former group of countries in fundamental national orientations, state architecture and coordinating capabilities. Please see details in Weiss, "State Power and the Asian Crisis."

¹² Amsden, *Asia's Next Giant: South Korea and Late Industrialization*.

¹³ Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*. The most common industrial policy tools were the creation of tariff barriers, the subsidization of R&D and infrastructural development, the use of export incentives (such as tax break), and centralized control over the financial system.

¹⁴ World Bank, *The East Asian Miracle: Economic Growth and Public Policy*.

¹⁵ Deyo, *The Political Economy of the New Asian Industrialism*. Haggard, *Pathways from the Periphery: the Politics of Growth in Newly Industrializing Countries*.

the neoclassical paradigm. It sought to refute the neo-liberal vision of East Asian growth in terms of the economic benefits of trade liberalization, private enterprise, and a restricted role for the state.¹⁶ The adherents of the new paradigm were dedicated to demonstrating not only the causal linkage between the economic performance and the politically institutional arrangements¹⁷ but also the historical, geopolitical and international context for the rise of developmental states in East Asia.

Wong has well summarized these points:

“At the policy level, the postwar developmental state was characterized by its use of market-intervening policies. These policies were tolerated by the rest of the world because of the imperatives of postwar economic reconstruction and the need to contain the spread of communism during the Cold War. The developmental state was also understood in terms of its internal institutional configuration, for example, the hierarchical organization of the bureaucracy and the state’s meritocratic recruiting procedures. Last, the developmental state was defined by its ability to balance strategic linkages with, and relative autonomy from, different societal forces.”¹⁸

In other words, in a broader term, a successful developmental state involves not only certain critical institutional arrangements but also some historical and international preconditions. But, this also implies that it will be difficult for other countries from other regions at a different time to completely emulate this particular state-led regime

¹⁶ Onis, “The Logic of the Developmental State,” 109-110.

¹⁷ Chu, “State Structure and economic Adjustment of the East Asian Newly Industrializing Countries.”

¹⁸ Wong, “The Adaptive Developmental State in East Asia,” 352.

as “the East Asian developmental state was the product of a certain time and space.”¹⁹

2. How the East Asian model has been assessed before and after the Asian financial crisis of 1997-1998?

The East Asian model was confronted with its first challenge as Japan slipped into its “lost decade” of economic recession after its bubble economy burst in the early 1990s.²⁰ However, as East Asian tiger economies like South Korea and Taiwan which adopted the same model were still thriving, Japan’s economic misfortune did not immediately amount to a fatal setback for the model. A more essential blow to the model came later after a regional financial crisis broke out over 1997-98. As many countries in the region such as Thailand, Indonesia, Malaysia, and South Korea were all heavily hit by the crisis, the criticism of the East Asian model behind the crisis-hit economies reached such a level that many predicted the model’s doom in the near future.²¹ Indeed, the Asian financial crisis of 1997-98 is a critical juncture for the East Asian model. Before the crisis, the model was widely praised as an alternative to a neoclassical approach for economic development where market forces were regarded as the main drives for economic improvement and upgrading. Then, soon after the crisis, the model was seriously discredited and even seen by some as the root cause

¹⁹ Ibid.

²⁰ The economic recession finally ended in 2002.

²¹ See the related discussion in the collected papers in *Developmental states: relevancy, redundancy or reconfiguration?* Ed. Linda Low.

behind the crisis.²² Since then, the literature on what caused the financial disaster and the debates on the value of “Asian model” have surged.²³

There have been two main approaches to assess the crisis: the financial-panic view and the weak-fundamental view. The financial-panic view focuses on what turned the original event into a crisis. One of the best examples of this view could be represented by Radelet and Saches.²⁴ According to them, those crisis-hit countries were vulnerable to panic as they all had large-scale foreign capital inflows into their financial systems before the crisis broke out. As the abrupt reverse of foreign capital triggered the crisis, policy mistakes of the governments and poorly designed rescue programmes by the IMF turned the capital outflows into a full-fledged financial panic, and deepened the crisis more than was either necessary or inevitable. For them, the underlying weak economic fundamentals of the crisis-hit countries were not severe enough to warrant a financial crisis of that magnitude which occurred in the latter part of 1997. In other words, this view largely does not blame the East Asian model itself for causing the crisis. Thus, while it provides little help in assessing the value of the model in the aftermath of the regional financial crisis, it indirectly keeps the model

²² Ibid.

²³ For example, please see Chang, “The Hazard of Moral Hazard: Untangling the Asian Crisis.” Feldstein, “Refocusing the IMF.” Krugman, “What happened to Asia?” Soros, *Open Society: Reforming Global Capitalism*. Stiglitz, *Globalization and Its Discontents*. Wade, “From ‘miracle’ to ‘cronyism’: explaining the Great Asian Slump.” Weiss, “State Power and the Asian Crisis.” IMF, “Recovery from the Asian Crisis and the Role of the IMF.”

²⁴ Radelet and Saches, “The East Asian financial crisis: Diagnosis, remedies and prospects.”

from attack. Also, the view does remind us of the impacts of capital movement in affecting financial stability and governance of individual nations in East Asia.

In contrast, the weak-fundamental view, which argues that weak economic fundamentals are the keys to the crisis, points the finger at the East Asian model itself.

The view contends that some common economic problems existed in those affected countries. Externally, they all had large short-term foreign borrowing used to finance current account deficits, leaving their economies vulnerable to capital flow reversals.

Domestically, inadequately supervised and capitalized banks made excessively risky loans to poorly governed firms. Widespread moral hazard existed because financial institutions were poorly regulated and companies had little accountability to shareholders. As a result, corporations borrowed heavily to invest in risky projects, financed by loans from banks that, in turn, borrowed heavily (and unhedged) from abroad. At the same time, foreign creditors were willing to lend large amounts to banks and corporations in these economies --- for the region had a strong track record for economic performance, and the borrowers were often state-owned banks and corporations which the lenders thought, had implicit or explicit sovereign guarantees.²⁵ In short, the East Asian model itself is treated as the root cause of the regional financial meltdown.

²⁵ Ahearne, Fernald & Loungani. "Countering contagion: Does China's experience offer a blueprint?" 39-40. IMF, "Recovery from the Asian Crisis and the Role of the IMF," 2-3.

In fact, behind the moral hazard account for the Asian financial crisis is a broader accusation against the East Asian model: *crony capitalism*. After 1997, crony capitalism has been wildly drawn as a systemic flaw in the “Asian model” of development.²⁶ It means close linkages among the domestic banking sector, target industries, and the government. As the government is encouraging the development of the target industries by asking the domestic banks to provide cheap credit, the banks have no incentive to assess the creditworthiness of their borrowers or the quality of the investments their loans are financing. For they know that no matter how risky and overextended their lending is, they will always be bailed out by the government. Gradually, it leads to a mountain of bad papers and the de facto insolvency of a major part of the banking system, not to mention the corruption involved among the close linkages.²⁷ Since there is a systemic flaw in the “Asian model” of development, the model’s demise becomes inevitable if the structural problem is not fixed.

But as Meredith Woo-Cumings asks, “How can one era represent a developmental miracle and the next a mere mirage, when nothing fundamental has changed?”²⁸

Adherents of the East Asian model often raise such a question to the criticisms of the model after the Asian financial crisis. They argue that all the criticisms, based on the

²⁶ For example, please see Chin, *Heijin: Organized Crime, Business, and Politics in Taiwan*. Kang, *Crony Capitalism: Corruption and Development in South Korea and the Philippines*. Hutchcroft, *Booty Capitalism: The Politics of Banking in the Philippines*.

²⁷ Lal, “The Challenge of Globalization: There Is No Third Way,” 32.

²⁸ Woo-Cumings, “Preface,” x.

argument of moral hazard, of the “Asian model” are misleading and partial.²⁹ For example, in response to the claimed major origin of moral hazard behind industrial policies in East Asia --- scholars such as Chang contend that “the point is not that such socialization of risk does not generate any moral hazard, but that the benefits that it brings about (higher productivity, better-coordinated investments, prevention of the “wastes” from duplicative investments) can more than offset the costs from the moral hazard that it may generate. The success of industrial policy in various East Asian countries in the past is good proof of this.”³⁰ Likewise, responding to the allegations of cronyism in contributing to the financial crisis, they argue that cronyism was a feature in all the crisis-stricken Asian countries throughout their high-growth periods in various forms and degrees. Why did it not cause similar crises before?³¹

To counter, they further argue that the demise or weakening of the model itself in the crisis-stricken countries over the years before the crisis was largely responsible for their crash in the regional financial meltdown. Wade and Veneroso, for example, contend that a significant level of government capacity and monitoring on financial regulation was the key to the endurance of the East Asian model. Once the level was reduced, the likelihood of the crash of the model increased.³² Accordingly, for Wade

²⁹ Chang, “The Hazard of Moral Hazard: Untangling the Asian Crisis.”

³⁰ Ibid, 778.

³¹ Ibid, 780.

³² Wade and Veneroso, “The Asian Crisis: The High Debt Model Versus the Wall Street-Treasury-IMF

and Veneroso, financial deregulation undertaken by East Asian governments before the crisis was strongly related to the occurrence of the crisis:

“...removed or loosened controls on companies’ foreign borrowing, abandoned coordination of borrowing and investments, and failed to strengthen bank supervision. By doing so, they violated one of the stability conditions of the Asian high debt model, helping to set the crisis in train.”³³

South Korea was such a case in this argument. The financial regulation since the late 1980s and the official end of the planning practice in 1993 were all seen as the root causes for South Korea’s vulnerability in facing a financial crisis. Because they had all significantly reduced the scope for state influence in resource allocation and removed the restraints on unnecessary investments in some industries, inflows of foreign capital and massive foreign borrowing over 1993-97.³⁴

Thus, what is needed to be blamed is not the model, but those forces that led to the dismantling of the model. Mostly, the list of those forces entails the measures of economic liberalisation advocated by neo-liberals at home and abroad,³⁵ and the pressures of economic globalisation as well as the domestic factors like a major demographic shift, unproductive rent-seeking and democratisation that made the

Complex.”

³³ Ibid, 9.

³⁴ Thurbon, “Ideational inconsistency and institutional incapacity: why financial liberalization in South Korea went horribly wrong.” Thurbon, “Two paths to financial liberalization.”

³⁵ Wade and Veneroso, “The Asian Crisis: The High Debt Model versus the Wall Street-Treasury-IMF Complex.”

developmental state unsustainable.³⁶ In other words, if an East Asian country could keep its developmental state regime free from erosion by those forces, it should have been able to weather the financial storm.

3. From the developmental to the regulatory state? --- Impacts of economic liberalisation and political democratisation

But this “decline of monitoring capacity” argument, in the words of Jayasuriya, fails to answer the following question --- “Why did East Asian governments liberalise financial markets when the results were obviously so deleterious?”³⁷ Wade and Veneroso argue that it was because the policy-makers of those governments were so misled by international financial organizations that they made irrational decisions.³⁸

But then how do we explain that “policy mistakes were made not just in one country, but across the entire region” as Jayasuriya has rightly questioned?³⁹ Alternatively, Jayasuriya suggests that a structural explanation is needed to better explain the disruption and instability of the East Asian model of economic governance. He further advocates that “it is useful to locate the dynamic of some these changes in the gradual shift of power from technocratic elites to business group. ... this shift is reflected in

³⁶ Wong, “The Adaptive Developmental State in East Asia,” 355-356.

³⁷ Jayasuriya, “Authoritarian liberalism, governance and emergence of the regulatory state in the post-crisis East Asia,” 318.

³⁸ Wade and Veneroso, “The Asian Crisis: The High Debt Model versus the Wall Street-Treasury-IMF Complex.”

³⁹ Jayasuriya, “Authoritarian liberalism, governance and emergence of the regulatory state in the post-crisis East Asia,” 318.

the increasingly polycentric distribution of power within the state.” --- the process of democratisation in those East Asian countries.⁴⁰ Meanwhile, he also notices the importance of international context or factors in sustaining the East Asian model of economic governance. He argues that the model was nested within certain structures of international economic governance in the post-war era --- “embedded liberalism”⁴¹ in Ruggie’s terms.⁴² Against this backdrop, the East Asian developmental states had the room and capacity to control the movement of capital. But as the structures of international economic governance shifted to be in favour of the free flows of capital, inevitably, the East Asian developmental states gradually felt the difficulty to regulate the movement of capital. As a result, the existing way of economic governance collapsed or was forced to shift.

Overall, from the late 1980s to the whole 1990s, we witness that almost all East Asian countries encountered a double transition: economic liberalisation and political democratisation. What the consequence of this double transition will be has raised strong interest and hot debate among media and political and academic circles. For a handful of scholars, they see that “the regulatory state” or even “the post-regulatory state” is emerging in East Asia.⁴³ In the wake of the Asian financial crisis of

⁴⁰ Ibid.

⁴¹ Ibid.

⁴² Ruggie, “International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order.”

⁴³ For example, see Jayasuriya, “Authoritarian liberalism, governance and emergence of the regulatory

1997-1998, Gillespie and Peerenboom have observed that:

“...administrative guidance lost prestige in East Asian countries such as Japan and South Korea. Japan and South Korea responded to their economic problems by re-regulating. They not only enacted a raft of new commercial laws, but also sought to judicialize administrative processes by shifting discretionary power from bureaucrats to judges and citizens, a process that was occurring globally and in other East Asian states as well.”⁴⁴

This period of re-regulation, they noted, coincided with, and was influenced by, what has been termed the rise of the “regulatory state” in the West.⁴⁵ They found that:

“States that had moved to privatize companies, reduce red tape, and use market-like incentives, were not really deregulating, but rather finding new ways to regulate the economy. Neoliberal deregulation moved in tandem with regulatory reforms that have spread new institutions, technologies, and regulatory instruments around the globe. For example, the World Bank advocates neoliberal reforms, but also promotes re-regulation throughout Asia as a method of stabilizing private markets through a range of measures bundled together as ‘good governance’.”⁴⁶

The main implications and consequences of this double transition of deregulation and

state in the post-crisis East Asia.” Gillespie and Peerenboom, “Pushing back on globalization: an introduction to regulation in Asia.” Yeh, “Democracy-driven Transformation to Regulatory State: The Case of Taiwan.”

⁴⁴ Gillespie and Peerenboom, “Pushing back on globalization: an introduction to regulation in Asia,” 4.

⁴⁵ Majone, “The Rise of the Regulatory State in Europe.” Majone, “From the Positive to the Regulatory State: Causes and Consequences of Changes in the Mode of Governance.” Moran, “Review Article: Understanding the Regulatory State.” Moran, *The British Regulatory State: high modern or post modern?* Shleifer, “Understanding Regulation.”

⁴⁶ Gillespie and Peerenboom, “Pushing back on globalization: an introduction to regulation in Asia,” 4.

reregulation in Asia are:

“...the regulatory state challenges the convention that norms must be imposed by the public sphere on the private sphere. It developed new forms of ‘responsive’ regulation that involve privatization, market competition, and increased state reliance on self-regulating organizations and regimes. In short, it reengineers the way state and non-state actors think about who is permitted within the regulatory space and who is excluded from exercising regulatory power.”⁴⁷

As for the “the post-regulatory state,” it is a new governance based on a flexible array of regulatory techniques. “It unshackles regulation from state-based processes and opens the regulatory space to complex forms of private or non-state mechanisms.” It implies that “the notion of the state withdrawing from some regulatory functions and supporting non-state actors to engage with global laws and principles. States are described as performing a ‘steering’ function, leaving the ‘rowing’ function to others.”⁴⁸ “In practice this means that states not only provide policy guidelines and criteria to assess regulatory objectives, they also design regulatory structures and processes that stimulate and respond to non-state regulation. In post-regulatory states one task of state regulators is to regulate self-regulation by non-state actors.”⁴⁹

The emerging governance regimes demonstrate an obvious direction of change for the

⁴⁷ Ibid.

⁴⁸ Ibid, 5.

⁴⁹ Ibid, 5.

old East Asian developmental states --- removal or reduction of the regulatory burden imposed by the state on industry. This confirms the strong effects of neoliberalism, which advocates a smaller state, emphasizes deregulation, privatization, and decentralization to combat the perceived “inefficiencies” caused by state interference in market regulation. But, does this mean that the emerging governance regimes in East Asia are totally departed from the old developmental states? Are they similar in nature as their counterparts in the U.S. and Europe? These are popular questions for debate on the state and prospect of the East Asian model.

The thesis will address these questions by examining the Taiwan case in the following chapters. But here we need to clarify the attempt of thesis by asking following questions: If the pressure of implementing neoliberal reform measures is irresistible to all East Asian countries, have they all experienced similar trajectories in their reform process and had similar results? If not, what has contributed to the difference among them? Can we now assert that the East Asian model is the past?

In other words, the thesis will not challenge or deny the massive influence of external pressure⁵⁰ on shaping the transformation of the East Asian model. But, it will concentrate on the study of the process and result of national response in undertaking

⁵⁰ Here indicates the neoliberal reform pressures imposed by international economic organizations, the West and globalisation.

economic liberalisation while facing a political environment of rapid democratic transition and consolidation. From this perspective, the thesis is turning the research focus to the relationship between democracy and development in the East Asian developmental states against the background of the heydays of neoliberal values pervasive both at home and abroad in the recent two decades.

4. Democracy and development in East Asia

In the era of “*The East Asian Miracle*”⁵¹ in the 1980s and early 1990s, the most successful cases of the East Asian model, except for Japan, were all under authoritarian rule. This fact leads many writers to associate the model with political authoritarianism. Now that some of these countries have become democracies or are in a process of democratic transition and consolidation, can they still have the same remarkable economic performance under democratic rule? Can democracy bring economic prosperity as usual?

Before going to review the details of related literature on the question, it is better to define first what “democracy,” “democratisation” and “democratic consolidation” mean in the thesis as these are all central and mutually-connected variables for my argument and explanation. To begin with the usage of “democracy,” there are several

⁵¹ World Bank, *The East Asian Miracle: Economic Growth and Public Policy*.

frequently mentioned definitions in the existing literature. Schumpeter, for example, argued that “Democracy means only that people have the opportunity of accepting or refusing the man who are to rule them.”⁵² Huntington added more concrete elements in his definition of democracy: “the most powerful collective decision makers are selected through fair, honest and periodic elections in which candidates freely compete for votes and in which virtually all the adult population is eligible to vote.”⁵³ Dahl clearly listed the key institutional requirements of democracy: election of government officials, free and fair elections, inclusive suffrage, right to stand for election, freedom of expression, free access to alternative sources of information and associational freedom.⁵⁴ Another relatively concise but comprehensive definition which I prefer is made by Centeno. He defined democracy as “requires the provision for participation of all adult members of a community, freedom to formulate and advocate political alternatives, and the credible possibility of turnover in power.”⁵⁵ To a large extent, this definition could seem to catch all the essential points of the definitions mentioned above. Accordingly, “democratisation” or “democratic transition” can be “defined as the transformation from a non-democracy to

⁵² Schumpeter, *Capitalism, Socialism and Democracy*, 268-70.

⁵³ Huntington, *The Third Wave*, 7.

⁵⁴ Dahl, *Democracy and Its Critics*, 221.

⁵⁵ Centeno, “Between Rocky Democracies and Hard Markets: Dilemmas of the Double Transition,” 126.

representative and accountable government.”⁵⁶

As for democratic consolidation, Huntington’s well-known criteria --- two turnover test --- still worth our attention. He argued that a democracy can be considered consolidated if it can survive two changes in ruling parties through post transition elections.⁵⁷ Another famous definition is Przeworski’s “the only game in town.” For him, “Democracy is consolidated when under given political and economic conditions a particular system of institutions becomes the only game in town and when no-one can imagine acting outside the democratic institutions.”⁵⁸ I tend to use both definitions together in the thesis as they are complementary to each other.

Now I return to the theme of this section --- the relationship of democracy and development in East Asia. In a sense, the experience of democratic breakthroughs in East Asia over the 1980s fits the argument and prediction of modernization theory. Martin Seymour Lipset, a master of the theory, has argued that democracy is a product of modern capitalism. Due to modernization, a wealthier and better educated population and large middle class are created. This demographic and class structure change, in the meantime, triggers a cultural change favourable to democracy such as secularism and erosion of traditional hierarchal values. In short, once a country

⁵⁶ Fell, *Government and Politics in Taiwan*, Chapter 3, 1.

⁵⁷ Huntington, *The Third Wave*, 267.

⁵⁸ Przeworski, *Democracy and the Market; Political and Economic Reforms in Eastern Europe and Latin America*, 26.

achieves certain pre-conditions of economic wealth, democratisation should be expected to take place.⁵⁹

Nevertheless, even though modernization theory is right about how democratisation began in some East Asian countries,⁶⁰ it is unable to answer whether democracy can maintain or create higher economic growth in these new democratic countries of the region. Indeed, so far strong empirical evidence in supporting that democracy promotes development is still in short supply. In fact, as Benjamin M. Friedman has reminded us that, “Even within the Western world ... where electoral democracy and a market-oriented economy are mostly taken for granted --- parallel movement does not automatically imply a causal linkage.”⁶¹ Furthermore, in recent years, due to the dramatic rise of China’s economic power, the so-called “Beijing Consensus,”⁶² which promotes economic development without democratisation, is gaining prestige within Asia and beyond and challenging the status of the neoliberal doctrine “Washington Consensus.”⁶³ As a result, China up to now has become a strong case for rejecting the notion that democracy is necessary for economic development.

⁵⁹ Lipset, “Some Social Requisites of Democracy: Economic Development and Political Legitimacy.”

⁶⁰ Some criticize that modernization theory ignores the importance of elite level interactions in shaping the course of democratic breakthrough, transition and consolidation. See Rustow, “Transition to Democracy: Toward a Dynamic Model.” But this criticism and other related debates on what make democratisation likely are not relevant here.

⁶¹ Friedman, “Capitalism, economic growth & democracy,” 47.

⁶² Ramo, *The Beijing Consensus: Notes on the New Physics of Chinese Power*.

⁶³ Williamson, *The Political economy of policy reform*. Peerenboom, *China Modernizes: Threat to the West or Model for the Rest?*.

In sum, as some East Asian developmental states enter their democratic eras, what democracy can deliver for economic development to them is by no means certain. Actually, as the experience of the states in East Europe and former Soviet Union had shown in the 1990s, young democratic regimes were often very fragile when they failed to deliver sound economic growth as expected. Likewise, for those young East Asian democracies which are still in the process of democratic transition and consolidation, there is no way to rule out the possibility of the return of authoritarian rule.

However, two things seem apparent in East Asia. One is that: “The regulatory space is clearly now more crowded than in the past, whether in authoritarian states such as China or Vietnam, or in post-developmental states such as Japan or South Korea, where the influence of the technocratic elite has waned in the wake of the Asian financial crisis and economic stagnation.”⁶⁴ The other one is that “In general, civil society plays a more active role in policymaking in democratic Asian states.”⁶⁵ How the “more crowded regulatory space” and “more active civil society” are shaping the East Asian model is the core subject of the thesis.

⁶⁴ Gillespie and Peerenboom, “Pushing back on globalization: an introduction to regulation in Asia,” 10.

⁶⁵ Ibid, 17.

5. What is the special role of Taiwan?

Taiwan is a special case in the debate of assessing the East Asian model over the past decade after the Asian financial crisis. Firstly, right after the crisis, it emerged as a strong case to prove the strength of the model. The main reason behind this was that Taiwan appeared relatively unscathed at a time when many of its neighbours fell apart in the powerful financial storm.⁶⁶ As a result, Taiwan has been frequently compared with those East Asian countries which failed to weather the storm. Among those comparison studies, “Taiwan vs. South Korea” during the regional financial meltdown is the most mentioned theme, as they are the two core developmental states in Northeast Asia. The main argument behind Taiwan’s success and South Korea’s failure was that the developmental state in South Korea was dismantled in the 1990s before the regional storm as Taiwan kept its intact.⁶⁷ Meanwhile, Taiwan is also been used to rebut the claim that crony capitalism was the main cause behind the regional financial crisis. For example, Godement notes that Taiwan survived despite the fact that Taiwan's politics and public economy are riddled with the special relationships, shady dealings and complete opacity now universally ascribed as the main reason for

⁶⁶ Kuo and Liu, “Taiwan.”

⁶⁷ For example, please see Thurbon, “Two paths to financial liberalization.” Kondoh, “Policy networks in South Korea and Taiwan during the democratic era.” Smith, “The state, banking and corporate relationships in Korea and Taiwan.” Zhang, “Domestic institutions, liberalization patterns, and uneven crises in Korea and Taiwan.” Weiss, “State Power and the Asian Crisis.”

Asia's fall from grace.⁶⁸

But as Taiwan began to suffer from its domestic financial troubles from late 1998 to 2003,⁶⁹ the strength of its developmental state was gradually challenged by other researchers. Kuo, for example, notices that an emerging “distorted democracy” in Taiwan has gradually jeopardised its state’s capacity of economic governance.⁷⁰ Kuo and other scholars in different papers also particularly highlight the impact of democratisation on Taiwan’s financial sector.⁷¹ With similar arguments, some researchers take an even more pessimistic view on Taiwan’s developmental state. Take Lee Pei-shan’s research as an example. The title of her work, “Democratization and the Demise of the Developmental State,” has clearly indicated her main argument that “the demise of the developmental state has its domestic sources.”⁷² By examining the case of Taiwan, she shows how democratization since the mid-1980s has incrementally undermined the institutional foundations for effective functioning of the developmental state. She finds that “electoral competition ended the KMT’s one-party dominance which, like it or not, had provided a stable, predictable and

⁶⁸ Godement, *The Downsizing of Asia*, 55-56.

⁶⁹ The troubles here refer to a looming bad loan crisis of the banking sector. Please see Chapter 6 of the thesis for details on the crisis.

⁷⁰ Kuo, “Taiwan's Distorted Democracy in Comparative Perspective.”

⁷¹ Kuo, Chen and Huang, “You qian dajia zhuan? Minzhuhua dui Taiwan jinrong tixi de yingxiang” [Is there money everybody can get?: Impact of democratization on Taiwan's financial system]. Kuo and Chen. “The Growth of Casio Capitalism: Mixed Reforms of Financial Institutions.” Sato, “Democratization and Financial Reform in Taiwan: The Political Economy of Bad-Loan Creation.”

⁷² Lee, “Democratization and the Demise of the Developmental State,” 1-2. Also see Lee and Chu’s paper: “The New Political Economy after Regime Turnover: An Assessment of the First Chen Shui-bian Administration.”

institutionalized environment for economic governance. The delivery of particularistic goods to win votes and reward followers corrupted the process of economic policymaking. Distribution coalitions sprang up and the economic bureaucracy often stood at the sideline.”⁷³

A more recent example is the work of Wu Yu-shan. Though he does not use “demise” to describe the status of the developmental state in Taiwan, his argument is similar. He contends that “It is clear that democratization in the 1990s softened Taiwan’s erstwhile authoritarian regime and dampened the power of the economic bureaucracy – the engine of the capitalist developmental state.”⁷⁴ He argues that the Asian financial crisis and the two political shocks⁷⁵ before and after the crisis have seriously undermined Taiwan’s developmental state structure due to political reasons.⁷⁶ After examining four key industrial cases that he chooses, he finds that “interest politics replacing regime autonomy, electoral competition leading politicians away from developmentalism, economic dynamism blunting state penetration, and bureaucrats making risky forward designating under great pressure.”⁷⁷ Although

⁷³ Ibid, 21.

⁷⁴ Wu, “Taiwan’s Developmental State: After the Economic and Political Turmoil,” 978.

⁷⁵ According to Wu, the first political shock was democratization in the late 1980s and early 1990s; the second political shock was the transfer of power from the KMT to the DPP in 2000. The former brought down Taiwan’s economic growth from an average of 8.2 per cent in the 1980s to an average of 6.5 per cent in the 1990s; the latter, accompanied later by an international slowdown, further drove the growth rate down to an average of 3.7 per cent in 2000–06. Wu, “Taiwan’s Developmental State: After the Economic and Political Turmoil,” 982.

⁷⁶ Ibid.

⁷⁷ Ibid, 1001.

admitting that the old structure of the developmental state in Taiwan is not completely dismantled by democratisation, he emphasizes that the challenge ahead for Taiwan will be “to combine those elements from their old developmental model that are conducive to growth and the requirements of democratic governance.”⁷⁸

This, however, is not the end of the debate. Some of those who are arguing for the resilience of the East Asian model prefer to use “adaption” rather than “obsolescence” to indicate the reconfiguration of the model. For instance, Wong has argued that “The developmentally oriented state continue to play important roles in East Asia’s economic, social, and political development.”⁷⁹ He warns that “One should not equate liberalization, globalization, transnational harmonization, or economic policy convergence with the retreat of the state from the tasks of promoting national development.”⁸⁰ He cites Japan, South Korea, Taiwan and China to show that the developmental states “continue to experiment with industrial policies, R&D policies, social welfare reforms, and economic policy more generally in creative ways, albeit under many more constraints.”⁸¹

Dent also has similar observation by examining the recent development in technical

⁷⁸ Ibid, 1001.

⁷⁹ Wong, “The Adaptive Developmental State in East Asia,” 357.

⁸⁰ Ibid.

⁸¹ Ibid.

aspects of Taiwan's foreign economic policy.⁸² He argues that "smart approaches to economic liberalization do not necessarily require a weakening of state capacity but rather its upgrading."⁸³ According to his research, Taiwan has adopted a "liberalisation plus" approach --- synchronous liberalisation with re-regulation --- in dealing with the pressure of economic liberalisation, "revealing the adaptive nature of the Taiwanese developmental state."⁸⁴ "As trade liberalization is intended to open up Taiwan's firms to greater international competition, so Taiwan's industrial policy is simultaneously designed to enhance the economy's export competitiveness and techno-industrial advancement --- the tools may have changed but the underlying objectives of industrial policy have not."⁸⁵ Hence, he concludes that "the Taiwanese experience demonstrates that liberalisation can be most effectively implemented in an environment where comparatively high degrees of state capacity and institutionalized market order are evident."⁸⁶

As for the future of the East Asian model, however, Wong adds a cautious tone. It "will be shaped by how the developmentally oriented state adapts to the politics of democracy."⁸⁷ Still, overall, it will be unwise to assert the doom of the model in

⁸² Dent, "Taiwan's Foreign Economic Policies: The Liberalisation Plus Approach of an Evolving Developmental State."

⁸³ Ibid, 461.

⁸⁴ Ibid, 468.

⁸⁵ Ibid, 480.

⁸⁶ Ibid, 481.

⁸⁷ Wong, "The Adaptive Developmental State in East Asia," 358.

Taiwan and other East Asian countries at this early stage.⁸⁸

All these existing researches on the developmental state related to Taiwan in recent years recall an important issue about the East Asian model: the relationship of democracy and development in East Asia in the present day. But the verdicts are quite different. On the one hand, Taiwan appears to be struggling of making a balance between democratic rule and governance for effective economic development. On the other hand, Taiwan also has been adapting to the changing global economy well in many other ways. This double face regarding Taiwan's developmental state makes Taiwan a perfect case for study on the political challenges that the East Asian model is facing.

To sum up, from the brief review above, it seems that Taiwan has a strong potential as a subject for a case study approach to examine the status of the East Asian developmental states. That is, if we could clarify what has happened to the developmental state in Taiwan before and after the Asian financial crisis, it would help us figure out whether the special mode of development in East Asia could still survive in the changing global economy.

⁸⁸ Chen I-ru's study on financial liberalisation in Taiwan particularly demonstrates the capability of the developmental state in implementing an orderly financial liberalisation in Taiwan during the 1990s. See Chen, *State Autonomy and Financial Liberalization in Taiwan*.

6. How the research was conducted and built upon existing literature?

Against such a backdrop, a study on the process of financial reform initiated by the state in Taiwan from 1988 to 2008 is aimed at responding to those mixed views on Taiwan. By addressing the issue, it is hoped to shed some light on the status of the developmental state in Taiwan and thus on the prospects for the East Asian model.

6.1 The connections and differences

Inspired by the given literature mentioned above, there are two main reasons to specifically focus on the politics of Taiwan's financial reform. First, as the whole debate concerning the East Asian model has escalated to a peak level over the past decade after the Asian financial crisis of 1997-98, how the Taiwanese state handled financial reforms and crises before and after the regional financial crash is undoubtedly highly relevant. Second, since its commencement in the late 1980s, large-scale financial liberalisation has been undertaken by the state in Taiwan for more than two decades. Through examining the long process of financial engineering launched by the Taiwanese state, we can get a more complete picture about the status of the developmental state in Taiwan.

In my study, I stress the importance of the impacts of rapid political democratisation

on the financial governance of the state. Overall, I argue that the developmental state in Taiwan has been under increasing constraints imposed by the new political forces and structures as a result of Taiwan's rapid democratisation since the late 1980s. This line of argument is following the existing researches of Kuo, Chen, Sato, Lee and Wu, who have singled out the negative impacts of democratisation on economic governance of the state in Taiwan as just mentioned. What distinguishes my study, however, is the scope of research. While the above authors only focus on very limited cases since the late 1990s, my study covers the most important cases of financial reform since the launch of financial liberalisation by the state in the late 1980s.

My argument is also inspired by the given literature which examines the weakness of the East Asian model, particularly those on the crony capitalism in East Asia. The most relevant part of this kind of research is about the moral hazard behaviour of poorly regulated banks and firms in particular, and crony capitalism in general. However, I agree with the criticism that one should explain why moral hazard and crony capitalism were not detrimental to the banking sector and wider economy prior to 1997 in East Asian developmental states. Therefore, it is important to make clear why moral hazard and crony capitalism only seriously damage the function of the developmental state in a democratic era in Taiwan. In my view, both of them are embedded in some contexts of a political economy. Instead of making judgments from

a normative perspective and dismissing it immediately, we have to examine them in a positivist way within historical contexts.

6.2 A comparative historical study

My research basically is a comparative historical study. With a holistic view of methodology, a comparative historical study emphasizes history, relationship, interaction, structure and context. If we look back at the development of social science in the past three decades, we can discern a number of scholars who advocate similar concepts or perspectives.⁸⁹ Most of them come from the school of neo-Weberian historical sociology.⁹⁰ The neo-Weberians emphasize taking the state seriously and put it in a broader context in their analysis. They not only ask us to “bring the state back in”⁹¹ but also stress that the state is embedded in domestic and international society. Besides, in adopting comparative historical analysis in their studies, they have to go back to the history of a specific country to find the answers. Meanwhile, by comparing different cases or times, they can acquire additional knowledge about similar patterns of dynamic and enrich their concepts for further

⁸⁹ See Mann, “The autonomous power of the State: its origins, mechanism and results.” Evans, *Embedded Autonomy: States and Industrial Transformation*. Hobson, *The wealth of states: A comparative sociology of international economic and political change*. “The two waves of Weberian historical sociology in international relations.” Hobson and Weiss, *States and Economic development: A comparative Historical Analysis*. Pempel, *Regime shift: comparative dynamics of the Japanese political economy*. Weiss, *The Myth of the Powerless State: Governing the Economy in a Global Era*.

⁹⁰ Hereafter referred as the neo-Weberian school.

⁹¹ Skocpol, “Bringing the State Back In: Strategies of Analysis in Current Research.”

research.

In addition, the methodology of the thesis is also inspired by Przeworski's views on social relations. He argues that:

“Social relations are treated here as structures of choices available to the historical actors, individual and collective, at each moment of history, and in turn as the outcomes of strategies adopted earlier by some political forces. Behavior is thus analyzed as strategic action, oriented toward goals, based on deliberations, responding to perceived alternatives, resulting from decisions.”⁹²

“If we are to draw lessons from historical experience, we can assume neither that the practice of political movements is uniquely determined by any objective conditions nor that such movements are free to act at will, independently of the conditions they see to transform. These conditions constitute at each moment the structure of choice: the structure within which actors deliberate upon goals, perceive alternatives, evaluate them, choose courses of action, and pursue them to create new conditions.”⁹³

To be more specific, the thesis tends to see the relationship between (political, economic, social and historical) structures and actors in a mutually-dependent way similar to Przeworski's views on “the structure of choice” and “actors.” I contend that as structures constrain and shape the behaviour and decision of actors, the actors' response will also alter structures in return. Since the thesis focuses on

⁹² Przeworski, *Capitalism and social democracy*, 5.

⁹³ *Ibid*, 3

democratisation and transformation of the developmental state, this structure/actor view will be helpful in examining the complicated process involved. This is also indispensable to a holistic view of methodology mentioned above.

As a matter of fact, my holistic view of methodology is also echoing Polanyi's views to see "the market as part of the broader economy, and the broader economy as part of a still broader society"⁹⁴ In my view, a country is an organic entity, in which economy, society and the state are closely linked to each other in a complex way. With this in mind, Polanyi's insight about "the complex intertwining of politics and economics"⁹⁵ should be taken seriously to any researcher in the field of political economy.

6.3 The research

However, unlike most predecessors who used more than two cases (countries) to determine similarity or difference in their comparative historical analysis,⁹⁶ I use one case (country) to do cross-time comparison. Since my concern is the process of the financial liberalization in Taiwan, I explore and compare the performance of the state in terms of its financial governance at different stages in different issues related to financial reform.

⁹⁴ Stiglitz, "Foreward," XV. In 2001, Stiglitz wrote a foreword for Palanyi's influential book: *The Great Transformation: The Political and Economic Origins of Our Time*.

⁹⁵ Ibid.

⁹⁶ Skocpol, *States and Social Revolutions: A Comparative Analysis of France, Russia, and China*. Evans, *Embedded Autonomy: States and Industrial Transformation*.

Moreover, a comparative historical analysis involved a great deal of reading and hinged heavily on the researcher's subjective selection. In order to prevent the research result from becoming just a personal judgment, repeated cross-checks from different sources such as interviews, official reports and other related findings from some academic agencies were necessary and helpful. I have employed the following sources:

1. Books

the secondary literature, in English and Chinese, on developmental states, financial reform (or liberalization) and international political economy.

2. Journals

Comparative Politics, Comparative Study, World Politics, Review of International Political Economy, New Political Economy, Review of International Studies, Journal of East Asian Studies, China Quarterly, the Pacific Review, Comparative Political Studies, Pacific Affairs.

3. Newspapers:

The Economist, Financial Times, Taipei Times, Tzuyou shihpao [自由時報, Liberty Times], Chungkuo shihpao [中國時報, China Times], Lienhepao [聯合報, United Daily], Chingchi jihpao [經濟日報, Economic Daily News], Kungshang shihpao [工商時報, Commercial Times].

4. Magazines:

the most popular magazines focusing on finance and politics are Shangyeh choukan [商業週刊, Business Weekly], Tsaihsun [財訊, Wealth Magazine], Hsinhsinwen [新聞, The Journalist].

5. **Official publications:**

involving question time minutes, policy announcements and regulations made by the Legislative Yuan and other key government branches, departments or agencies.

6. **Internet:**

financial statistics, electronic journal or papers, reports of international organization, think tanks and government agencies could be found in the following websites:

IMF: <http://www.imf.org>,

National Bureau of Economic Research: <http://www.nber.org/> ,

The Central Bank of Taiwan: <http://www.cbc.gov.tw> ,

The Ministry of Finance: <http://www.mof.gov.tw/mp.asp?mp=1>,

Financial Supervisory Commission: <http://www.fscey.gov.tw/>,

Directorate General of Budget, Accounting and Statistics:

<http://www.dgbas.gov.tw/mp.asp?mp=1>.

7. Informal **field interviews** with policy insiders and senior bankers in Taiwan's banking sector.

The main purpose of my field interview was not to directly quote what my interviewees say but to provide me with a critical source for double-checking my observations or correcting my research direction. Nevertheless, in order to get more systematic and complete information from the interviewees, my interview **questions** focused on the general issue areas of:

Where did the financial disorder come from in recent decades?

Why did the government push for financial liberalization?

What were the main government policies in dealing with financial liberalisation?

The method, goal and difficulty of managing financial liberalization

The comparison of the banking market between and after financial liberalization

The banks' strategy for competition in the new banking market

Appendix A is a list of interviews I conducted over 2003 to 2005.

Chapter Three

The Taiwanese Context

This chapter is aimed at setting the scene for the following case chapters on the four major issues of financial reform in Taiwan from 1988 to 2008. It addresses the general context against which the four issues were initiated and handled. Since Taiwan is the focus of the study, this chapter begins with a general introduction about Taiwan and its history before 1945. Then the next section goes further to a broad review on the political and financial development in Taiwan from 1945 to the late 1980s. It is outlined to present the big picture of how the KMT authoritarian regime maintained its rule and legitimacy and how the financial sector evolved against such a political backdrop during the period. Then the focus shifts to the dramatic years of Taiwan's rapid democratisation from the late 1980s to 2000. While the KMT seemed to deal with the impacts of democratisation well, its autonomy was in decline. Against such a background, the state's launch of financial liberalisation, the main theme of financial development during the 1990s, encountered various delays and failures. At last, the final section introduces the new development of politics and financial reform amid the DPP years from 2000 to 2008. It highlights the characteristics of the new political landscape and how these affected financial reform under the DPP rule.

Together, these reviews will present a general background for bridging to the next four case chapters in which how political democratisation had significantly affected the state's financial governance in Taiwan over the recent two decades are examined.

1. Taiwan before 1945

At first glance, Taiwan is one of Asia's few functioning democracies with strong economic performance. Its achievement in pursuing democracy and economic development could be easily demonstrated by the following statistics and surveys. First, according to the Freedom House, a US non-governmental organization which conducts annual survey on the freedom of the press around the globe, Taiwan was listed as a "free county" and its ranking was the highest in Asia in 2007.⁹⁷ In the individual country report of the survey, the organization specifically said:

“Taiwan is known for having one of the freest media environments in East Asia because of its firm commitment to judicial independence and economic freedom. The constitution provides for freedom of speech and of the press, and the government generally respects these rights in practice.”⁹⁸

Considering that Taiwan was still under authoritarian rule before the early 1990s, the ranking and comment are particularly significant.

⁹⁷ Of all the 195 countries included in the rankings, Taiwan was listed in the 33rd spot, ahead of Japan at 39th, South Korea and Hong Kong at 66th, and Singapore at 154th. Please see Freedom House, *Freedom of the Press 2007: A Global Survey of Media Independence*.

⁹⁸ It is cited from the report at <http://www.freedomhouse.org/template.cfm?page=251&country=7283&year=2007> (accessed June 27, 2008).

Second, on the economic side, according to a report by the World Trade Organization (WTO), Taiwan was the world's 16th-largest exporting nation of merchandise trade in 2007 with exports valued at US\$246 billion.⁹⁹ On top of that, Taiwan's gross domestic product (GDP) per capita was US\$17,252 in 2007 and it was the world's 24th-largest economy in terms of GDP in the same year. For a small country¹⁰⁰ lacking ample natural resources for its development and still regarded as a less developed country in the 1950s, these statistics mark Taiwan's remarkable achievement in economic growth over the past decades as a newly industrialised economy.

Behind these recent achievements, however, Taiwan's history is full of struggle and pain in fighting for controlling its own destiny. Located in the Western Pacific Ocean, Taiwan is an island between Japan and the Philippines off the southeast coast of China, from which it is separated by the Taiwan Strait. Before the 17th century, Taiwan was a wild land inhabited by aboriginals who were a part of the Austronesian people and it was visited mainly by pirates and fishermen around the region. It only began to draw significant attention from the outside world when some European powers such as Portugal, Spain and the Netherlands sailed to Southeast Asia from the mid-1500s to the early 1600s. With an eye on expanding trade in East Asia, both the Spanish and

⁹⁹ World Trade Organisation, *WORLD TRADE 2007, PROSPECTS FOR 2008*.

¹⁰⁰ With a total area of about 36,179 square kilometres, Taiwan is 394 kilometres long and 144 kilometres wide at its widest point. Its size is approximately equal to that of Wales.

the Dutch established their forces in Taiwan. But their stay was short and their influence was small compared to the rule of the two Chinese Empires (Ming and Qing) over Taiwan from 1662 to 1895.

The Han Chinese's settlement in Taiwan began in the late years of the Ming Empire after Cheng Cheng-kung (also known as Koxinga) and the Ming loyalists drove the Dutch from Taiwan.¹⁰¹ Cheng and his followers used Taiwan as a base to fight against the Manchu who invaded the Ming Empire and established the Qing Empire. But soon the Qing Empire took over Taiwan and began its rule over the island until 1895. While the Han Chinese immigrants surged during this period and soon became the majority of residents on the island, the Qing Empire was not active in its rule over Taiwan until the late 19th century before its war with Japan. The change of the attitude, however, was too late and Taiwan was finally ceded to Japan in the Treaty of Shimonoseki after Japan won the Sino-Japanese war in 1895. Subsequently, Taiwan was a colony of Japan for 50 years until 1945.

The Japanese colonial rule significantly transformed Taiwan and left a strong legacy. Firstly, Taiwan was forced to be rapidly modernized and industrialized in five decades. During its rule, Japan not only imposed Western systems of administration, law,

¹⁰¹ The Dutch only stayed in Taiwan from 1622 to 1661.

finance, public health and education on Taiwan but also built or upgraded¹⁰² Taiwan's modern infrastructure such as railway networks, irrigation systems, ports, power plants and telecommunication networks. Though mainly out of its ambition to establish an empire in Asia --- by using Taiwan as a bridge and base to provide necessary resources that could help its expansion and colonial rule in Southeast Asia, Japan's contribution to Taiwan's modernisation in the early 20th century cannot be denied. In a nutshell, Japan set the institutional grounds and basic infrastructural frameworks for Taiwan's development after 1945.

Secondly, the Japanese colonial rule raised a vast barrier between the Han Chinese in Taiwan and their counterparts in China, sowing the seeds of conflict in the future after China regained Taiwan in 1945. The barrier was multiple. It was involved living standards, ways of life, culture, historical memory and identity and so forth, due to Taiwan's nearly total insulation from what happened in China during the 50-year colonial rule of Japan. For the Han Chinese in Taiwan, relatively, they had lived a more modernized life than their counterparts in China. In addition, they had been forced to identify themselves with Japan as the colonial regime ruthlessly implemented its assimilation policy after 1936¹⁰³ --- at a time when their motherland

¹⁰² In its late years in Taiwan, the Qing Empire had begun to build some modern infrastructure.

¹⁰³ The policy was so effective that most Taiwanese had Japanese names and some were even willing to fight for Japan during the Second World War

was in a war with Japan for eight years until 1945.¹⁰⁴

2. Political and financial developments in the KMT era

(Part 1: from 1945 to the late 1980s)

After the end of World War Two, China reinstated its control over Taiwan in accordance with the Cairo and Potsdam Agreements. At first, most Taiwanese were enthusiastic about the return and tried to adapt to the new regime from the motherland. But soon their initial enthusiasm and positive attitude turned into immense despair and anger after they found that the new government and troops from mainland China were so ignorant, arrogant and corrupt --- even worse than the previous colonial regime of Japan.¹⁰⁵ The resentment and tension surged after numerous clashes took place at a time when Taiwan's economy rapidly deteriorated and people's life turned into being unbearable as a result of the poor governance of the new regime.

In the meantime, the new regime thought that the local Taiwanese should thank the

¹⁰⁴ When Taiwan was ruled by Japan from 1895 to 1945, China was experiencing sea changes. The last dynasty in China's history, Qing, was overthrown by the nationalists in 1911 and the Republic of China (ROC) was established in 1912. But afterwards the new republic was weak and unstable. Firstly, the republic ran into years of domestic conflicts among the warlords. Then, after Chiang Kai-shek of the KMT achieved a partial unification of the country following the Northern Expedition, the communists were still independent from the control of Chiang's regime. The rivalry between the KMT and the communists relatively cooled down during China's war with Japan in 1937-1945, but escalated into a civil war in 1945 after Japan surrendered.

¹⁰⁵ When the KMT government in China took control of Taiwan in 1945 after Japan was defeated, it took over many assets belonging to either the Japanese colonial government or citizens. In the age of the KMT party-state rule, a significant part of these properties became private-owned by the KMT itself, planting seeds of the future controversy about the legitimacy of KMT's assets. The issue is still in dispute now.

motherland for what it had sacrificed during the war with Japan. From its perspective, the sacrifice was crucial in ending the Japanese colonial rule. Besides, it also suspected that the Taiwanese had been “brain-washed” by Japan in their culture and thinking. It had doubts about the loyalty and identity of the Taiwanese to China. From its standpoint, the Taiwanese needed to be re-educated to become Chinese again.¹⁰⁶

The tension between the local Taiwanese and the new Chinese regime eventually escalated into to an island-wide uprising of local people against the new regime for weeks in 1947. The uprising was triggered by an incident involving a conflict between the police and a female vendor of cigarettes in the capital city Taipei on February 28. Due to the inept response of the police, the incident turned into a riot of local citizens in Taipei for protest and revenge and then soon expanded into an island-wide uprising. Shocked by the scale of the revolt, the central government in China led by Chiang Kai-shek of the KMT sent more troops to Taiwan to “restore order.” As a result, thousands of Taiwanese people died during the ruthless military crackdowns.¹⁰⁷ This is the so-called “228 incident,” which forged the foundation of the anti-KMT forces. It created enduring ethnic tensions between the local Taiwanese¹⁰⁸ and new immigrants

¹⁰⁶ In my opinion, Wu Cho-liu’s two historical works of fictions can best illustrate the context of the lack of trust and understanding between the local Taiwanese and the new regime: *Yaxiya de guer* [Orphans of Asia] and *Wu hua guo* [The fig]. These were both published around this time.

¹⁰⁷ There is still no official number about the accurate death toll in the incident. A cautious estimation is that at least 10 thousand people died in the incident and the following crackdowns. See Li, “Ererba shijian siwang duoshaoren?” [How many people died in the 228 incident?].

¹⁰⁸ They are the so-called *Benshengren* (meaning people of this province) and now make up approximately 85 per cent of Taiwan’s population. Their ancestors came mainly from two of China’s

who came to Taiwan with the KMT regime,¹⁰⁹ and propelled some Taiwanese to pursue Taiwan's independence.

Taiwan's status entered into an ambiguous stage after the KMT lost the civil war to the Chinese Communist Party (CCP) and completely retreated to Taiwan in 1949.

After the CCP successfully established a new regime --- People's Republic of China

(PRC) --- in China, the KMT insisted that its Republic of China (ROC) still existed

even though it only had Taiwan under its jurisdiction. It claimed that the civil war was

not finished and the ROC was still the only legitimate government of the whole China.

It pledged to retake mainland China in the near future when the time was ripe. As

such, what Taiwan stood for became complicated. On the one hand, Taiwan was still a

part of the ROC as a province according to the ROC constitution; on the other hand,

as its territory was almost completely overlapping with that of the ROC,¹¹⁰ Taiwan

was de facto an equivalent of the ROC as a country.

The claim that the ROC still existed in Taiwan, however, could only be sustained

internationally under the support of the U.S. in the first half of the Cold War. Initially,

southeast provinces - Fujian and Guangdong. Due to their difference of local dialects from their original places, *Benshengren* could be further broken into two ethnic groups: Holo and Hakka. The population of the Holo group reaches 73 per cent of the total in Taiwan; the Hakka has only 12 per cent.

¹⁰⁹ They are the so-called *Waishengren* (meaning people from outside the province) or mainlanders and now make up approximately 13 per cent of Taiwan's population. Due to *Waishengren's* close relationship with the KMT regime, this group dominated Taiwan's politics for many years before Taiwan's democratisation in the late 1980s.

¹¹⁰ In addition to the province of Taiwan, the ROC government still controls a small part of Fujian province, which consists of only two small island counties - Kinmen and Lienchiang - off the southeast coast of China.

in fact, the U.S. took a hands-off attitude towards the KMT regime, which was on the verge of a total collapse in 1949. The outbreak of the Korean War in 1950, however, forced the U.S. to change its stance. It began to bolster the KMT regime with a timely injection of economic and military aid until the regime was relatively consolidated in the late 1960s. In return, the KMT regime, as the U.S. expected, played a role in countering the spread of communism and the influence of “Red China” in East Asia. Thus, the ROC in Taiwan under the KMT regime was portrayed by the West, the U.S. in particular, as a symbol of “Free China” during the early years of the Cold War.

Yet, domestically, the “Free China” discourse was maintained in quite ironic ways. On the one hand, Chiang Kai-shek and his KMT built a Leninist party-state in Taiwan to ensure its effective monopoly of power and control over people. In the name of the unfinished civil war with the CCP, martial law was imposed to serve the party-state by essentially stripping away people’s political rights and liberties and ruthlessly cracking down on political dissents as well as tightly controlling the media.¹¹¹ On the other hand, in an attempt to demonstrate its difference from the CCP to the West, the KMT allowed open and direct elections to be held at local levels from the 1950s. In later years, it also allowed partial by-elections for lawmakers of the Legislative Yuan

¹¹¹ The martial law rule was maintained from 1949 to 1987, the longest ever in the world history.

(Taiwan's parliament) and members of the National Assembly¹¹² when it was no longer likely to recruit vacancies with replacements in Taiwan.¹¹³ Nevertheless, those elections were far from being fair and democratic. Only a small minority of seats were open for direct election. People were forbidden to form political parties to challenge the KMT, and election fraud, like vote-buying was common. Elections in Taiwan under the martial law rule were more for painting the KMT government as a pro-democracy regime.

The claim of "Free China" was, after all, no match for the evolving political reality in the world politics. With the CCP consolidating its rule in China and more and more countries recognising the PRC instead of the ROC as the only legitimate regime of China, it was getting unrealistic to convince the international community about the continued existence of ROC and its claim over China. The defining moment finally came in 1971 as the majority of the member countries of the United Nations (UN) decided to replace the ROC with the PRC to hold the seat of China in the UN. Then, shortly after the devastating blow, the U.S., Taiwan's most important ally, also prepared to normalize its relations with the PRC. In 1978, the U.S. finally ended its

¹¹² This was Taiwan's second parliament which used to be mainly in charge of constitutional amendments and electing the president and vice president of the country on a four-year basis before 1996. It was abolished in June 2005.

¹¹³ Before the KMT officially gave up its goal to retake the mainland China in the early 1990s, it insisted that Taiwan's parliament had to be composed of members from the constituencies of all China, an attempt to maintain its legitimacy as a regime for the whole China. Thus, all lawmakers elected before 1949 in China could keep their positions in Taiwan permanently until they died.

formal relationship with the ROC and officially recognised the PRC. As a result, the legitimacy of the KMT regime and Taiwan as a country in the international community was seriously undermined.

Still, the KMT regime and Taiwan did not collapse afterwards. Externally, it was mainly because of the continued strong commitment of the U.S. to safeguard Taiwan from the military threats from China. Though the U.S. no longer had formal diplomatic relations with Taiwan after 1978, through the Taiwan Relations Act passed by the U.S. Congress in 1979, the U.S. still maintained a strong and close “informal” relationship with Taiwan. According to the act, the U.S. was committed itself to providing Taiwan with defensive weapons and implicitly ensuring the safety of Taiwan if it was attacked by the PRC.

Domestically, the rapid progress of economic development was the key to preventing the KMT regime and Taiwan from falling apart. Thanks to the success of its export-oriented strategies, Taiwan’s economy grew at double-digit rates in the 1980s and emerged as a new economic power house in Asia into the 1990s, known as one of four little Asian “dragons” or “tigers.”¹¹⁴ Thus, against the thriving economy and achievement of economic growth, the confidence of people in Taiwan was greatly

¹¹⁴ The four little dragons were Hong Kong, South Korea, Singapore and Taiwan.

boosted. Meanwhile, while what has contributed to “Taiwan Miracle”¹¹⁵ is open to debate,¹¹⁶ the forward and effective industrial policies formulated by the strong developmental state under the KMT regime were widely regarded as one of the key factors. In a word, the falling legitimacy of the KMT regime was significantly shored up by its performance in economic governance.

The success of the developmental state in Taiwan from the 1950s to the late 1980s relied on its exceptional autonomy and capacity. The strong autonomy of the developmental state came from both the authoritarian nature of the KMT regime and the regime’s weak linkage with the local society in the past. Due to the autonomy, the developmental state was relatively independent of the influence of the society and was able to be less constrained by the society in decision-making. But the strong autonomy did not guarantee that the state was always capable. The high capacity of the state, actually, came from a group of capable economic technocrats. Empowered by the KMT regime, these technocrats were capable of setting the target and strategy for national development from a long-term perspective of national interest. But, why was the KMT regime willing to empower the economic technocrats? Firstly, as a regime which had few linkages with the Taiwan society before 1945, the KMT was

¹¹⁵ See the term used in Gold, *State and Society in the Taiwan Miracle*.

¹¹⁶ For example, some have stressed the effects of the Cold War on promoting Taiwan’s economic growth. They argue that countries in the U.S. camp during the war often benefited from special market access arrangements of export products to the U.S. See Heo and Tan, “Democracy and Economic Growth: A Causal Analysis.”

clearly aware that its legitimacy was largely built upon its performance in pushing for economic development. It needed the skilful bureaucrats to make this happen and continue. Secondly, the KMT heeded its lesson of losing the Chinese civil war to the CCP: economic disorder would easily trigger social unrest, costing its power. Thirdly, the threat of the military invasion of the PRC reinforced the KMT's commitment to economic development, a crucial base of national survival.

Under such circumstances, the financial development was under the strong control of the state from 1945 to the late 1980s. Two measures were undertaken to ensure the strong grasp of the state on the financial system in the initial stage of the period. First, the KMT government took over and nationalized all financial institutions which used to be owned by the Japanese during the colonial rule. Second, it reopened those state-owned banks which used to run banking business in China before 1949. Coupled with the postal saving system, these national banks from the above two sources became the solid base of the KMT's control of the financial system. To be more specific, the system was dominated by a state-controlled banking sector, composed of domestic banks, local branches of foreign banks, investment and trust companies(ITCs), credit cooperatives, credit departments of farmers' and fishermen's

associations(CDFFAs) and Chunghwa Post.¹¹⁷

Though this state-dominant financial system was criticised as financial repression,¹¹⁸ the system actually worked relatively smoothly and contributed significantly to the economic development in Taiwan before the mid 1980s. Academics were impressed to see that low price inflation and high real interest were both well-maintained from the 1960s to the early 1980s in Taiwan except for two irregular inflations in 1974 and 1980-1981 which were associated with two oil shocks (see Table 3.1).¹¹⁹ As the low price inflation made Taiwan's economic development immune to the threat of domestic inflation, the high real interest encouraged people to save with high yields to depositors and protection of implicit deposit insurance of state-owned banks. Together, these created a stable and conducive financial environment for capital formation and economic growth.

In terms of the linkage with the industrial policies, through the state-dominant financial system, the government extracted private savings to support state enterprises and export industries with preferential interest rates. With cheaper credit, it was

¹¹⁷ Chunghwa Post only took deposits and did not directly provide loans. All its deposits initially were sent to be saved either in the central bank as a tool for controlling money supply or particular state-owned banks for implementing some government policies. Now it can decide how to deal with its deposits but is still constrained from direct involvement in the loan market.

¹¹⁸ A concept coined by McKinnon and Shaw to indicate the inefficiency of allocation of financial resources due to the state's aggressive intervention in the financial market. See McKinnon, *Money and Capital in Economic Development* and Shaw, *Financial Deepening in Economic Development*.

¹¹⁹ McKinnon, *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy*, 35-36.

hoping to make the state enterprises efficiently carry out the mission of building up basic industrial infrastructures such as utility facilities, logistics, steel industry, and petro-chemical industry, and provided a conducive industrial environment and lower-priced material to the small and medium enterprises to improve their competitiveness in exports. In the mean time, the export industries also enjoyed lower interest loans (as shown in Table 3.1) and tax breaks to further increase their competitive advantage in the international market.

Table 3.1 Interest Rates and Inflation Rates in Taiwan (Percentages)

End of Year	At Banks			Curb-Market Unsecured Loans	Consumer Price Inflation
	Saving Deposit*	Unsecured Loan	Export Loan		
Average					
1956-62	17.0	20.9	11.2	41.1	84.4
1963-73	10.1	14.1	9.7	25.4	3.4
1974	13.5	15.5	9.0	29.3	47.5
1975	12.0	14.0	7.0	26.4	5.2
1976	10.7	12.7	7.0	27.6	2.5
1977	9.5	11.5	6.5	25.6	7.0
1978	9.5	11.5	6.5	27.2	5.8
1979	12.5	15.2	10.5	30.1	9.8
1980	12.5	16.2	10.5	31.3	19.0
1981	13.0	15.2	11.0	30.1	16.3
1982	9.0	10.7	8.2	27.7	3.3
1983	8.5	10.2	8.0	26.8	1.8
1984	8.0	10.0	7.7	29.9	1.7

*One-year saving deposits.

Source: McKinnon, *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy*, 36.

In a nutshell, through controlling the financial system, the state could extract private savings for rapid capital formation and had the power to allocate scarce financial resources on its targeted industries and sectors. That is why political economist T. J. Cheng describes the state as a banker controlling the commanding heights in the

financial system of Taiwan before the 1990s.¹²⁰ But “the commanding heights”, according to Cheng, has more implications. As the KMT was an alien regime dominated by elites from the minority mainlander ethnic group, it had used the financial system as a tool to maintain its power. Firstly, as the state controlled the commanding heights, the local Taiwanese capitalists were constrained from involvement in running private banking. As a consequence, there were no giant Taiwanese financial capitalists who could pose a potential threat to the KMT regime. Secondly, the room for private banking institutions was only restricted to a few areas for specific reasons. For grassroots finance, mainly the credit cooperatives and the rural credit unions, it not only served the financial needs of the rural areas but also as a tool and favour to deal with local factions around the island.¹²¹ The Medium and Small Business Banks (MSBBs) were established on the existing civil banking organizations and granted the special task to provide loans for the development of small and medium enterprises which were the backbone of Taiwan’s export industries. As for a small number of ITCs and commercial banks, they were used to patronize those business forces which were in cooperation with the KMT regime (mostly mainlander-run businesses) and demonstrated as good gestures to local business interests and overseas Chinese investment as well. Nevertheless, as a whole, these

¹²⁰ Cheng, “Guarding the Commanding Heights: The State as Banker in Taiwan.”

¹²¹ The details about the relationship between the KMT, local factions and grassroots financial institutions will be examined in Chapter 7 of this thesis.

private banking institutions played relatively insignificant roles in terms of market shares, business scopes and economic scales, compared to the strong state-owned financial institutions.

3. Political and financial developments in the KMT era

(Part 2: from the late 1980s to 2000)

Despite its distinct performance on economic governance, the KMT regime, however, was still fearful of losing its governing legitimacy in the 1980s. The first and utmost challenge was the fallout after the UN shut its door to Taiwan and the U.S. normalized its relations with China in the 1970s. The immediate effect was the end of the “Free China” myth, the central pillar of the KMT regime’s ruling legitimacy over Taiwan. Now that most countries around the world, including the U.S., recognized the PRC as the only legitimate regime of representing China, Taiwan was slipping into a crisis where its statehood was questioned worldwide. Besides, since the KMT regime never gained its governing legitimacy over Taiwan through normal democratic procedure before the 1990s, how could it continue its rule by a widely dismissed myth of “Free China?” Third, the fast shrinking of the number of the countries which maintained formal relations with Taiwan also reinforced the pressure on the KMT regime. As the sense of isolation and frustration grew stronger among the general Taiwanese about

their existence and position in the international community, they inevitably began to question the competence and ruling legitimacy of the KMT regime.

Meanwhile, the KMT regime was also facing vast challenges from a revitalising civil society. With the take-off of Taiwan's economy and the resulting general improvement of living standards and education over the previous two decades, the continuing existence of the martial law and authoritarian rule was getting unbearable for the rising middle class in particular and the public in general. The demand for social reform was clearly reflected in the surge of organized social movements on various social issues even before the martial law was lifted in July 1987.¹²² It not only sent a strong signal to challenge the authority of the KMT party-state, but also indicated an increasingly maturing civil society in which the public were getting conscious of their basic rights and willing to protect or pursue their rights.

In the meantime, the demand for political reform was also soaring even though the KMT regime had just heavily crushed the anti-KMT forces in the Kaohsiung Incident of 1979.¹²³ The incident put many key leaders of the *tangwai* (people outside the

¹²² According to Hsiao's studies, the first wave of organized social movements which took place between 1980 and 1986 comprised of seven movements: 1) the consumers' movement, 2) the anti-pollution protest movement, 3) the nature conservation movement, 4) the women's movement, 5) the aborigines' movement, 6) the students' movement and 7) the New Testament church protests. See Hsiao, "Emerging Social Movements and the Rise of a Demanding Civil Society in Taiwan."

¹²³ Right before the incident, the KMT was facing a double governing crisis. On the one hand, its legitimacy was faltering due to the decision of the U.S. to cut its formal relations with Taiwan and establish official ties with China in 1978. On the other hand, it was deeply worried about the rising opposition had taken shape after several local elections in the 1970s. Hence the KMT decided to halt the momentum of the anti-KMT movement by arresting almost all of its leaders when they organised a

KMT) in prison and it seemed to abruptly reverse the momentum of the rise of the opposition. But as soon as elections were resumed in the 1981, the associates¹²⁴ of the jailed *tangwai* leaders soon filled the power vacuum and continued to strengthen the influence of *tangwai* among the voters in several elections.¹²⁵ The high tide of *tangwai* campaigns was reached at the time when *tangwai* leaders decided to defy the ban of the martial law on establishing a new political party. The first opposition party, the Democratic Political Party (DPP), was hastily founded by those leaders in late 1986.

In face of these critical challenges to its rule, the KMT's leader Chiang Ching-kuo, the son of Chiang Kai-shek and the last authoritarian leader in Taiwan,¹²⁶ surprisingly took a more conciliatory approach to deal with them. Different from his father's way of rule and that of his own in his early years in power in the late 1970s, Chiang Ching-kuo was more tolerant of the surging social and democratic movements in Taiwan in his final years in power in the 1980s. He seemed to have sensed the profound change of Taiwan's society and the need to transform the KMT to meet those new challenges. For example, he consciously launched a reform to transform the

public gathering on the streets in Kaohsiung on International Human Rights Day in late 1979.

¹²⁴ The main part of the associates came from either the spouses or the attorneys of the jailed leaders. Many of those attorneys later became the rising political stars of the DPP. Former President Chen Shui-bian and former Premier Hsieh Chang-ting are all good examples.

¹²⁵ From the 1970s, regular elections had provided a key venue for the opposition forces to organize themselves and challenge the KMT regime. *Tangwai* was the product of this mechanism and practice.

¹²⁶ Chiang Kai-shek died as a dictator in 1975 and his son Chiang Ching-kuo soon took power, serving as president until his death in 1988.

power structure of the KMT by injecting more fresh talent with native Taiwanese background, including his successor Lee Teng-hui, into the party. The move aimed to not only balance the dominance of mainlanders in the top decision-making circle of the party and the state, but also designed to send a message to the general Taiwanese, the majority of the residents on the island, that the KMT was on its way of becoming more Taiwanese.

Chiang Ching-kuo's more liberal approach in dealing with the social/political challenges was crystallised in his attitude toward the establishment of the DPP in 1986 and his decision to lift the martial law in 1987. After the DPP was "illegally" founded according the martial law, Chiang Ching-kuo took no action. He rejected the idea of dissolving the DPP or persecuting its leaders. Instead, in less than a year, about six months before his sudden death in 1988, he announced the lifting of martial law. The move essentially relaxed government controls on the civil society, marking the beginning of Taiwan's rapid democratisation in the next decade.

Lee Teng-hui, the deputy of Chiang Ching-kuo, ascended to power after Chiang's death. Taiwan went through relatively successful democratic transitions during Lee's era when he was both the President of Taiwan and the head of the KMT from 1988 to 2000. Indeed, in just 12 years, many milestones of democratic reform were achieved.

For example, firstly, in May 1991, Lee declared the termination of the Period of Communist Rebellion and scrapped the Temporary Provisions effective during the period. The move was not merely to officially stop treating the Chinese Communist Party of the Mainland China as a rebellion group. More importantly, it showed the KMT regime's determination to pursue liberal democracy in Taiwan.¹²⁷ Secondly, in December 1992, the members of the Legislative Yuan were all directly elected by the people in Taiwan for the first time after those so-called "senior members" who were elected to represent mainland constituencies in 1948 were forced to resign in late 1991. Since then, the Legislative Yuan began to emerge as one of the major political centres in Taiwan's politics as its legitimacy was greatly enhanced by its direct mandate from the voters. Thirdly, in December 1994, the mayors of Taipei and Kaohsiung and the governor of Taiwan Province, the three highest posts of Taiwan's local governments, were all subject to open competitions through direct elections by the electorate. This not only significantly strengthened the autonomy of local governing but also marked the rising power and importance of these posts in national politics.¹²⁸ Fourthly, in March 1996, for the first time, Taiwan's President was

¹²⁷ In the name of the Chinese Civil War, the Temporary Provisions were in place from 1948 to freeze a part of constitution from functioning so that the power of the president could be enormously expanded and there was no term limit for the president. In other words, the provisions facilitated and justified the rule of the authoritarian leaders Chiang Kai-shek and Chiang Ching-kuo.

¹²⁸ Since 1994, many rising political stars have tried to run for the three posts and a number of them have become national leaders as president or premier after their terms as mayors in Taipei and Kaohsiung. Former President Chen Shui-bian, current President Ma Ying-jeou and former Premier Hsieh Chang-ting are all typical examples.

popularly elected.¹²⁹ This was a defining moment of Taiwan's democratisation as the highest position of the national government was finally decided by the residents in Taiwan after they had been ruled by different foreign regimes over the past four centuries. From this moment, the period of democratic transition in Taiwan was formally finished as it had transformed from a non-democracy to a totally representative and accountable government.¹³⁰ Fifthly, Lee streamlined the government structure by "freezing" the Taiwan Province Government (TPG) in 1998. Taiwan used to maintain a redundant multi-tier government structure. From 1946 to 1998, under the central government, which was located in the national capital Taipei, the TPG was in charge of all "local" affairs on a territory almost completely overlapping with the whole nation.¹³¹ The TPG and its assembly (the Taiwan Provincial Assembly, TPA) worked with real function until 1998. Under the cooperation between Lee and the DPP, a constitutional reform in 1997 downsized the TPG and TPA to empty shells.

What was even more extraordinary about these achievements of democratic reforms was that they were all reached in a gradual, stable and peaceful way. Shelley Rigger, an expert on Taiwan's politics, has vividly characterized the past success of Taiwan's

¹²⁹ Lee Teng-hui won the presidency with 54 per cent of the vote.

¹³⁰ See the definition of democratic transition at Chapter 2, 34.

¹³¹ The system was maintained to support the central government's claim to the whole of China after the KMT lost the civil war and fled to Taiwan in 1949.

democratisation as below:

“Among these uneven ‘third-wave’ democratizations,¹³² Taiwan’s stands out as relatively smooth and successful. Taiwan’s transformation from single-party authoritarianism to multiparty democracy came about with very little violence or bloodshed. Nor did it require wrenching economic or social upheavals. In fact, one might describe Taiwan’s experience as a ‘best-case’ democratization.”¹³³

In retrospect, a number of scholars have attributed this ‘best-case’ democratisation to the leadership of Lee Teng-hui. They argue that Taiwan’s democratisation was undertaken in a top-down way, in which the ruling KMT led by Lee Teng-hui controlled both the pace and the content of democratic reforms.¹³⁴ Indeed, in the abovementioned achievements of Taiwan’s democratic reforms, Lee’s commitment to reform and his determination to overcome existing obstacles were indispensable. But this view ignores, at least, two supporting forces behind Lee’s credit --- a demanding civil society and the rising opposition DPP.

A “demanding civil society” was observed and defined by sociologist Hsin-Huang Michael Hsiao at the end of the 1980s:

“A new kind of political culture is gradually appearing in Taiwan --- a participatory one --- emerging, slowly but surely, from the mobilization of its civil society in the

¹³² Huntington, *The Third Wave*.

¹³³ Rigger, “Democratization in Greater China: Taiwan’s Best-Case Democratization,” 285.

¹³⁴ Ibid

1980s. Taiwan's civil society is no longer a passive recipient of the state's domination. It has been mobilized through a learning process engendered by these protest movements. Through this, the civil society as a whole, not just those active in the movements, have learned how to make claims on the state. It can be characterized as a 'demanding civil society' with a new kind of 'participatory political culture' as its socio-psychological base."¹³⁵

In fact, it was because of the mounting pressure for more political reform from this "demanding civil society" that Lee Teng-hui could get a strong leverage to fight against those who were resisting change --- which mainly came from the old guards of his own party. In other words, for Lee Teng-hui, a reform-minded leader without a solid power base in the nation and his party at his early years in power,¹³⁶ a "demanding civil society" was both a driving force to push him to undertake reform and a powerful weapon to carry out reform tasks.

The same logic also applied to Lee's interaction with the DPP on the issues of political reforms. For Lee, though the DPP was emerging as a strong competitor to his party,¹³⁷ it was also an important outside source of his leverage on pushing through some particular political reforms. For example, since the early 1990s, the DPP had

¹³⁵ Hsiao, "Emerging Social Movements and the Rise of a Demanding Civil Society in Taiwan," 178.

¹³⁶ Lee was promoted by Chiang Ching-kuo as a competent technocrat with a local Taiwanese background. But why Chiang finally picked Lee as his deputy was not clear.

¹³⁷ Since the DPP was born in 1986, it consolidated itself through taking part in regular elections and winning stable support. In terms of voting shares in the elections for the members of the Legislative Yuan from 1989 to 1995, it got 28.29 per cent in 1989, 36.09 per cent in 1992 and 33.17 per cent in 1995. Meanwhile, it performed even better in the elections for city mayors and county magistrates. It received 38.34 per cent of the votes in 1989 and 41.03 per cent in 1993.

strongly campaigned to have the president and vice president directly elected by the people not by the members of the National Assembly. The issue gradually got support among the public but the KMT was divided on it. Lee finally decided to cooperate with the DPP on the issue and mobilize more public opinion to support the change. In other words, the persistent campaigns of the DPP on the issue ahead of the change had provided Lee with basic momentum and social support. Lee's final success on the reform owed significantly to the assistance of the DPP.

In short, Lee used the cry for reform from the public and the rise of the DPP to crush the resistance to his political reform. The peaceful and gradual democratic transitions were only possible through the mutually reinforced interplays among Lee, a demanding civil society and the rising DPP over 12 years when Lee was in power from 1988 to 2000.

As Lee's KMT seemed to be capable of controlling the progress and course of democratization, its autonomy in governing was actually in decline. In order to address the impact of democratization and maintain its rule, the KMT had to give more power and resource to crucial business groups and local factions in exchange for their loyalty and cooperation in the existing socioeconomic alliances and political-economic institutions. As a result, some influential business groups and local

factions began to interfere in the decision-making process within the state through their business organizations, lawmakers in the legislature and even representatives in the central standing committee of the KMT. In a word, the seeds of subsequent dismantlement of a developmental regime were sown in KMT's attempt to prolong its rule.

As the developmental regime was challenged and squeezed, serious side effects emerged in the process of Taiwan's financial liberalization. First, with the increasing influence of foreign and private financial institutions, the state was losing its leverage to control or maintain the stability and order of the financial system. Second, the direction, pace and content of financial liberalisation were more frequently disrupted than before by the intervention of the rising political forces. Thus, while the financial system was greatly deregulated and more private players entered the market in the 1990s, the cases of financial irregularity like bank runs and bad loans also surged to record highs, and the project to privatise or deregulate the state-owned banks was also beyond the control of the KMT government.

4. Political and financial developments in the DPP era

(from 2000 to 2008)

Taiwan's democracy entered into a new era when Chen Shui-bian of the DPP became

the president from 2000 to 2008.¹³⁸ It was the first time that Taiwan was governed by a political party other than the long-time ruling party, the KMT, after the Second World War. While the "peaceful transfer of political power" from the KMT to the DPP proved again the remarkable progress and maturity of the young democracy, it also marked the beginning of a new testing time of profound challenges.

With hindsight, the DPP government faced at least three new challenges during its years in power. First, the DPP was inexperienced in governing the country due to its lack of chance of playing the role as a ruling party during the uninterrupted rule of the KMT over the post-war decades in Taiwan. As a result, awkward policy U-turns of the DPP government, out of its inexperience in assessing the situations of reform projects, occurred frequently. The most infamous case was probably the decision to terminate the construction of the fourth nuclear power plant in 2000. The decision was in line with Chen's election platforms and the DPP's long-time commitment to creating a nuclear-free environment. But the decision was suddenly made without consulting the opposition parties, the business groups and the general public in advance. Thus, the decision was highly controversial and ended up as a failure --- eventually the project was restarted in 2001.¹³⁹

¹³⁸ Chen was elected as president in 2000 for the first time and won his second term in 2004.

¹³⁹ In the end, Chen's administration failed to win the support of the Council of Grand Justices in acknowledging its power to unilaterally terminate the project without the consent of the legislature.

Second, through the whole eight years, the DPP never essentially controlled the Legislative Yuan. Without a majority support, the DPP government faced constant troubles in implementing its policy agenda. The consequence was constant boycott of the opposition parties on key bills, budgets or nominations of government officials that mattered a lot to the DPP or even the whole country. For example, the arms sales offered by the Bush administration of the U.S. to Taiwan in 2001 were not approved by the Legislative Yuan until 2007. Another example was the nomination of new members of the Control Yuan.¹⁴⁰ After President Chen nominated the new members in late 2004, the opposition parties boycotted the nomination until the end of Chen's second term in 2008. The Control Yuan, as a result, ceased to function for almost four years.

Third, clash of national identities between those who identified themselves as Taiwanese and those who see themselves as Chinese escalated.¹⁴¹ As a result, politics became increasingly polarized and made sound policy deliberations less likely.¹⁴² The clash, of course, had much to do with the pro-Taiwan independence stance of the DPP. But, from a long-term perspective, it might be an inevitable result of Taiwan's democratisation --- democratisation allowed people to question what "Republic of

¹⁴⁰ According to the Constitution, the Control Yuan is the highest control body of the State and exercises the power of impeachment, censure and audit.

¹⁴¹ The former tended to regard Taiwan as a separate and different country from China; the latter is inclined to see Taiwan as a part of China.

¹⁴² See more discussion about the challenges of the DPP and Taiwan's democracy after 2000 in Rigger, "The Unfinished Business of Taiwan's democratisation."

China” meant for themselves and Taiwan, and what kind of relationship that Taiwan should maintain with China. Actually, in the final years of Lee Teng-hui’s rule, the KMT government had defined Taiwan’s relations with mainland China as a “special state-to-state relationship.” Whatever the reasons, polarization of politics resulting from escalating clashes of national identities did have a strong effect on the making of public policies. Cross-Strait policy was probably one of the worst victims of these clashes. As the ruling DPP was cautious toward the pace and content of negotiations and interactions between Taiwan and China, it was often criticized by the opposition parties as “locking up the country.” Eventually, the opposition parties even bypassed the government and went to negotiate with the Chinese authority directly.

The three challenges mentioned above were not necessarily separate. On many occasions, in fact, they were linked and reinforced, creating even more obstacles. Under such circumstances, the DPP had faced a much more difficult situation than the KMT in governing the country. Thus, it was no surprise to see stronger resistance to the DPP’s attempts to sell and implement many crucial policies including those for overhauling the financial sector.

The DPP inherited a financial system which was on the verge of collapse. The harmful side effects of failing to put a new and sound financial sector in place during

the 1990s were crystallised in a looming bad debt crisis in 2000. Consequently, to prevent the crisis from worsening and to defuse it entirely became the top priority of the DPP's financial policies during its first term in power from 2000 to 2004. While overall the DPP was successful in reaching those reform targets, it paid a high price in terms of its image as a reformist party. What contributed to its success and failure are the main themes in the following case chapters that cover the DPP's era in addressing financial governance and reform.

But one thing has to be mentioned first here is about the philosophy of the DPP's financial governance when it was in power. It had showed an even stronger tendency than the KMT to embrace "free market economics." It had strong faith in size, market mechanism and private players. Thus, after quelling the concern of financial crisis during its first term, it sought to create national champions in the banking sector by forcefully encouraging mergers and acquisitions among banks and financial holding companies in its second term from 2004 to 2008. The move raised a huge controversy as many people questioned its legitimacy to sell state-controlled banks to the private players in a reckless way in a short period of time. Some even questioned whether the Chen administration might have secret deals with particular business conglomerates for its own benefits in terms of political donations or bribes. All these cost the DPP much popularity and forced its measures of financial reform in this aspect to be

scrapped in the end.

Conclusion

This chapter has provided a general context about Taiwan's history and its political and financial development during different eras from 1949 to 2008. It shows that political regimes have significantly shaped the function, structure and development of the financial sector. In particular, it demonstrates how democratisation has influenced the path, pace and content of financial liberalization, reform and governance through undermining the autonomy and capacity of the state since the late 1980s. In the following case chapters, from Chapter 4 to Chapter 7, more concrete examples will be presented and examined to justify the argument.

Chapter Four

The Prolonged Reform of State-owned Banks (1988-2008)

The reform on the state-owned banks (SOBs) is the most enduring event among the attempts of the Taiwanese state to overhaul its financial system. It was launched in the late 1980s and continued for the whole of the 1990s by the KMT government. Until today, it is still unfinished even after the DPP was in power from 2000 to 2008. What has contributed to its continuing extension or failure is the main concern of this chapter.

The ultimate target of the SOB reform was to effectively enhance the efficiency of Taiwan's financial system as the SOBs had been dominant lenders in the banking sector in terms of their market shares. To reach the target, originally, the KMT had planned to undertake a series of measures of privatisation and deregulation for the SOBs. The standard for privatisation was to reduce the government's share holding of a bank to below 50%. Once this was achieved, all the regulations related to state-owned enterprises would cease applying to the bank.¹⁴³ In contrast, to deregulate a SOB indicated to keep state ownership of the bank but liberate it from government red tape on budget, personnel, auditing and so on. This would only apply

¹⁴³ However, the government could still control the bank to some extent as long as it keeps a significant part of shares. It is only after the government sells all its shares of a bank that the bank becomes purely private.

to those SOBs which were not for privatisation due to their special “policy missions”¹⁴⁴ or technical difficulties of ownership transfer.

The root of the delayed or failed reforms of the SOBs, I argue, lies in the rapidly changing political landscape of Taiwan during democratic transition and consolidation over the recent two decades. It, in a significant part, stems from the fact that the state’s ability to control its reform agenda has been constrained by the newly rising political forces as a result of Taiwan’s rapid democratisation. With the new legitimacy as elected representatives or officials, in the name of check and balance, politicians have strong incentives and interests to meddle in the SOB reform policies. To be more specific, the interplays among three key policy players, including the Executive Yuan (Cabinet), the Legislative Yuan (Parliament) and the Taiwan Provincial Government (TPG) with its Assembly (TPA) before they were downsized in 1998, have together decisively shaped the pace and content of SOB reform.

This chapter is thus divided into five parts to elaborate the argument. First, a review of the origins of the SOB reform is presented to situate the issue in its initial context. Then, the attention is drawn to the original SOB reform plans formulated by the KMT government at the beginning of Taiwan’s financial “Big Bang” in the late 1980s. The rationale behind the policy designs will be explored, providing a foundation to

¹⁴⁴ For example, some SOBs are asked to provide cheap credit to target industries.

trace the change of the reform afterwards. Part Three and Four will highlight the impacts of interventions from other political forces outside of the Executive Yuan, the main body of the central government and the state apparatus, in two main reform areas: privatisation and deregulation. In these two parts, we will see why, in addition to the Executive Yuan, the Legislative Yuan and the TPG as well as its Assembly were key players, and how did their interplay affect the SOB reform in the whole 1990s. Finally, Part Five sheds lights on the development of the SOB reform under the Democratic Progressive Party (DPP) government from 2000 to 2008. The point will be made on whether the first transfer of ruling parties changes the nature of the issue. That is, as Taiwan's democratisation moved to a new height, did it significantly alter the way by which the SOB reform was addressed? In conclusion, I will outline the implications of the SOB reform for financial governance in Taiwan and challenges ahead for the SOB reform.

1. Origins of the reform (the late 1980s)

The origins of the SOB reform involve the unprecedented challenges that the authoritarian KMT government faced on both the domestic and external fronts in the second half of the 1980s. On the external front, due to the massive trade surplus that Taiwan enjoyed with the U.S. in the 1970s and 1980s, the U.S. kept forcing Taiwan to

take necessary measures to improve the trade imbalance with the threats of unilaterally retaliatory measures authorised by the U.S. “Super 301.”¹⁴⁵ The so called “necessary measures” could be divided into three parts. The first was to ask Taiwan to import more goods from the U.S. by either reducing its tariffs or undertaking special procurements for U.S. products. The second was to ask Taiwan to open its domestic market to the U.S. companies. The third was to ask Taiwan to significantly appreciate its currency against the U.S. dollar. Since the U.S. was Taiwan’s most important export market and closest ally in East Asia, Taiwan had no choice but to accept most of the U.S. requirements.

In terms of the impact of these concessions on Taiwan’s financial market, the second and third part had far reaching consequences. Firstly, the introduction of new financial institutions from the U.S. posed a threat to the survival of local players, most of which were under state control. Secondly, the massive and dramatic appreciation of Taiwan’s currency, the New Taiwan Dollar (NTD), led to a financial chaos as the KMT government allowed the NTD to appreciate almost 40 per cent from 40 NTD: 1 USD in 1986 to 25 NTD: 1 USD in 1989. The huge trade surplus plus the surge of “hot money” from abroad in seeking for the profit of NTD appreciation created the excessive supply of local money, leading to an economic bubble.

¹⁴⁵ “Super 301” is the section of the U.S. Trade Act that gives power to the U.S. Trade Representative to investigate U.S.’s trade partners to see if they apply fair and open access to U.S. exporters.

The effects of the economic bubble emerged fast on the domestic front. At the peak of the bubble, the enthusiastic participation of the public in speculative investments on objects like stocks, properties, illegal investment companies as well as underground lotteries, could be sensed almost everywhere. Thus, the threat of the burst of the economic bubble and its potentially disastrous social consequences forced the KMT government to seek effective financial solutions.

What was even worse for the KMT government was that rising democratic movements also brought serious challenges to its legitimacy of rule at the same time. One of the main challenges was targeted at the KMT's party-state business empire. The DPP, the first opposition party established in 1986, and other anti-KMT forces accused the KMT of exploiting its status as the ruling party by using the state-owned enterprises (SOEs) to promote its own business. Besides, the low efficiency and monopoly of the SOEs which occupied a significant part of the economy in upstream industries and utility facilities as well as public transportation was also under heavy attack. The demands to swiftly privatise most SOEs and return KMT's "suspiciously acquired" assets back to the people were building momentum by gaining increasing support from the public. Thus, the political side reinforced the pressure for genuine and comprehensive economic reform as the KMT was desperate to boost its legitimacy.

Under such circumstances, the KMT government decided to push for economic liberalisation in an unprecedented scope and scale. Unsurprisingly, the SOEs including those SOBs became the prime targets for liberalisation. Two key measures of economic liberalisation were set in motion in 1989. The first one was to set up a cabinet-level task force, the SOE Privatisation Committee (SOEPC), in pursuing the privatisation of the SOEs. Shortly after the SOEPC was set up, 20 SOEs were chosen on the first list for privatisation, among which 8 were state-owned financial institutions. The second one was aimed exclusively at the financial sector. By significantly revising the Banking Law, Taiwan's version of "Big Bang" was unveiled. Apart from scraping control on banks' interest of deposits and loans, the new Banking Law increased the penalty of financial crimes, strengthened banks' capacity in managing risks and allowed the establishment of new private commercial banks which had been banned for decades.¹⁴⁶ Although this policy did not directly get the SOBs involved, the inevitable competition pressure brought by the new private players in the following years deepened the sense of crisis of the major players at the time --- the SOBs.

¹⁴⁶ See the details of the revised Banking Law at Ministry of Finance, "Yinhangfa xiuzheng neirong baogao"[A report to the Legislative Yuan on the revisions of the Banking Law].

2. Plan and rationale of the reform

If we pay attention to what has occurred to SOB privatisation in recent years, we might think that to privatise *most* SOBs has been a consistent policy since the late 1980s. But this is not the whole picture. At least, under the KMT rule before 2000, the SOB privatisation, in fact, was just one part of the project to reform the SOBs. As mentioned, in fact, two crucial ways of reform were initially adopted: privatisation and deregulation. For the former, it was believed that numerous SOBs could get rid of SOE regulations by becoming “private” banks and thus could compete with private players on a level playing field. For the latter, while recognizing the efficiency that would be brought by privatisation to some SOBs, the government also sought to enhance the operational autonomy of the rest of SOBs by this alternative way. It was planned to draft a new act, *Regulations Governing State-run Financial Institutions* (RGSFI), to push for the SOB deregulation. The government argued that for some SOBs state ownership was not the key for their competitiveness. The excessive government regulations were. If the new act could be enacted, it would bring similar positive effects as privatisation. The difference was that with the new act the government could still maintain a part of its banks as government-owned without worrying that they would lose their competitiveness. “State-owned but run in a private

way” was the slogan that the KMT used to symbolise the spirit of the new act.¹⁴⁷

The former minister of finance Paul Chiu¹⁴⁸ recalled why there was a need for this dual approach in a reply to the legislators during the question time in the Legislative Yuan in 1999:

”...Despite their enormous contributions to our national economy over the past decades, the state-run financial institutions (SFIs)¹⁴⁹ have been under immense pressures of competition from the newly established private financial institutions from abroad and at home due to the active opening-up of Taiwan’s financial markets by the government in recent years. ...Nevertheless, constrained by the existing government regulations on their personnel, budget and audit, the SFIs have found difficulty in improving their operational efficiency and become vulnerable to the surging challenges from new rivals. Thus, on the one hand, we have been pushing the privatisation of some SFIs; on the other hand, *for those SFIs that are bearing policy missions or won’t be privatised in the near future, we will enact the RGSFI* [to let them gain operational autonomy and efficiency in another way].”¹⁵⁰

In his later response to questions from legislators, Mr Chiu gave an example of banks with policy missions. He said that the government-owned Export-Import Bank of the Republic of China would not be privatised because it had special functions to

¹⁴⁷ Legislative Yuan, *Lifayuan Gongbao* (Parliament Minutes), 88, no.33:192.

¹⁴⁸ Paul Chiu was in office as Minister of Finance from 1996 to 2000.

¹⁴⁹ Sometimes, the government uses the term SFIs instead of SOBs because the former includes other state-owned financial institutions like insurance firms and investment companies. But as banks are the bulk among the SFIs, SOBs and SFIs are almost interchangeable terms in Taiwan’s context. In this thesis I treat them as the same.

¹⁵⁰ Lee, “Taiwan Gongyou Jinrong Jigou Quanli zhi Tantai” [On the management of state-owned financial institutions], in *Gongying Yinhang Quanli Caoan Cankao Ziliao* [Collections of the documents related to the drafts of RGSFI], 150.

facilitate export and import trade of Taiwan.¹⁵¹ Then he went on to say that it would take time for some SOBs to be privatised because they needed to be restructured and registered again as corporations first; once they were ready, they would be transferred into private banks as well.¹⁵²

Ultimately, the KMT government failed to deliver these SOB reform policies as it initially planned. For the SOB privatisation, it only managed to complete a number of cases after 1997. For the SOB deregulation, the expected new RGSFI act never passed. The delay and failure must be explained as the KMT kept formally full control of the state power in the 1990s at the executive and legislative levels.

3. The delay of SOB privatisation in the KMT era (the 1990s)

3.1 The SOB privatisation and democratisation

As mentioned earlier, the SOB privatisation was initiated in the wider context of all SOE privatisation in 1989. Therefore, the proceeding of the SOB privatisation was moving with all the SOEs all the way. After announcing its broad direction and plan for the SOE privatisation, the Executive Yuan took its first step to implement its agenda in details – providing a legal framework for the SOE transformation. It

¹⁵¹ Normally it is through offering export credit insurance, re-lending facility and other various kinds of financing facilities.

¹⁵² *Lifayuan Gongbao*, op. cit., 197.

proposed to revise the existing “*Act of Privatization of Government-Owned Enterprises*” (APGOE) as the fundamental law for SOE privatisation. The purposes of the statute are made clear in the first two articles:

“This Statute is enacted to facilitate the privatization of government-owned enterprises, to exert the market mechanism, and to enhance the operational efficiency of enterprises (Article 1).”

“The privatization of government-owned enterprises, either in whole or in part, shall be governed by this Statute... (Article 2)”¹⁵³

Then, shortly after the statute was approved by the Legislative Yuan in 1991, the Executive Yuan rushed to promulgate the “Enforcement Rules of Statute of Privatization of Government-Owned Enterprises” in 1992. The rules were made to let involved parties of government agencies, SOEs and their employees learn how to follow the APGOE in details. The next step, as planned, after the legal foundation for the SOE privatisation was in place, was to let the Legislative Yuan to review the budget and plan for individual SOE privatisation case submitted by the Executive Yuan.

As far as the SOE privatisation was concerned, five banks were the focus of the debate before the late 1990s. These five banks were: First, Hua Nan, Chang Hwa,

¹⁵³ The full texts of these two articles and whole APGOE are available on the website of Laws & Regulations Data Base of the Republic of China: <http://law.moj.gov.tw/Eng/LawClass/LawAll.aspx?PCode=J0120044> (accessed July 8, 2011).

Farmers and Chiao Tung,¹⁵⁴ as the third column of Table 4.1 shows. The first three were under the TPG control and the other two were under the central government.

Table 4.1 Progress of privatisation of state-owned banks in the 1990s

Bank Names	Controlled by which authority	Year of proposal for privatisation	Planned Year for completing privatisation	Year of privatisation
First Commercial Bank	TPG*	1989	n/a	1998
Hua Nan Commercial Bank	TPG	1989	n/a	1998
Chang Hwa Commercial Bank	TPG	1989	n/a	1998
Taiwan Business Bank	TPG	1989	n/a	1998
Farmers Bank of China	CG**	1992	1996	1999
Chiao Tung Bank	CG	1994	1997	1999
Taipei Bank	Taipei City	n/a	n/a	1999
Bank of Kaohsiung	Kaohsiung City	n/a	n/a	1999
Taiwan Cooperative Bank	TPG	These banks were not planned to be privatised soon. The new drafted act RGSFI would apply to them before privatisation.		
Land Bank of Taiwan	TPG			
Bank of Taiwan	TPG			
Central Trust of China	CG			

*TPG: the Taiwan Provincial Government; **CG: the Central Government

Source: The author's own collection from newspapers and parliament minutes

It is not clear why the central government targeted these TPG-controlled banks first.

With hindsight, it might be due to the following reasons. First, in terms of business nature, although the three TPG-controlled banks were government-owned, their banking business was basically commercial-oriented with few specific policy missions imposed by the government. Second, the government shares in two of the three banks were less than 60%, making them relatively easier to be privatised (i.e., reduce government shares to be under 50%). Besides, because these three banks were holding each other's shares to a certain extent, they would be linked in the change of their share structure if anyone of them proceeded with privatisation. Third, the three

¹⁵⁴ Why the Taiwan Business Bank was not mentioned in the public debate about SOB privatisation is not clear as it was on the list for the first wave of SOB privatisation. A possible reason is its relatively smaller size in term of assets compared to the other three big provincial banks.

banks were all flagship SOBs in terms of their ranking in assets and market shares in lending. If they could be successfully privatised first, the rest of SOBs would be easier to be addressed with previous landmark examples.¹⁵⁵

Whatever the reasons, the central government's efforts in SOB privatisation suffered a serious setback at the very beginning. As soon as the central government unveiled the list, the TPA passed a crucial resolution in October 1989 to damp the central government's hope of a quick solution. The resolution required that the TPG shares in the three big provincial banks should be maintained at or above 51 per cent.¹⁵⁶ In other words, it was impossible to privatise these banks under this resolution as the TPG would always have more than half of the banks' shares. The resolution became the biggest obstacle on the way for the central government to speed up SOB privatisation as the resolution was maintained until May 1997. The long blocking requires a detailed explanation.

Historically, the TPG had enormous power over the banks under its authority despite the fact that all these banks were also subject by law to the supervision of the central

¹⁵⁵ Two senior bankers of SOB background significantly contributed to the analysis in my interviews with them. They are Mr. Huang Tien-lin and Mr. Chien Ming-ren. Huang was the chairman of the First Commercial Bank in the late 1990s and was a economic policy adviser to President Chen Shui-bian when interviewed. Chien was the chairman of the First Financial Assets Management Co., Ltd in 2003 when he was interviewed.

¹⁵⁶ It was a bipartisan resolution. The KMT's attempt to stop its members from voting for the resolution failed in the end. See Lai, "Guangu chushouan guoguan fudai jueyi: shengyou gushu bude diyu 51%" [resolution on share sale passed with conditions: TPG's holding no less than 50 per cent].

government. The central government barely intervened in TPG's affairs in this area due to TPG's special status and role in Taiwan's politics. The TPG's jurisdiction was almost completely overlapping with the one of the central government except for Taipei, Kaohsiung and a number of tiny islands surrounding Taiwan, and the autonomy of the TPG was safeguarded by Taiwan's constitution at that time. In the face of such a sizable provincial government, the central government had to show its respect for the autonomy of governance of the TPG. Besides, before 1992 the Taiwan Provincial Assembly (TPA) was the highest level legislature where all members were all directly elected by their constituents in Taiwan.¹⁵⁷ The TGA was used as a showcase for the KMT government to demonstrate to the international community that Taiwan had democracy at a time when Taiwan was still under martial law and had limited democracy. As a result, the power of TPA was recognized on the issues under its supervision.¹⁵⁸ Furthermore, prior to 1994, while all the TPG governors were appointed by the central government, they needed the approval of TPA to confirm their nomination. Thus, the power of TPA could not be underestimated by the central government. Against this backdrop, when the central government took initiatives to firstly privatise three SOBs under the authority of TPG and TGA, instead of forcing

¹⁵⁷ The Taipei City Council and Kaohsiung City Council also enjoyed the same status but their constituencies were small in comparison with the TPA.

¹⁵⁸ Because of this special status, many of today's leading political figures in Taiwan began to build their political reputations as the members of TPA. The former Premier Su Tseng-chang and his predecessor Yu Shyi-kun are all good examples.

the TPG and TPA to accept its decision, it needed to “convince” both of them.

Apart from the tricky central/provincial government relationships, the new political landscape as the result of Taiwan’s rapid democratisation since the mid-1980s reinforced the influence of TPG and TPA. Taiwan’s democratisation moved into a new stage in the late 1980s after the DPP was founded in 1986 and the Martial Law was lifted in 1987. In appearance, the KMT was still dominant everywhere, but the importance and influence of elected officials and representatives were surging as people expected them to play a more significant role in a new democratic era. As a result, those newly elected officials and lawmakers started to challenge more often the decisions or orders from the central government or their parties to reflect the concerns and interests of their constituents.

The long-upheld TPA resolution of 1989 was one of the typical examples. The resolution was passed because the TPA members claimed that they were worried the rights and benefits of the current employees in the three TPG-controlled banks would not be well-protected after privatisation, especially when they found that related laws for privatisation were not in place.¹⁵⁹ While it was true that those laws were not in place until 1992, the TPA members’ lasting opposition to the privatisation until 1997

¹⁵⁹ Chang, “Te gao: sanshangyin jueyian jijiang fanan” [An analysis: on the upcoming TPA decision to repeal the resolution regarding the ceiling of share holding of three TPG-owned commercial banks].

implied other reasons.

Most of all, these banks were convenient tools for TPA members. With these banks, the TPA members could get cheap loans for themselves or their cronies even when lacking sufficient collateral security to back them up. They could even force the banks to purchase their branch offices in a specific location at a much higher price, just because those office buildings belonged to the cronies of some TPA members. In fact, some TPA members even held shares of these banks and got involved in inside trading on the stock market. This was all because, in the name of supervision, the TPA could essentially control “their” banks. For example, they could decide who would be promoted in the TPG-controlled banks and how much budget these banks could get at annual reviews.¹⁶⁰

Chang Chao-shun, a senior banker with the background of TPG-run banks, also provided his related observation in my interview:¹⁶¹

“Before their elections, some TPA members (or their ‘figureheads’) would try to get loans from the TPG-run banks to finance their costly campaigns. If re-elected after elections, they would get new loans from the TPG-run banks with new ‘figureheads’ to repay the previous loans. The process would be repeated until the money they

¹⁶⁰ Lienhepao, “Shelun: Kuangzheng minyi daibiao ganyu jinrong jigou de waifeng”[Editorial: Address the improper intervention to the financial institutions from the elected representatives].

¹⁶¹ Chang was the chairman of the Overseas Chinese Bank in 2004. He was transferred to run Taiwan Business Bank in 2005. Then soon again he moved to be in charge of the First Commercial Holding Co. from 2006 to 2008. The interview was made in August 2004.

borrowed became non-performing loans. The reason why they could do this was because the promotion of high-ranking managers of the TPG-run banks needed their endorsement in private. In other words, if someone wanted to be promoted to a high position in a TPG-run bank, he needed to find recommendation from some TPA members first, which was crucial in the final decision of the TPG governor. This is also why some managers in the central Taiwan (where the TPG/TPA was located) branches of the TPG-run banks were easily got promoted. As a result, not surprisingly, the bad loan percentages there were much higher than the other branches.”¹⁶²

As a matter of fact, the TPG was also opposed to privatising its banks. The TPG never openly revealed its opposition to the privatisation but it always used the TPA resolution as an excuse to defend itself. Actually, in its own first privatisation plan unveiled in 1995, the three banks were not even mentioned in the plan at all.¹⁶³ The fundamental reason for this negative attitude was the concern of fiscal problems that the TPG faced. The first directly elected TPG governor James Soong had even openly accused the central government of concentrating tax incomes on its own hands regardless of the fiscal difficulty of his government and constituents.¹⁶⁴ Given that the three banks’ revenues were important sources of annual fiscal income to the TPG, especially at a time when the TPG was in serious debt, the TPG would not easily let

¹⁶² Ibid.

¹⁶³ Lu, “Shoupo minyinghua mingdan sanshangyin quexi” [three TPG-owned commercial banks are not on the first list for privatisation].

¹⁶⁴ Yang, “Song Chu-yu paohong caizheng huafen bu jianquan” [James Soong criticized the biased fiscal system].

privatisation proceed soon.¹⁶⁵

The blocking from the Legislative Yuan against the two central government-controlled SOBs took place in similar scenarios though for slightly different reasons after a new parliament was created in 1992. Under the strong protest of the public who opposed the continuing existence of “permanent” national representatives in the Legislative Yuan and National Assembly for decades,¹⁶⁶ the KMT undertook political reform through cooperation with some lawmakers in the Legislative Yuan by sending a petition¹⁶⁷ to the Constitutional Court of the Judicial Yuan for interpretation regarding the qualifications of those representatives. Consequently, the interpretation¹⁶⁸ disqualified those representatives in 1990 and Taiwan’s first parliament where the lawmakers were completely and directly elected by their constituents was created in 1992.¹⁶⁹ The new Legislative Yuan immediately seized the centre of the political stage. The newly elected lawmakers were all keen to voice their opinions on public policies considering the public was constantly watching their performance, which would affect their chance of getting re-elected at the next

¹⁶⁵ While the TPG could benefit from immediate sale of its shares, it would lose its annual income from these banks in the future. See Liu, “Chuantai baodao: Taiwansheng fazhan huiyi ” [A special report: on the conference for development of Taiwan Province].

¹⁶⁶ See details about the existence of these permanent representatives in Chapter 3.

¹⁶⁷ The petition was initiated by twenty-six lawmakers in the Legislative Yuan. The leading three lawmakers were from the DPP.

¹⁶⁸ Justices of the Constitutional Court, Judicial Yuan, “Interpretation No. 261: Should the first-term national representatives be allowed to exercise their powers indefinitely without periodical reelection?”

¹⁶⁹ See details about the political reform on electing lawmakers in Chapter 3.

election.

The central government initiated its privatisation plans for the Farmers Bank and Chiao Tung Bank in 1992 and 1994 respectively. While it was not very clear why these two central government-controlled banks were chosen to be privatised first, based upon the way the government handled SOB privation at that time by releasing its shares in the stock market, it might be because these two banks were listed corporations and it would be less difficult to sell their shares quickly. Initially, the KMT government assumed these two banks were qualified for privatisation and would be sorted out in an efficient way. Unfortunately, most lawmakers had different views on the issue and the Executive Yuan had difficulty in convincing them until 1998. Although most lawmakers agreed with the direction to privatise the two banks, they expressed following concerns time and again:

1. These two banks all had special policy missions. Farmers Bank was for the farming industry; Chiao Tung Bank was for mid or long-term development of targeted industries. If they were privatised, would they continue these missions?¹⁷⁰
2. Some precedents showed that SOE privatisation turned out to transfer shares from the government to a number of private conglomerates, putting public interest at risk. The two SOBs might end up in the same situation.¹⁷¹

¹⁷⁰ Wang, “Jiaoyin shiguan guangu weichi liucheng” [The state still keeps 60 per cent share holding of the Chiao Tung Bank].

¹⁷¹ Lin, “Lin Chung-cheng pengji minyinghua jiang gongying bian dangying” [Lin Chung-cheng questioned the risk of turning SOEs into KMT-controlled enterprises through privatisation].

3. The government's privatisation policies were not complete while the government only tried to reduce its share holding to be less than 50%. If the government was really serious about giving up its control of the two banks, it should sell all its shares. The government was just trying to free the two banks from the supervision of the Legislative Yuan after privatisation.¹⁷²

4. The prices and timings to sell the government shares of the two banks' in the stock market were not appropriate. The two banks shares deserved higher prices and their release should be undertaken under the condition that it would not affect the price level of the stock market.¹⁷³

With these concerns not being properly addressed by the government, they argued, the bipartisan decision in the Legislative Yuan was to continue blocking the government's privatisation plan for the two banks.

3.2 Political reforms broke deadlocks of SOB privatisation

The aforementioned oppositions from the TPG/TPA and the lawmakers in the new Legislative Yuan notably disappeared in 1997 after President Lee Teng-hui launched new political reforms in 1996 and 1997. After Lee was re-elected as President --- for the first time by popular vote --- in March 1996, he sought to find consensus among different political forces about the development of Taiwan in several key policy areas such as cross-strait relations, economic development and constitutional reform. With

¹⁷² Ibid.

¹⁷³ Ho, "Nongyin jiaoyin erbaiyi yuan shiguan jingxian guoguan" [20 billion-sale project of government-owned stocks in Farmers Bank and Chiao Tung Bank approved among interruptions].

support from the DPP,¹⁷⁴ Lee successfully convened the National Development Conference (NDC) in December 1996 and put the political consensus reached in the NDC into practice by constitutional amendments in July 1997.

The most important result from this series of political reforms regarding the SOB privatisation was the decision to downsize the TPG and TPA by the end of 1998 with almost all their functions and assets including TPG-controlled banks transferring to the central government. In response, the TPA decided to overthrow its 1989 resolution and implement the privatisation of the three TPG-controlled banks.¹⁷⁵ Suddenly, “A case which had been delayed for two decades was sorted out in two years.”¹⁷⁶ Chen Yi-shan, a journalist of a leading magazine in Taiwan, described the moment in her investigation report right after the TPA decision. In this report, Chen also reviewed the change and process regarding privatisation of TPG-controlled banks over the past two decades before late 1997:

“...In the 1970s, due to the KMT’s memory about financial chaos in the mainland China before 1949, the [central] government never thought to give up its control of

¹⁷⁴ The DPP shared common political goals with Lee. The most important one was the downsizing of the TPG and TPA. In addition to their concern for better efficiency and governance, they also wanted to reduce the power of TPG governor James Soong, whose approval rate among the public was extremely high at that time.

¹⁷⁵ By controlling the agenda, the TPA could get involved in deciding the price of shares of the banks for sale and the timing to put the sale in the market. See Chen, “Jinjinmu shengfu qiangzhe ‘zixing liaoduan’” [The TPA rushes to ‘kill its own hen that lays golden eggs’].

¹⁷⁶ Chen, “Minyinghua muhou: sanshangyin zoubuchu zhengzhi yinying?” [Behind privatisation: Is the three TPG-controlled commercial banks still in the shadow of politics], 172.

state-owned banks¹⁷⁷. ...In 1983, then Premier Yu Kuo-hua thought it was still better not to privatise TPG-run banks in light of their 'big size' in the banking sector even though he agreed to let new banks in the future private-owned. ... In the late 1980s, the [central] government began to favour the idea of privatisation. But the elected representatives emerged to become new obstacles of privatisation. While the [central] government announced to privatise three TPG-run commercial banks in 1989, The TPA responded with passing the '51 per cent' resolution in the same year. ...After political delay for two decades, now a political conference [the NDC] speeded up the pace of privatisation."¹⁷⁸

This report not only concisely confirms my previous analysis but also indicates a new political wind which would affect the following pace of SOB privatisation was blowing. Soon after in 1998, all the three banks including another smaller bank were all privatised as the fifth column of Table 4.1 indicates. The success of the reform triggered a follow-up at the Legislative Yuan. On the one hand, the reform had set a precedent and all involved parties were satisfied with the results.¹⁷⁹ On the other hand, the political climate pushed the Legislative Yuan to react to the privatisation issue. Because one of the resolutions passed in the NDC required that all the SOEs should be privatised in 5 years, though not legally binding, the Legislative Yuan had pressure to follow. As a result, Farmers Bank and Chiao Tung Bank all successfully completed

¹⁷⁷ More details about the mentality are addressed in Chapter 5.

¹⁷⁸ Chen, "Minyinghua muhou: sanshangyin zoubuchu zhengzhi yinying?" [Behind privatisation: Is the three TPG-controlled commercial banks still in the shadow of politics], 172-173.

¹⁷⁹ The positive reactions from the employees in the four banks were particularly meaningful.

their procedure of privatisation in 1999.

4. The failed deregulation on the SOBs in the KMT era (the 1990s)

As the SOB privatisation was seriously delayed throughout the whole 1990s, the other dimension of SOB reform – deregulation – failed completely in the end. The KMT government was never able to pass the *Regulations Governing State-run Financial Institutions* (RGSFI) despite repeated attempts at the Legislative Yuan. At least ten versions of RGSFI were drafted by the KMT since the first formulation of the idea of deregulation in the 1970s.¹⁸⁰ However, according to the study of Lee Yun-san, since the beginning a lasting dispute among different branches of the central government doomed its enactment.¹⁸¹

As the draft of RGSFI was proposed by the Ministry of Finance (MOF) under the Executive Yuan and its purpose was to free the state-run financial institutions from the existing regulations for all civil servants and SOEs, it ran into the strong opposition from other related governing Yuans: the Control Yuan, the Examination Yuan and the Legislative Yuan. For the Control Yuan, it had the power to audit whether government agencies used their budgets in accordance with their original plans and amounts. For

¹⁸⁰ See these versions of different drafts at Ministry of Finance, *Gongying Yinhang Quanli Caoan Cankao Ziliao* [Collections of the documents related to the drafts of RGSFI].

¹⁸¹ Lee, “Taiwan Gongyou Jinrong Jigou Quanli zhi Tanta” [On the management of state-owned financial institutions]. Lee used to be the minister of finance. He was in office in 2002 for the DPP government.

the Examination Yuan, it was in charge of recruiting civil servants and their promotions and pensions. As for the Legislative Yuan, it had the power to review all the budgets and plans of government agencies before they were implemented. If the new act RGSFI could make an exception, these Yuans contended that the Executive Yuan would cross the line of power boundary and create constitutional controversies. As a result, the MOF had tried to strike a compromise among the Yuans and all those different versions of the RGSFI were the results. Unfortunately, the gap among different views was so huge that a deal was difficult to be reached.

While this explanation is convincing in a sense, it does not seem to be able to explain why an authoritarian regime like the KMT before the 1990s could not coordinate different views on this issue. Perhaps, the real cause behind the delay to put the RGSFI into practice is that the KMT did not really want it to happen before the financial “Big Bang” of 1989. As the SOBs were still very helpful in promoting industrial policies, excluding largely the participation of private players in the banking sector and maintaining the stability of the financial system, the KMT lacked incentives and determinations to enact the RGSFI.¹⁸²

To break the deadlock, a constitutional amendment with regard to the RGSFI was approved by the National Assembly in 1994. The article says:

¹⁸² Again, I am indebted to Mr. Huang Tien-lin for this argument.

The state shall manage government-run financial organizations, in accordance with the principles of business administration. The management, personnel, proposed budgets, final budgets, and audits of the said organizations may be specified by law.¹⁸³

The passage of the article stemmed from the strong lobby pushed by the Association of Banks when sustainable SOB privatisation was still not in sight and new private commercial banks just entered the banking sector. The SOB members of the association attempted to strengthen their position in the future market by enacting the RGSFI.

The latest draft of the act was sent to the Legislative Yuan for deliberation in 1997. Once again it did not get through. Firstly the Legislative Yuan was too concentrated on SOB privatisation that it did not have a session for discussing the draft act. Then, when the act was finally discussed in 1999, most lawmakers insisted that there was no need to enact the act if the government planned to privatise almost all SOBs soon. Also, they argued that, as a number of cases of SOB privatisation were just completed recently, all the MOF had to do was to keep doing this task.¹⁸⁴

¹⁸³ Article 10, Item 4, the Additional Articles of the Constitution of the Republic of China, available at <http://www.gio.gov.tw/info/news/additional.htm> (accessed August 26, 2005)

¹⁸⁴ Legislative Yuan, *Lifayuan Gongbao* [Parliament Minutes], 88, no.33: 191-231.

5. The SOB reform in the DPP era (2000-2008)

5.1 The DPP's basic stance before 2000

Before the DPP came to power in 2000, it held an extremely negative attitude toward the state-owned enterprises (SOEs) including the state-owned banks (SOBs). From its perspective, the SOEs were inefficient to the economy and provided special access for profit to the KMT. Taking side with a number of liberal economists,¹⁸⁵ the DPP saw the SOEs as a burden to the economy for their survival lay not in their competitiveness but in their monopolistic or oligarchic positions in their individual sectors. If they could be privatised and other private enterprises were allowed join the competition, their productivity would pick up and the whole economy would benefit because of better product quality and lower prices spurred by open and fair competitions among market competitors. It also denounced the SOEs as channels for political feedbacks to some high-ranking government officials and military officers after they retired. Normally, these retired officials and officers would be granted the positions as the chairmen or presidents in some SOEs. What was even worse was that the SOEs were frequently contributing to the growth of the KMT's own business empire by providing massively profitable contracts, an evident symptom of the KMT's abuse of its long-time political rule.

¹⁸⁵ Chen, Lin, Chu, Chang, Shih, and Liu, *Jiegou Dangguo Ziben Zhuyi* [Disintegrating KMT-State capitalism].

Because of this negative stance, the DPP upheld privatisation as a tool to dismantle the colossal SOEs and undermine the KMT's economic power base. In the DPP's Fundamental Guidelines, the section on economic, fiscal and financial policies briefly outlined these goals:

The SOEs have to be privatised and exposed to market competition. In order to get rid of political cronyism and market monopolies, and enhance operational efficiency, this basic principle should be followed. For some SOEs enjoying monopolistic or oligarchic market positions but having difficulties being privatised in the near future, their functions have to be adjusted and put under the careful surveillance of the legislatures.¹⁸⁶

Accordingly, the DPP should have shared a common ground with the KMT regarding SOE privatisation since the KMT's announced policies were on the track that the DPP wished. Nevertheless, in practice, the DPP was also worried that the KMT might manipulate the process of privatisation for its own benefit. As the KMT was the ruling party, it had easy access to inside information about many projects of the SOE privatisation. In the name of privatisation, the KMT could either let its own business empire acquire some SOEs or instead let its powerful partners, the local business tycoons allied with it, get similar juicy deals. As a consequence, SOE privatisation would not produce a healthier economy but a lasting twisted economic system under

¹⁸⁶ See Section 3, Article 7 of the DPP Fundamental Guidelines at Democratic Progressive Party, "Jiben gangling" [Fundamental stances and guidelines of party Constitution].

the dominance of the KMT business empire and its cronies. Moreover, even after privatisation, the KMT government could still control most former SOEs through controlling the majority in their boards as the biggest share holders. Under such circumstances, while the “privatised” SOEs were still under the government’s control, they were no longer under the monitoring of the legislatures. Thus, the DPP tended to insist on a “real” privatisation of the SOEs: without any interference from the government and the KMT in any way.

The DPP’s concerns were highlighted and addressed in the National Development Conference (NDC) of 1996 because the KMT needed the support from the DPP to avoid the failure of the conference. Under the demand of the DPP representatives and the widespread support of other participants, the NDC reached two important consensuses with regard to SOE privatisation and KMT enterprises:

1. All the SOEs have to be privatised in 5 years.
2. The KMT promises that its enterprises will not take part in the investments which are involved with business in monopolistic or oligarchic position and government projects.¹⁸⁷

Overall, the DPP’s stance on SOE privatisation before 2000 was cautious support. It embraced the idea of using privatisation as a means to improve the SOEs in particular

¹⁸⁷ Chen, “Dangying shiye jiangshe sida jinzhi tiaokuan” [Four No’s will be imposed on the KMT enterprises].

and the whole economy in general. But the worry that the KMT might exploit its ruling position to benefit from the process of privatisation made the DPP see the issue with caution.

5.2 Two stages of financial reform under divided government

After the DPP took power in 2000, the issue of SOB reform was reduced into how much and how fast the rest of the SOBs should be privatised and controlled. The DPP government gave up the idea of enacting a new act to deregulate a part of the SOBs and decided that most SOBs were needed to be privatised soon. But the issue of SOB reform was no less complicated for the DPP than it was for the KMT before 2000. No sooner than it came to power, the DPP faced a looming non-performing crisis and a significant number of financial institutions were on the verge of insolvency. It had to sort out the crisis before it could continue the SOB reform. Besides, the issue of “government-run but private-owned” banks needed to be further addressed. As Table 4.1 shows, the KMT actually had privatised eight SOBs before 2000. But these banks were still controlled by the government after 2000 because the government still held the biggest part of their shares.¹⁸⁸ Whether the government should keep reducing its shares caused new controversy about the state’s role in the banking sector.

¹⁸⁸ As the private share holders were scattered, it was not easy for them to have collective and concerted actions against the control of the government on these banks, even though the percentage of private shares outnumbered that of the government in total.

Furthermore, politics in Taiwan during the DPP era made constructive policy deliberation less likely. Even though the DPP won the presidential elections of 2000 and 2004 consecutively, the KMT and its ally the People First Party (PFP) kept control of the Legislative Yuan. The constant confrontation between the opposition's "Blue camp" and the ruling party's "Green camp" (composed of the DPP and its ally the Taiwan Solidarity Union, TSU) on national identity grounds and other related issues made politics more polarised than ever. As a result, party discipline was much more tightened in all political parties in the Legislative Yuan. The former bipartisan opposition to the KMT's Executive Yuan's policies obviously declined. What occurred more, instead, was that the Blue overthrew, altered or blocked the policies of the Green, putting the DPP government in a difficult ruling position.¹⁸⁹

Nevertheless, as we look back at the DPP's first term in government from 2000 to 2004, unlike its many policies in other areas, the DPP's financial reform policies suffered relatively less from its minority position in the Legislative Yuan. Despite numerous delays on approving essential bills, budgets or plans by the opposition parties, the DPP managed to attain notable credit for its financial reform. The goal of the first stage of financial reform was the so-called "258 financial reform." Initiated

¹⁸⁹ The best example is the issue of arms sale deal with the US. As the Bush administration approved to sell a number of important weapons to Taiwan in 2001, the budget had been constantly blocked by the Blues in the Legislative Yuan.

by President Chen Shui-bian in August of 2001, the reform target was to lower non-performing loan ratios to below 5 per cent and raise capital adequacy rates to 8 per cent of domestic banks within two years. Eventually, the target was achieved on time. Meanwhile, after the passage of the Financial Holding Company Act in 2001, 14 financial holding companies had been established from 2001 to 2002. In addition, with regard to speeding up the disposal of seriously troubled financial institutions, the Financial Restructuring Fund was established and had successfully bailed out 47 of these institutions and forced them to drop out the market through closures or mergers. Also, the DPP government overhauled the financial regulation system by setting up the Financial Supervisory Commission (FSC), an single integrated agency aiming at independently supervising and monitoring the operation of the whole financial system.

With hindsight, two key factors contributed to these better-than-expected outcomes. First, as a looming banking crisis approached, the opposition parties were under social pressure to be in cooperation with the DPP on reform bills and measures. Although sometimes they disagreed on some technical matters or worried that the DPP might get too much credit, they did not totally block the DPP from implementing financial reform, especially as it attained strong support from the media and public opinion. Secondly, the convention of the Economic Development Advisory Conference

(EDAC) by President Chen in 2001 reinforced the mandate of the DPP reform agenda.

The conference took place at a time when Taiwan experienced the worst economic downturn in past decades. By inviting representatives from the ruling and opposition parties, scholars, business leaders, and labour unions, President Chen was hoping to use the conference to find out common goals and effective solutions to the unprecedented economic challenges facing Taiwan.¹⁹⁰ What was approved by the conference got such a strong legitimacy that no political parties could oppose them without good causes.

The conference also sped up the SOB privatisation as one of the consensuses reached required that the government-run banks should be entirely privatised.¹⁹¹ The DPP then focused on reducing the government shares in the “government-run but private-owned” banks.

Based on the accomplishment of financial reform made in his first term, in October 2004, President Chen took a further step in his second term on consolidating the banking sector by unveiling his goal of “the second stage of financial reform” --- to half the number of government-run banks to six by 2005 and the number of financial

¹⁹⁰ See the background of the conference at a press release at Office of the President, Taiwan, “Background for Convening the Economic Development Advisory Conference.” Available at http://www.president.gov.tw/2_special/economic/e_index.html (accessed August 14, 2005).

¹⁹¹ In the common views of the finance group of the conference, which is available in Chinese at: http://www.president.gov.tw/2_special/economic/index-92.html (accessed August 14, 2005).

holding companies to seven by 2006, increase the market shares of three domestic banks to above 10 per cent,¹⁹² and encourage one financial institution to be taken over by a foreign counterpart or listed in overseas markets.¹⁹³ The rationale behind this reform agenda, according to the former Vice Premier Wu Rong-yi, who was commissioned to supervise the banking sector reform in 2005, was to solve the problem of over-banking and strengthen the competitiveness of local players by increasing their scale. The long-term goal of the second stage of financial reform was to have three to five “national champions” banking groups that would together have a market share above 80 per cent. As the private players remained wary about merging with their rivals, the government decided to begin the consolidation process by requiring the SOBs and government-run banks to seek for mergers and acquisitions first.¹⁹⁴

However, the push for the second stage of financial reform in 2005 raised public concerns and surging oppositions of the labour unions when government-run banks were planned to be acquired by private players. The typical case is the failure of the sale of shares in government-run Taiwan Business Bank. The labour union of the

¹⁹² The three banks could be private or public-owned and did not rule out the participation of foreign capital. The point is to cultivate national champions of banks and make the banking sector less scattered.

¹⁹³ Lin, “Dier jieduan jingai xingli licu jinkong zheng bing” [The second stage financial reform aims at creating profit by consolidating financial holding companies].

¹⁹⁴ Chou and Lu, “Erci jingai zhihuiguan gui Hua lantu” [Commander of the second stage financial reform specified the blueprint].

bank was not satisfied with the early-retirement packages for laid-off workers proposed by the private bidder E. Sun Financial Holding Co. After a four-day strike and prolonged negotiations, the bidder dropped its bid.¹⁹⁵ Since then, a controversy had been raised on the way the DPP government “privatised” government-run banks. Some were questioning that the government was deliberately selling out its banks to private players at a low price, which not only undermined the public interest but also put the benefit of current employees of banks at risk. Against the backdrop that the income gap between rich and poor was increasing over recent years in Taiwan, the government’s rushed attempts to sell banks to private conglomerates had been viewed by critics as adding fuel to the fire.¹⁹⁶ Seizing the opportunity, the opposition parties vowed to stop the government from pushing ahead with the second stage of financial reform, casting more uncertainty on the reform’s future. With the setback, the DPP government could only push for the mergers among the government-controlled banks as this approach would encounter less resistance and opposition.¹⁹⁷ While it eventually did reach the target deadline to half the number of government-run banks

¹⁹⁵ Lin, “Sale of state-run bank declared a failure.”

¹⁹⁶ A social movement group, *Fanzi Lianmeng* [Alliance of fairness and Justice], is one of the most active critics. See its view on the issue on its website: <http://www.justice.org.tw/index.htm> (accessed August 20, 2005). Also see the analysis from the perspectives of consumers and bank labours at Hsia, *Sujiao yapian: shuangka fongbao shuachu Taiwan fujhai weiji* [Plastic Opium: The credit and debit cards crisis and debt crisis in Taiwan]. Hsia, “Jinrong zihben ruhe chihren [How financial capital destroys people’s lives].

¹⁹⁷ For the mergers among government-controlled banks did not involve private players at all, thus raised less concern of benefiting any private player.

to six by 2005,¹⁹⁸ the rest of the reform fell apart in 2006 amid growing controversy.¹⁹⁹

Conclusion

As this chapter shows, the rapid democratisation over the recent two decades in Taiwan has significantly affected how the Taiwanese government addressed the SOB reform. Due to rapid democratisation, the government has been forced to accommodate a new political environment where the power of the elected politicians at the provincial level (the TPG/TPA) or at the national level (the Legislative Yuan) has been elevated to such an extent that it constantly challenged policies formulated by the administrative power centre. Meanwhile, the nature of challenge has significant difference before and after the first power transfer in 2000. While the impact of democratisation on SOB reform was more felt in term of independent behaviour by elected politicians from all political parties in the KMT era, it evolved into a clash between the ruling party and the opposition parties in the DPP era.

Democratisation has brought mixed impacts on the SOB reform. On the one hand, the government has suffered delay or failure; on the other hand, the transparency and accountability of the government is far more improved. The prospect of financial

¹⁹⁸ The six government-run banks were the First Financial Holding Company (FHC), Hua-Nan FHC, Mega FHC, Bank of Taiwan, Taiwan Cooperative Bank, and Land Bank of Taiwan.

¹⁹⁹ For more details about the controversy, please see Section 3.2 of Chapter 5.

governance particularly and economic governance generally in Taiwan will depend on whether democracy can further deepen to find a right balance among governing transparency, accountability and efficiency.

As far as the SOB reform is concerned, a major challenge is unsolved --- the role of government-run banks is not clear. On the one hand, the majority views agree to reduce the government intervention in the banking sector. But, on the other hand, as people are also worried that the influential financial groups owned by private players²⁰⁰ might control the sector and put the public interest at risk, people are expecting the government can play a stronger role as a counter balance. If the government keeps selling all its shares of the banks it still controls, it will lose a strong leverage against the dominance of big private players from abroad or at home.

To sum up, the SOB reform in Taiwan is at a crossroads. In a new democratic era, the rapidly changing political landscapes behind the reform and the shifting public opinions on the issue have made it more complicated and controversial. The next chapter, which focuses on the state's policies on the new private commercial banks, will provide another strong case to prove this view.

²⁰⁰ In the financial sector, there are three most influential family financial groups: the Koo family with Chinatrust FHC (No.7) and China Development FHC (No.12), the Wu family with Taishin FHC (No.2) and Shin Kong FHC (No.8), and Tsai family with Cathay FHC (No.1) and Fubon FHC (No.6). The numbers behind these FHCs are their rankings in terms of total assets among the 14 FHCs in Taiwan. Politically, these families are active in maintaining their relationships with all the main political parties. Their influence is persistent no matter which party is in power.

Chapter Five

The policies on the new private commercial banks (1988-2008)

Aside from the reforms on the state-owned banks (SOBs), another crucial plan in Taiwan's financial "Big Bang" launched in the late 1980s was to open up the banking sector to the new private players. The plan was a milestone in Taiwan's financial history as the banking sector had been dominated by the SOBs for decades after the Second World War. Basically, the argument for the need of the plan was similar to that of SOB privatisation. It was strongly believed that the addition of more private banks could bring greater competition, improve service quality and push the SOBs to upgrade effectively. In other words, most people were anticipating a new banking sector where the dominance of SOBs would become history and the whole sector would turn out to be more diverse, competitive and efficient.

In contrast to the SOB reform which ran into serious delays and failures as the previous chapter has shown, the plan to allow the establishment of new private commercial banks went through almost without any difficulty. From its approval in 1989 to the granting of licences to 15 new banks in 1991, the plan was completed in only about two years. Why, against a similar background, could the plan get through in a relatively easy way?

Moreover, it seems that the government, no matter under the KMT or DPP, has difficulty in dealing with the new private banks after the opening. In the KMT era, bank runs and non-performing loans (NPLs) surged with the increase of new private banks over the 1990s. In the DPP era, as briefly mentioned in Chapter 4, the public has serious concerns about the growing influence of a small number of family business groups which will have a huge potential to control a significant part of the financial sector through acquisitions of small private players and state-controlled banks under official encouragement after 2000.

What went wrong with the government's policies on the new private banks from 1988 to 2008 is the focus of this chapter. Three key questions are highlighted. Why did the government want to open the banking sector in the first place? Why did the government allow 15 new private banks to open at the same time in 1991? Why did the government run into difficulty in managing the new private banks afterwards?

In my view, the policies on the new private commercial banks are just like to "open Pandora's box." Before the box was opened, the government was confident that everything would be under its control and expected that all the good effects would come along with the new entries of private players. After the box was opened, however, some "unexpected" troubles occurred and challenged the government's

capability in coping with them. This is another case to justify the argument of the thesis from the perspective of how the emerging business power in the banking sector makes it difficult for the state to deliver sound financial governance in the context of Taiwan's rapid democratisation.

1. A forced opening (1988-1989)

1.1 Private Banks before 1991

Looking back at the post war history of Taiwan's financial development, there is no question that the decision to lift the ban on the establishment of new private banks in 1989 is an enormous breakthrough. Prior to the lifting, the KMT government had deliberately repressed the development of private banks and let the SOBs dominate the financial system. The policy was upheld for two fundamental reasons: the KMT's overriding concerns of financial stability and its deep distrust of big private capital.

As a "foreign" regime which only began to have formal connections with the Taiwanese after their previous colonial government of Japan surrendered in 1945, the KMT had been highly alert to how to consolidate its effective rule in Taiwan especially after its loss of the civil war to the Chinese Communist Party (CCP) in 1949. In addition to imposing the martial law to tighten political control and constrain political rights, the KMT heeded its lessons from the civil war --- it could only sustain

its rule by effectively controlling hyperinflation and maintaining financial stability, which was a crucial precondition for preventing social disorder and fostering economic development. Moreover, the official ideology of KMT preached by Sun Yat-sen,²⁰¹ the “three principles of the people” or *San Min Chi I* (nationalism, democracy and the people’s livelihood), advocated that state capital was more useful and reliable for national development than private capital. Hence, it was not surprising that the KMT monopolized the banking sector through SOBs and controlled key industrial sectors through state-owned enterprises (SOEs).

As a result, private banks were relatively few and weak before 1991 on Taiwan. The only private banks which could exist were all with special considerations. The first kind of these banks was connected with overseas Chinese capital, composed of The Bank of Overseas Chinese and United World Chinese Commercial Bank. Their origins have been well explained in their official websites:

“...was established with funds from overseas Chinese and domestic investors in response to the government’s appeal for overseas Chinese to return and invest in financial institutions in Taiwan, and thereby help develop business and industry in general and overseas Chinese-invested enterprises in particular.”²⁰²

²⁰¹ Sun Yat-sen was the founding father of the KMT and Republic of China.

²⁰² See the website of Bank of Overseas Chinese: http://www.booc.com.tw/english/about_us_1.asp (accessed April 9, 2007). The bank was acquired by Citi financial group in 2007 to become Citibank Taiwan Ltd. United World Chinese Commercial Bank had merged with Cathay United Bank in 2003. But similar statement has also been mentioned on the website of new merged bank in Chinese. See

At a time when Taiwan was short of foreign capital and the KMT regime was in competition with People's Republic of China (PRC) under the CCP for the favour of overseas Chinese from the 1950s to 1970s, the existence of private banks with overseas Chinese capital had its economic functions and symbolic meanings in politics.

The second kind of private banks established in Taiwan before 1989 was those banks which used to have business operations in mainland China. Shanghai Commercial & Savings Bank (SCSB) and International Commercial Bank of China (ICBC) were under this category. The SCSB used to be the biggest private bank in mainland China. It transferred to Taiwan with the KMT regime after 1949. Its unique existence relied on its special past and sound relations with the KMT.²⁰³ As for the ICBC, it used to be called "Bank of China" and was a state-owned bank with origin traced back to the late Qing Dynasty. It was privatised in 1971 before the PRC replaced the Republic of China's (ROC) position in the United Nations for the fear that PRC might claim its ownership of the bank when Taiwan lost most official recognitions worldwide.²⁰⁴

The third group of private banks before 1989 was composed of the private companies

<https://www.cathaybk.com.tw/cathaybk/about.asp> (accessed April 9, 2007).

²⁰³ The current chairman of SCSB, Mr. Yung Hung-ching, comes from a legendary business family that has a successful business record for more than 100 years in China. The Yung family is still active in business in China, Hong Kong and Taiwan.

²⁰⁴ Nevertheless, as the government still held largest shares of the bank, the bank was still run by the government.

for mutual loans & savings. Although these companies were not called “banks”, they actually provided financial service to their members on savings and loans and worked liked cooperatives for decades in Taiwan. Following the promulgation of the revised Banking Law in 1975, these companies were required to transform into commercial banks for the purpose of providing financing assistance and guidance to small and medium-sized enterprises (SMEs) in specific regions. In other words, they all became regional SME banks. Totally, there were seven of this kind of regional SME banks and each of them was named after the place where its banking business was centred.²⁰⁵

Overall, among the 24 domestic banks, 11 private banks existed before the entry of new private banks in 1991. But the actual influence of these private banks was much smaller than it appeared in the whole banking sector. As Table 5.1 shows, in terms of their assets shares among all financial institutions in the banking sector, they only represented less than 9 per cent. In contrast, the SOBs had almost 54 per cent. Likewise, the same applied to the foreign banks. Although there were 36 of them, their total assets only stood for less than 3 per cent.

Apart from size and amount, in a heavily regulated banking industry, the scope of business of private banks was highly constrained too. For example, for the 7 regional

²⁰⁵ For example, the one in Taichung was called “Taichung Business Bank.”

SME banks, they could only operate in certain administrative areas and the majority of their lending was required to target the SMEs. In addition, the kind of service the private banks could provide was also subject to the discretion of the Ministry of Finance (MOF). Normally, the SOBs, especially those with mainland origins, were given the widest scope of business and their service consisted of the most lucrative business like foreign exchange transactions and overseas business.²⁰⁶

Table 5.1: Landscape of Taiwan’s banks in 1990

	Private Banks			State-owned Banks			Foreign Banks
	Overseas Chinese	Mainland origin	regional SME	Mainland origin	Pre-war origin	others	
Name of banks	1.Bank of Overseas Chinese 2.United World Chinese Commercial Bank	1.Shanghai Commercial & Savings Bank 2.International Commercial Bank of China	1.Taipei 2.Hsinchu 3.Taichung 4.Tainan 5.Kaohsiung 6.Hualien 7.Taitung	1.Central Trust of China 2.Chiao Tung Bank 3.Farmers Bank of China	1.Bank of Taiwan 2.Land Bank of Taiwan 3.Taiwan Cooperative Bank 4.First Bank 5.Hua Nan Bank 6.Chang Hwa Bank 7.Taiwan Business Bank	1.Export-Import Bank of the ROC 2. Taipei Bank. 3.Bank of Kaohsiung	
Numbers	2	2	7	3	7	3	36
Total	11			13			36
Asset (%)	*8.89			*53.68			*2.9

Source: the author’s collection

* The asset percentages of different kind of banks among all the financial institutions in the banking sector. See Lee, Jih-chu “Taiwan kaifang minyin yinhang zhi jingyan yu zhanwang” [Reflections on Taiwan’s policies on new private banks], December 2002, NPF Research Report, National Policy Foundation. The paper is available at <http://www.npf.org.tw/PUBLICATION/FM/091/FM-R-091-063.htm> (accessed April 11, 2007).

In a word, the private banks played a far less significant role than the SOBs in

²⁰⁶ It was a discrimination policy against those banks with pre-war origins in Taiwan. As the mainlanders controlled the KMT before the late 1980s, their favour of those banks with mainland origins was demonstrated in this kind of regulation for banks’ business scope. See a critique to the policy in Huang, “Yi liang jiang shidai zhi jinrong zhimin zhengce” [Recall the financial colonialism under the KMT authoritarian rule].

Taiwan's banking sector before 1991. Except for these special cases, it was impossible to set up private banks under the KMT regime before the 1990s.

1.2 Mounting pressures for lifting the ban

Nevertheless, in the second half of the 1980s, the KMT government was under mounting pressures to open the closed, tight-controlled and state-dominated banking sector. The convergence of pressures from a number of sources forcefully pushed the KMT government to pursue economic liberalisation.²⁰⁷ But, for the sake of focus, here we will only concentrate on the part of emerging business influence, which had played an important role in pushing the government to lift the ban on entry of new private banks.

After a long span of rapid and sustainable economic development for almost three decades, the rise of the business class seemed inevitable and in Cheng's terms, "the rapid growth had liberalizing social consequences that the KMT had not fully anticipated."²⁰⁸ As he observed, economic take-off had led to tremendous social transformation:

"With the economy taking off, Taiwan displayed the features common to all growing capitalist societies: the literacy rate increased; mass communication intensified; per

²⁰⁷ These sources mainly included the US's strong requirement to open markets, rapid rise of political oppositions, emerging business power and a bubble economy. Please see details in Chapter 4.

²⁰⁸ Cheng, "Democratizing the Quasi-Leninist Regime in Taiwan," 481.

capita income rose; and a differentiated urban sector-including labour, a professional middle class, and a business entrepreneurial class--came into being.”²⁰⁹

Also, he noticed that

“...the dynamic capitalist system had simply outgrown the regime's political capacity. ...The ever-expanding civic and economic associations are simply beyond the capacity of the KMT to monitor, much less to control. Moreover, there is a limit to which the regime can penetrate internationally oriented organizations, such as the Junior Chambers of Commerce, the Lions Clubs, and the Rotary Clubs.”²¹⁰

In short, the business class had consolidated its economic power and gained its autonomy which was gradually beyond the KMT's control in the late 1980s.

In fact, to be more specific, the business class could be further divided into two groups: the SMEs and big enterprises. For the SMEs, they had been the majority of the business class due to the KMT's distaste of big capital. Individually, they were relatively weak and unorganized. But because they had been less reliant on the protection, credit and other forms of assistance from the state for their development, and they were the main drivers for industrial production and exports, they were more capable of keeping a distance from the party-state under the KMT. As a result, without too much economic concern, the SMEs were more willing to defy the KMT

²⁰⁹ Ibid.

²¹⁰ Ibid, 482.

and join the anti-KMT forces as democratic movements picked up in the mid 1980s. Particularly, as the oppositions constantly appealed to economic fairness and dismantling the twisted economic structure dominated by the SOEs (including the SOBs) and KMT-run enterprises, the SMEs were inclined to lend their generous sympathy and support to the campaigns of the oppositions.²¹¹

For the big enterprises, despite the KMT's deliberate repression, they gradually consolidated their business bases during the economic take-off. Although they were the minority inside the business class, politically they were more influential. They had tended to be in cooperation with the KMT in exchange of economic privilege and monopoly in certain industrial sectors such as textiles, food processing, cement and petrochemical inside the domestic markets. Due to this special partnership, they were inclined to give less support to democratic movements in the 1980s.²¹² But as their business expanded, the restricted sources of credit had gradually become an obstacle. They were longing for easier access to cheaper credit through diverse channels. Moreover, from their perspectives, the banking industry was lucrative after witnessing the huge profits made by the SOBs for decades.²¹³ It was tempting for them to join

²¹¹ Ibid, 481-486.

²¹² According to Wang, there was not any public statement expressed by the big capitalists in support of democratic or social movements in the 1980s in Taiwan. See Wang, "Taiwan xin zhengshang quanxi de xingcheng yu zhengzhi zhuanxing" [The State, Capital, and Taiwan's Political Transition], 141.

²¹³ There are two indicators of a bank's performance: return on assets (ROA = Net Profits/Assets) and return on equality (ROE = Net Profits/Equity Capital). In 1990, before new private banks join, the average ROA of domestic banks was 0.9 per cent and the ROE was around 17 per cent. In comparison to international standards, these numbers were not bad.

the industry. Profit concerns aside, in their expectations, to own a bank would also both help diversify and expand their business territory, as well as facilitate their investment in the future.

Overall, it appeared that to require the government to open the banking sector to new private players had gained wide support among the business class. Although the business class alone was not powerful enough to make a breakthrough, its support of lifting the ban on new private banks reinforced the given pressures that the KMT had encountered from multiple sources.

1.3 From reluctance to eventual opening

In spite of the widespread speculations that the KMT would consider to allow applications of new private banks, the KMT still could not make up its mind in 1988, a year before the financial “Big Bang.” In fact, the call for lifting the ban to new private banks had been formally suggested by a task force organized by the KMT government itself in 1985.²¹⁴ The KMT delayed the reform until it was almost unlikely to hold it anymore. Yang proposed some reasons behind the reluctance.²¹⁵

²¹⁴ The task force was called “Jingji gexin weiyuanhui” [The Committee for Economic Reform] and organized by the Executive Yuan. It was aimed to seek solutions for future economic reform based on common ground among government officials, business leaders and academics.

²¹⁵ Yang, “Yinhang kaifang minying weihe youyu ” [Why does the government hesitate to open the banking sector?], 121-122. The last two reasons were more related to the SOB privatisation. In Yang’s paper, to open the banking sector indicated to allow new private banks to establish and to sell the SOBs to the private sector.

First, the KMT was concerned that the gap between rich and poor might become wider if some conglomerates controlled certain banks. It was likely that these conglomerates might abuse their positions and use the savings in their banks for their own investments. Second, the KMT was also worried that no banks would be willing to implement policy missions imposed by the government if they were private. In contrast, the SOBs were convenient and easy to control for this purpose. Third, recent cases had shown that private financial institutions were not as reliable as government ones. The incident of Tenth Credit Cooperative of Taipei in 1985 was a perfect example. In which, the private owner had constantly and deliberately violated related financial regulations by moving funds out of the credit cooperative for his own overstretched business ambition. Eventually, the credit cooperative collapsed amid a panic run on it, generating financial disorder and social turmoil. Four, the SOBs could provide massive annual revenues to the government. The loss of revenue after privatization became a concern as well. Finally, the vested interests like current SOB employees and lawmakers who benefited from easy loans might be opposed to the reform.

Two cabinet reshuffles after Lee Teng-hui took over the presidency from Chiang Ching-kuo created a window of opportunity for speeding up reform. With an eye to consolidate his vulnerable power and push reforms, President Lee Teng-hui

strategically undertook two cabinet reshuffles in 1988 and 1989. In the first reshuffle, he greatly changed the cabinet members of Yu Kuo-hua, the last premier under Chiang Ching-kuo. Then, in the second one, he was allied with Lee Huan, who was then the general secretary of the KMT, to force Yu to leave his post in May 1989. Yu had been criticized for not being able to effectively respond to the multiple challenges rising with the rapidly changing nation, undermining the image and popularity of the KMT. After Yu's resignation, Lee Huan became the new premier.

The departure of Yu marked the decline of the conservative wing of policymakers on financial policies. Yu was the governor of the Central Bank from 1969 to 1984 before he became the premier from 1984 to 1989. Under his leadership for two decades, the prime goal of financial policies was always stability; reforms could only take place in a piecemeal way. Now that Yu and his affiliates had lost power, the new minister of finance Shirley W. Y Kuo, who took office in 1988, had less resistance in pushing large scale financial reform inside the administration. The draft of the revised version of the Banking Law finally surfaced in early 1989.

While the draft contained many measures for banking reforms, the measure concerning the establishment of new private banks drew most public attention. The immediate reason for this heavy attention was an overheated economy in which the

public had unusually extra funds to engage in speculation investments. Due to the underdevelopment of capital markets and the stringent banking sector, people could only invest their money in limited items such as stocks, property, underground lottery and illegal investment companies. Many people suffered in the rush for wealth as related regulations and rules were not in place. The abrupt boom and bust of the illegal private investment companies was one of those disastrous examples. These companies attracted funds from the public with high return yields. Then they poured the pooled funds into highly speculative investments. But the formula could only work when the target investments were booming. If not, these companies collapsed immediately, not to mention those companies which were deliberately set up for financial fraud. It was widely believed that the KMT government was going to crack down on these illegal investment companies with updated regulations proposed in the new Banking Law. Also, the KMT was planning to address excessive money held by the public by luring them into the investments for new private banks. Given these concerns and the strong interest of business class mentioned earlier, the Legislative Yuan efficiently approved the revised Banking Law in July 1989. The gate to establish new private banks was finally opened.

2. Fading prudence (1989-1991)

2.1 A prudential beginning

As Taiwan was marching into democracy after the martial law was lifted in 1987 and the death of Chiang Ching-kuo in 1988, the state-business relations went through intricate and rapid transformation. The period from 1989 to 1991, in which the detailed rules, criteria and procedures for bidding new private bank licences were made and the final winners were revealed, indicated such a sea change.

In the beginning, after the revised Banking Law was passed, the KMT government appeared to be prudent in handling issuing the licences to new private banks. It emphasized that it was the duty of the government to ensure that the upcoming new banks could be built and run upon sound basis from the very beginning. From its perspective, to run a bank involved public interest as the bank's funds came from the general public's savings. If something went wrong with a bank, the social impact would be huge and pervasive.

Accordingly, the MOF set following tough guidelines as the major requirements and criteria of setting up a new private commercial bank:

1. The required minimum capital to establish a new commercial bank is NT\$10 billion.
2. The maximum share holding that each individual person could possess is 5 per cent.

For the family members or associated enterprises of the same person, the ceiling of their total share holdings of a new bank is 15 per cent.

3. The qualifications of chief managers of a new bank have to meet the requirements imposed by the MOF.²¹⁶

For the first rule, it was designed to make it difficult for applying the licences as the required minimum capital of NT\$ 10 billion was quite high according to global standards. Ideally, the rule could hold some applicants back and significantly reduce the number of potential applicants. For the second, it was hoped to reduce the influence of certain business families or conglomerates over a new bank. The ceiling of share holdings could prevent a new bank from the capture of certain individuals or conglomerates. As for the third, it was aimed to ensure that all the new banks would be run by quality managers. In other words, professionalism in management and operation was regarded as one of the major means to guarantee a healthy development of a new bank in the future.

Initially, most potential applicants seemed to be calm about these guidelines, for not many of them anticipated that the government would easily issue new licences. After all, the deregulation was the first big move that the KMT made to depart from its conservative past. It made sense for the KMT to adopt a cautious and gradual attitude

²¹⁶ For example, people who have criminal records of serious crimes or have not enough experience in the banking industry will not be allowed to become the high ranking managers of a new bank. See the whole requirements for applying a license to run a new private commercial bank at Ministry of Finance, “shangye yinhang sheli biao zhun” [Requirements for establishing a commercial bank].

toward the issue. Therefore, instead of challenging these guidelines, all business groups which had interest in bidding for new bank licences began to undertake a large scale of mobilisation of resources and connections in an attempt to increase the likelihood of meeting the requirements and criteria for setting up a new private commercial bank and outperform their rivals . In the process of mobilisation, an “unusual” combination and cooperation among business tycoons, former government officials, lawmakers and even academics emerged.

It was “unusual” because this kind of combination and cooperation used to operate in private and within the KMT control. In the past, the authoritarian regime was dominant over the private sector in their interactions. In appearance, the private sector had its chambers of commerce and associations in expressing its collective opinions and protecting its interest.²¹⁷ It even had representatives in the Central Standing Committee (CSC) of KMT, the power centre of the party. But in reality, the leaders of those institutions were “chosen” by the KMT and the institutions ended up more like the KMT’s tools to control and monitor their members. Meanwhile, the final decision of crucial policies in the CSC of KMT was up to the leaders of the KMT; the business representatives only played passive and minor roles. In short, business was

²¹⁷ The Chinese National Federation of Industries, the General Chamber of Commerce of the ROC and the Chinese National Association of Industry and Commerce were three main institutions of this kind during the KMT authoritarian rule before the 1990s.

subordinate to the state in terms of their power relationships.²¹⁸

Now it turned out that the business tycoons and their conglomerates were at the centre of all connections in mobilizing resources. Former government officials and legislators were not afraid to join the applications in a public way. What was more surprising was that the KMT did not see this phenomenon as a threat any more. All in all, these signs had shown the significant change of the state-business power relationships. The dominance of the state seemed to be in a transition to become history.

2.2 The race of resource mobilization

As of 12 October 1990, the deadline for applying new bank licenses, the MOF received 19 applications. The list of the applicants was a collection of well-known listed enterprises and influential politicians. It crystallized the consequence of intensive mobilization of resources and connections among business groups and political forces over the past one year. Basically, the main driving forces behind the mobilization were a host of conglomerates. To be more specific, as Table 5.2 shows,

²¹⁸ Dr. Guo Jiann-jong, a political economist trained in the UK, emphasized that this institutional arrangement to incorporate business representatives under the KMT party-state umbrella was an essential part of Taiwan's developmental state before 2000. From this perspective, he argued that the developmental state did not even exist under the DPP rule from 2000 to 2008 due to the DPP's lack of capacity to incorporate business interest and maintain its own autonomy at the same time. Dr. Guo offered this analysis in my interview in late 2004 as he was the Executive Officer of the Taiwan Thinktank.

some of them were more dominated by one single business family; some were more equally controlled among a number of business groups.²¹⁹ However, the most unusual case was the KMT bank: Hua Shin. The KMT's business empire planned to expand into the banking industry by establishing its own bank. As the KMT was the ruling party, the public was concerned about how the MOF would handle the case.

Table 5.2: The list of 19 applicants for new bank licences

Name of the bank	Chairman	Chairman's background	Major driving forces
Fubon	Tsai Wan-tsai	wealthy businessman	the chairman's family
Taishin	Wu Dong-liang	wealthy businessman	the chairman's family
UNION	Lee Tsun-jing	former government official	the Lin family
Far Eastern	Hsu You-hsiang	wealthy businessman	the chairman's family
Wan Tong	Wu Tsun-shian	wealthy businessman	business groups with Tainan origins
Cosmos	Hsu Sheng-fa	wealthy businessman	several business groups
Bao Dao	Chen Chong-guang	wealthy businessman	several business groups
Ta An	Lu Run-kang	former government official	several business groups
Ya Tai	Chiu Chia-hsiung	senior banker	business groups based in Taichung
Chung Sing	Wang Yu-yun	politician	the chairman's family
Ta Chong	Chen Tian-mao	politician	several business groups
Chinese	Wang You-tseng	wealthy businessman	the chairman's family
Fan Ya	Hsieh Ren-dong	senior banker	the Yang family
Hua Shin	Lin Li-xin	senior banker	KMT
E. SUN	Lin Chong-hsiung	academic	several business groups
Fu Guo	Lee Deng-mu	wealthy businessman	several business groups
Hui Tong	Tsai Wan-lin	wealthy businessman	the chairman's family
Wu Chou	Chen Si-ming	former government official	several business groups
Lan Yang	Liu Shi-cheng	former government official	several business groups

Source: *Tsaihsun* [Wealth Magazine], November 1990, 155.

Besides, the column of "chairman" also revealed some differences. Some chairmen were formally involved in politics and had close connections with the KMT. For

²¹⁹ Even until now, most enterprises in Taiwan are family-oriented. That is, a single family can control an enterprise in terms of ownership and management.

example, Hsu Sheng-fa, chairman of the Cosmos Bank, was the member of KMT's CSC. Wang Yu-yun, chairman of Chung Sing Bank, was the former KMT mayor of Kaohsiung. Chen Tian-mao, chairman of Ta Chong Bank, was the KMT speaker of Kaohsiung City Council. The characteristics of these chairmen were that they were politicians with massive personal family businesses. With both the advantage of political influence and personal wealth, they were hoping to have an upper hand in the race for new bank licenses.

Some chairmen were retired government officials related to financial policies or management. For instance, Lu Run-kang chairman of Ta An Bank, was the former minister of finance. Chen Si-ming of Wu Chou Bank, Liu Shi-cheng of Lan Yang Bank and Lee Tsun-jing of UNION Bank were all with similar backgrounds. In most cases, they were invited by a handful of conglomerates in an attempt to promote the image of their banks to the public as "led by experienced professionals." Meanwhile, it was also believed that former government officials had better knowledge toward how to apply for bank licences and their closer connections with current government officials who were supervising banking policies provided further advantages for their applications.

With similar logic, some senior bankers were invited to head some new banks in the

run for licences. Normally, they were used to downplay the influence imposed by the business families behind their banks. It was frequently claimed that their banks were not subject to any business family. Instead, their banks were in professional hands. To have senior bankers as the chairmen of their banks was the best justification. Chiu Chia-hsiung, chairman of Ya Tai Bank and Hsieh Ren-dong, chairman of Fan Ya Bank, were examples of such cases.

Nonetheless, for some business families, they cared less about the professional qualifications of their chairmen. For, according to official requirements, it was compulsory to have senior bankers as the general managers of all new banks. Hence, they just chose to have the current leaders of their business families as the heads of their banks. Tsai Wan-tsai, chairman of Fubon Bank, Wu Dong-liang, chairman of Taishin Bank, Hsu You-hsiang, chairman of Far Eastern Bank, Wu Tsun-shian, chairman of Wan Tong Bank, Wang You-tseng, chairman of the Chinese Bank and Tsai Wan-lin, chairman of Hui Tong Bank were all examples.

In short, in order to outperform their rivals and meet the requirements for new bank licences set by the government, all the applicants had done their best to mobilize resources to organize their best teams to deal with the MOF. But before the winners were formally revealed, very few people expected that the KMT government would

allow a large number of new private players to enter the banking sector.

2.3 A surprisingly wide open: shift of power relationships

On 26 June 1991, after almost 9 months of preparation, examination and speculation, the MOF finally announced the winners of new bank licences. To everyone's surprise, 15 out of 19 applicants were granted licences. The amount was much higher than expected. For the new Minister of Finance Wang Jian-hsuan, who took office in June 1990 after the third cabinet reshuffle since Lee Teng-hui took presidency in 1988, had revealed mixing messages before the final result was unveiled. By sticking to the original tone of prudence that the MOF had shown on the issue of new bank licences, Wang firstly said that he considered issuing 3 to 5 licences of new banks. Then on the eve of unveiling winners of new bank licences, he claimed that there would be more winners than everyone expected. Still, the list of 15 winners of new bank licences shocked the public. After all, to let more than 80 per cent of applicants pass meant that the MOF's review was not serious at all. The causes behind the policy shift and the implications of the final list of winners need further analysis.

From the inside story revealed by the press,²²⁰ which was also confirmed by my own

²²⁰ See the story reported by Chen, "Wang Jian-hsuan hezhun shiwu jia xinyinhang neimu"[The inside story of Wang's approval of 15 new private banks], 80-85.

research interviews with two former government officials²²¹ who were involved in the application review of new private banks, it showed that Wang Jian-hsuan was the key person in making the decision to have more entries of new private banks than initially planned. While it was not very clear why Wang made the decision, two levels of analysis, micro and macro, for possible explanations were frequently mentioned. From a micro analysis, emphasis was placed on Wang's personal characteristics and attitude. During Wang's term as Minister of Finance for 26 months, he portrayed himself as a man of conviction --- a government official who defended public interest and dared to defy the pressures from vested interests, conglomerates in particular. Due to this stance, it was argued that he disliked the way that some conglomerates tried to make huge profit through manipulating share prices by establishing their own banks. In an attempt to "punish" these conglomerates, he deliberately allowed more-than-expected new banks to enter the banking sector at the same time.²²² The rationale was that as the supply of new bank stocks was excessive, there would be smaller room for a surge of share prices of the new banks.

By contrast, a macro analysis put its focus on the shift of power relationships between the state and the business. Observers had noticed a subtle adjustment in which the

²²¹ They are Mr. Lin Shih-lang and Mr. Wang Chun-chih. The interviews were made in September 2004.

²²² Hsu, "Xintuoye gaizhi chongji zhi duoshao?" [What is the impact of transforming investment trust companies into commercial banks?], 269-270.

state began to take a more conciliatory approach towards the business. In Wang Jenn-hwan's terms, the adjustment was to upgrade the capitalists' power position from a subordinate role "like sons of the KMT" to "junior partners."²²³ In other words, as the KMT was still in charge in its power relationships with the capitalists, the capitalist had enjoyed more power than before. From this perspective, Wang Jian-hsuan's wide open policy to new private banks was just one of those examples that showed the ascendance of the capitalists during Taiwan's democratisation in the early 1990s.

A reporter had similar observation after she had followed the development of the new bank policy until the list of license winners was officially revealed:

"The final results show that the MOF made the decision with political considerations. It is a product of being 'strict in reviewing but loose in issuing' the licenses. ...The technocrats [in the MOF] wanted to resist outside interventions and pressures with strict and objective criteria in reviewing the application cases for new bank licenses. But the political environment has changed [and made it unlikely]. ... A high-ranking official with duty in financial policy has revealed: 'The MOF was under enormously invisible pressures to issue so many licences.'²²⁴

²²³ Wang, "Taiwan xin zhengshang quanxi de xingcheng yu zhengzhi zhuanxing" [The State, Capital, and Taiwan's Political Transition], 151.

²²⁴ Yeh, "Congkuan fangxing duobiao yinhang ye you shiluogan --- zhengce yunzuo sannian lijing sanren caizhang juece yibian zaibian" [Even winners of new bank licenses are not happy with the wild-open policy --- financial policy-making swung all the way through three ministers of finance over three years].

The reporter concluded her report by questioning the MOF:

“Why are we forced to accept the reality when we all hate money politics? Why are we all somehow disappointed with the result when we anticipated so much from the entry of new banks in the first place? The MOF owes the public an explanation.”²²⁵

With hindsight, I prefer to take side with the macro analysis. While Wang Jian-hsuan might really have made the decision for the purpose of “punishing” the conglomerates which applied for new bank licences, the consequence suggests otherwise. Most conglomerates were delightedly to get what they wanted and lost nothing. Although they might not be able to earn a lot from their banks’ share prices; their dreams to have their own banks were fulfilled. That was why some interpreted Wang’s decision as a concession to conglomerates, far from a punishment. They accused him of being incapable of resisting the strong lobby pressures from various business groups and political forces which were behind the applicants’ bid for new bank licences.²²⁶

On top of that, the micro analysis is inclined to miss the bigger picture of the whole event especially considering what had occurred to Wang Jian-hsuan afterwards. Wang was forced to resign in October 1992. The main reason of his departure was that his tax reform measures had caused a backlash from the business community. It proved

²²⁵ Ibid.

²²⁶ Professor Chen Po-chi from the Department of Economics at National Taiwan University provided this viewpoint in my interview. Professor Chen was close to President Lee Teng-hui as an economic policy adviser. The interview was made in July 2004.

that the KMT would rather appease the capitalists than support a reform-minded minister of finance. From this angle, even if Wang's decision on new private banks was really intended to "punish" conglomerates, the consequence of his policy was ironically in line with the main trend where the KMT was courting the business class to consolidate its ruling position.

Indeed, from the race of resource mobilization during the bidding process for licences to the eventual wide open for new entries and Wang's short stay in office, it is difficult not to conclude that the KMT was giving away its original ground of confidence and prudence on the issue of new private banks. The growing influence of business class had reached a new height.

3. Struggling with the aftermath (1992-2008)

3.1 The KMT era (1992-2000)

It was until the late 1990s when negative effects of excessive supply of loan providers were too obvious to ignore that the KMT government began to face up the issue of over-banking. But before it could adopt further essential measures on reducing the number of domestic banks, it was defeated by the DPP in 2000 presidential elections. On the whole, the KMT was busy struggling with the aftermath of its wide open policy on new private banks for most of the 1990s.

Shortly after the entry of 15 new private banks, the KMT government anticipated the arrival of intensified competition among banking institutions. But its focus was on other existing banking institutions - trust & investment companies²²⁷ and credit cooperatives. It estimated that they would suffer in the fierce competitions after the addition of 15 new private banks. In order to alleviate their sufferings and making them to compete with commercial banks on a more equal basis, the MOF suggested them to upgrade into or merge with commercial banks. As a result, the amount of domestic banks began to swell like a balloon from 1991 to 2000.

As Table 5.3 indicates, before the lifting of the ban on new private banks, there were 25 domestic banks in 1991. Then, with the addition of 15 new banks in 1992, followed by the upgrading of a host of trust & investment companies and credit cooperatives into commercial banks between 1993 and 2000, the total amount of domestic banks arrived at a record new high --- 53. That is, in just one decade, the number of domestic banks in Taiwan had been doubled. While the MOF put its efforts on upgrading disadvantaged players over the years, it did nothing to address the continuing increase of banks.

²²⁷ Before the 1990s, the KMT allowed 8 trust & investment companies to undertake banking services for mid and long-term industrial projects. Unlike commercial banks, they could not receive deposits from the public and had narrower scope of business. Still, they became one of the alternative channels for the private sector to take part in the banking industry as the licences for private commercial banks were banned.

Table 5.3: Number of Financial Institutions (1991-2008)

Year	Domestic Banks	Foreign Banks	Credit Cooperatives	Credit Departments of Farmer's Associations	Credit Departments of Fishermen's Associations	Trust and Investment Companies	Bills Finance Companies	Postal Savings System
1991	25	36	74	285	26	8	3	1
1992	40	36	74	285	27	7	3	1
1993	41	37	74	285	27	7	3	1
1994	42	37	74	285	27	6	3	1
1995	42	38	73	285	27	5	10	1
1996	42	41	73	285	27	5	12	1
1997	47	45	64	287	27	5	14	1
1998	48	46	54	287	27	4	16	1
1999	52	41	50	287	27	3	16	1
2000	53	39	48	287	27	3	16	1
2001	53	38	39	260	25	3	15	1
2002	52	36	37	253	25	3	14	1
2003	50	36	35	253	25	3	14	1
2004	49	35	32	254	25	3	14	1
2005	45	36	29	253	25	2	14	1
2006	42	33	28	253	25	2	12	1
2007	39	32	27	261	25	1	12	1
2008	37	32	27	264	25	-	10	1

Source: Financial Statistics Monthly, Central Bank, Taiwan

The negative effects of the reckless increase of banks firstly emerged in the mid 1990s as runs on financial institutions surged, and developed into a looming banking crisis at the turn of the century. The runs on financial institutions mainly occurred to the credit cooperatives and rural credit unions. As they were largely community-based, smaller in assets and narrower in business scope, it was not surprising to see that they were the first victims of the expansion of commercial banks. As for the looming banking crisis, it involved almost all banking institutions while their average level of NPLs soared across the board. Not surprisingly, people blamed over-banking for the NPL crisis. Due to intensified competition, many banks had loosened their reviews and

requirements for clients in need of loans. Consequently, some shaky clients got loans that originally were unavailable and put their loan providers at high risk. The risk was most likely to be exposed when economic downturns hit, for those shaky clients tended to become insolvent during economic recessions. As they had difficulty in paying back their loans, their banks had to bear the burden of mounting NPLs.²²⁸

But we cannot help asking – what had contributed to the late response of the KMT to the problem of over-banking? How can we explain why the KMT was “blind” to the continuing increase of banks after the entry of 15 new banks? I argue that the evolving domestic politics under rapid democratisation was still the key to these questions.

Firstly, as the KMT tried to adapt to the new political landscape shaped by rapid democratisation, it gradually lost its long-term vision and consistency on key financial policies. Since the very beginning, there had been no shortage of advice from some technocrats inside the KMT administration about the proper sequence of financial liberalisation²²⁹ --- to finish SOB privatisation before lifting ban on new private banks --- and adequate number of new private banks, the KMT somehow did not heed

²²⁸ The next chapter will have more detailed and complete analysis of the NPL crisis. Here I just briefly touch upon the issue.

²²⁹ For example, the late governor of the Central Bank, Liang Kuo-shu, had repeatedly argued for the proper sequence of banking liberalisation and the importance of banking supervision. Most of his policy advice and analysis can be found in the collection of his speeches and papers in Chu, *Liang Kuo-shu xiansheng lunwenji* [The volume of the works of Mr. Liang Kuo-shu].

these advices. Instead, it just followed what was more acceptable in a new political environment without trying hard enough to stick to its ground.

Actually, right after the announcement of the list of new bank licenses, the deputy minister of finance Lai Ying-chao had confessed to the press about the difficult situation the MOF facing in addressing liberalisation of the banking sector:

“The MOF knew the [liberalisation] sequence was problematic. ... But considering the potential conflict between the central and the local government [TPG], we gave up the idea to privatise SOBs before lift bans on the entry of new private commercial banks. There were too many problems regarding SOB privatisation while the issue of new private commercial banks could not be held any longer. Under such circumstances, The MOF could only address the latter first.”²³⁰

Lai’s talk confirmed that the MOF knew a better best way to handle financial liberalisation at that time but could only chose an easier way not.

To compare the trajectories of the policies on SOB privatisation and new private banks could further highlight this point. As mentioned in the previous chapter, the SOB privatisation had been halted until 1998 for almost one decade due to the constant opposition not only from the DPP but also inside the KMT at various levels of governments and legislatures. In contrast, the decision to lift the ban on new private

²³⁰ Lai made the talk in an interview with a reporter. See You, “Fangdu jinrong biduan caibu jiang zengshe fanghuoqiang” [The MOF will establish firewalls to keep financial frauds at bay].

banks, which was proposed at the same time, came to reality in less than three years.

The key behind the huge difference of reform speed was simply that there was no obvious and strong opposition in the latter case.

To encourage trust & investment companies and credit cooperatives to transform into commercial banks was another example. The issue hardly faced any resistance as both the KMT and DPP shared a common ground despite for different reasons. For the KMT, the case was to “kill two birds with one stone.” On the one hand, the measure did help those disadvantaged players in a sense. On the other hand, it was responding to the intensive petitions made by the owners of trust & investment companies and credit cooperatives, many of which were close to the KMT. For the DPP, like its stance on SOB privatisation, it seemed to prefer market forces to state interventions in achieving an ideal arrangement for the banking sector. From this perspective, it had been in favour of seeing a more deregulated banking sector which was beyond the control of the KMT. Accordingly, it found no ground to oppose the upgrading of trust & investment companies and credit cooperatives into commercial banks. Besides, considering many credit cooperatives had close connections with local factions loyal to the KMT, the DPP was happy to see them conform more to market discipline than to local factions by upgrading into commercial banks.

Secondly, due to its concerns of financial stability and political alliances, the KMT was reluctant to fundamentally deal with the inconvenient truth - some banks and financial institutions had to leave the market. In theory, as more players join the market, the market forces will dictate which can survive. Eventually, the market will automatically reach its own optimum arrangement. In practice, however, this did not happen to the new banking sector under the KMT rule in the 1990s. Out of the concern of financial stability,²³¹ the KMT never allowed any financial institution to become bankrupt. It would take prompt measures to bail out those troubled financial institutions when they were on the edge of insolvency. Consequently, no failed financial institutions would exit the market through market mechanism.

Financial stability aside, the KMT's political concerns also constrained itself from taking aggressive measures in the early stages towards some troubled financial institutions, whose owners or major stakeholders happened to be the business tycoons, politicians or local faction leaders close to the KMT. In the face of its political partners, the KMT constantly showed hesitation and lenience in conducting financial supervision. It was often blamed for not being able to detect irregularity in advance or its failure to solve problems effectively before it was too late. Table 5.4 shows some notorious cases as examples to highlight the strong KMT connections with troubled

²³¹ As mentioned earlier, due to its memory of social disorder triggered by hyperinflation during the Chinese civil war with the CCP, the KMT had been unwilling to see any sign of financial turmoil.

financial institutions.²³²

In a word, after lifting the ban on establishing new private banks, the KMT did not try to really address the problem of an overcrowded banking sector. Although it did try to help some disadvantageous players by encouraging them to upgrade into commercial banks, this did not alleviate excessive competition brought by over-banking. The failure of the KMT in handling new private banks lay in its attempts to maintain its ruling power in Taiwan's democratic transition. By avoiding addressing the real issue and exerting lax regulation on its power partners, the KMT made the banking sector deteriorate in less than one decade after its open policy on new private banks.

Table 5.4: The KMT factor in some troubled financial institutions

Case/Year of outbreak	Mastermind	KMT connections	Main crimes
Chungsing Bank (2000)	Wang Yu-yun	KMT local faction leader in Kaohsiung city	illegal loans
Taichung Business Bank (1998)	Liu Sung-fan	KMT local faction leader in Taichung county and Legislative Yuan speaker	illegal loans
Tungkang Credit Cooperative (1999)	Kuo Ting-tsai	KMT local faction leader and legislator in Pingtung county	illegal loans, embezzlement

3.2 The DPP era (2000-2008)

In contrast to the lasting delay of the KMT in overhauling the banking sector generally and new private banks particularly, the DPP had shown an active attitude in

232 For this issue is closely related to the NPL crisis, there will be more details and explanations about how the KMT connections have undermined financial supervision of the state in Chapter 6. Also, to find more similar cases, please see official investigations at: The Control Yuan, *Woguo jinrong guoji jingzhengli zongtujian diaocha baogao* [An Investigation of Taiwan's Financial Competitiveness].

seeking effective solutions on both issues after it ascended to power for the first time in 2000.²³³ With the concern of the possible breakout of a NPL crisis, President Chen Shui-bian devoted his first term in office from 2000 to 2004 in launching large scale financial reforms on reducing the NPLs, encouraging mergers and acquisitions (M&A) among financial institutions, and streamlining the financial regulations and governing agencies for financial supervision. Except for the U-turn on reforming the rural credit unions,²³⁴ basically President Chen had achieved most of his reform targets by the end of his first term.²³⁵

In spite of these achievements, President Chen and the DPP had been under attack regarding their way of handling the second stage of financial reform launched in October 2004.²³⁶ As mentioned in the previous chapter, the critics had accused the DPP government of helping some family business groups expand their financial empires by selling shares of government-controlled banks to them with a low price. They claimed that the so-called “second stage of financial reform” was just a disguise for the irregular interactions between the DPP and those family business groups. They

²³³ To know more about why the DPP was active on these issues and how it addressed them, please see the analysis in the previous and next chapters.

²³⁴ Why the DPP failed to stick to its reform on rural credit unions will be the topic of Chapter 7.

²³⁵ Please see the details of the reform measures and their results in the previous chapter.

²³⁶ The four goals of the second stage of financial reform were to have at least three financial institutions with at least 10 per cent of the market; decrease the number of government-run banks to six; cut by half the number of financial holding companies; and have at least one financial institution with foreign management or listed on a foreign stock exchange. President Chen recalled these goals in a speech in May 2007 and insisted the direction of the reform was correct in spite of some flaws. See the full text on the official website of the Office of the President: http://www.president.gov.tw/en/prog/news_release/document_content.php?id=1105499424&pre_id=1105499424&g_category_number=145&category_number_2=145 (accessed May 23, 2007).

worried that a small number of capitalists were going to control the major part of Taiwan's financial sector, impeding the public interest.²³⁷

While this kind of criticism might be overstated, its effects were big enough to force the DPP to put the brakes on its reform efforts in April 2006. On behalf of the government, Vice Premier Tsai Ing-wen announced abandoning the original reform timetable but still claimed that the government's policy of encouraging financial consolidation would remain unchanged.²³⁸ The statement was widely interpreted as the formal admission of the DPP that some of its reform targets had been impractical and unattainable.²³⁹ Obviously, in comparison with its first stage of financial reform of 2000-2004, the DPP stumbled badly in the second one. Why did the DPP, with a solid record in the previous reform, ended up failing in this way in its second term?

Most importantly, as briefly mentioned in the final part of the previous chapter, the DPP lost the battle in winning the approval of the public. In face of a public which still had fresh memory of the dark side of government-business relationship --- "the black gold politics" --- under the previous government of KMT, the DPP was too

²³⁷ This kind of criticisms are quite common in some media on Taiwan since late 2005 after the DPP government failed to reach a deal with a private bank in bidding a government-controlled bank. See one of the typical examples of this kind of criticism at the editorial of *Chungkuo shihpao* [China Times]: "Zhe jiu shi Taiwan de 'erci jingai'?" [Is this what we call 'the second stage of financial reform' in Taiwan?].

²³⁸ Chiu, "Fuyuan dingdiao erci jingai cai shache" [The DPP administration has set the tone to put a brake on the second stage of financial reform].

²³⁹ For example, see the editorial of *Taipei Times* on the issue: "Retake on financial reform needed."

confident in its ability to avoid similar concern. While most people agreed with the direction of the reform --- the nation's fragmented industry needs further consolidation to stay competitive --- the DPP did not realize that the public was not ready to accept a financial industry dominated by a small number of private business groups. It wrongly assumed that it had a strong mandate in a rush to release the shares of those financial institutions under its control. It ignored the fact that a strong intervention by the government in forcing state-controlled banks to sell their shares to the private sector in just two years could easily raise speculations on the real motives behind the reform.

Besides, the reform mandate of the ruling DPP was declining due to the corruption allegations involved with the aides and the members of the first family of President Chen. Since the rise of the issue in April 2006, it led to prosecution of several related members and huge street rallies against President Chen's stay in power in late 2006 and 2007. But in terms of the setback of the second stage of financial reform, I do not want to lay too much emphasis on this factor. For the reform was already suspended before the corruption issue turned into political chaos and stalemate months later. Still, the undermined mandate of the DPP made it less likely for the DPP to resume the reform in its final two years in power until May 2008.

The public concern regarding the likely dominance of the private business groups in the financial sector had its roots in a broader context shaped by recent economic and political development over the past years. Economically, as Table 5.5 shows, Taiwan's economy significantly slowed down after 2001 while the household income gaps were widening. On the one hand, the average gross domestic product (GDP) growth rate dropped to 3.12 per cent in 2001-2005 from 6.51 per cent in 1991-2000. Meanwhile, the growth of GDP per capita also faced a bottleneck. After it reached the highest point record at US\$14,519 in 2000, it dropped with economic downturns from 2001 to 2003. It only began to regain momentum of growth in 2004 and made a breakthrough in 2005. Still, after five years of efforts, the GDP per capita only had a slight increase of nearly US\$700.

On the other hand, as the fourth column of Table 5.5 indicates, income distribution was worsening against the backdrop of lacklustre economic growth from 2001 to 2005. The disposable incomes of the households at the top 20 per cent were at least 6 times higher than those at the bottom 20 per cent, while it was within 5.6 times for the whole 1990s. At a time when the general income increase nearly stagnated but the wealthy was accumulating more wealth, there was no wonder that people were highly sensitive to the issues which had potential to favour a small number of family business groups.

Table 5.5: Three main economic indicators of Taiwan (1989-2005)

End of Period	GDP Growth Rate (per cent)	GDP Per Capita (US\$)	* Gap of Household Disposable Income
1989	8.45	7634	4.94
1990	5.70	8132	5.18
1991	7.58	9008	4.97
1992	7.85	10589	5.24
1993	6.90	11077	5.42
1994	7.39	11991	5.38
1995	6.49	12906	5.34
1996	6.30	13527	5.40
1997	6.59	13904	5.41
1998	4.55	12679	5.51
1999	5.75	13609	5.50
2000	5.77	14519	5.55
2001	- 2.17	13093	6.39
2002	4.25	13163	6.16
2003	3.43	13327	6.07
2004	6.07	14271	6.03
2005	4.03	15291	6.04

*Ratio of income share of highest 20 per cent to that of lowest 20 per cent

Source: Directorate General of Budget, Accounting and Statistics, Executive Yuan, Taiwan

The growing anxiety of the public over the aggressive mergers and acquisitions (M&A) undertaken by the conglomerates could be further sensed from the popular discourse of “M-shade society.” The discourse originally came from Kenichi Ohmae, a Japanese business strategist and writer. He argued that the new global economy had huge effects on Japan's domestic distribution of wealth since 1985. As those who could adapt to the new global economy were getting wealthy, the middle class was rapidly shrinking in two directions. A few among the class could ascend to the upper class by following the trend while the majority of the class sank to the lower classes due to their inability to adapt. Consequently, an “M-shade society” emerged, where

the middle class collapsed while the lower classes expanded in one extreme and the upper class in the other. Since Ohmae's book was translated into Chinese in 2006,²⁴⁰ the notion of “M-shade society” soon became a buzz word in Taiwan. At the centre of the discussion was whether Taiwan was shifting to an “M-shade society” like Japan and how to deal with its coming. Quite frequently, the intensive M&A in the financial sector was cited as one of the strong signs to justify that Taiwan was following Japan’s suit.²⁴¹

Finally, on the political front, it was not news that the DPP constantly had difficulty in pushing through its agenda as the opposition parties controlled the Legislative Yuan with a slim majority. In this case, the opposition parties as usual seized the opportunity to attack the DPP, reinforcing the related criticisms on the media and the influence of “M-shade society” discourse. Thus, unlike its success in the first stage of financial reform, the DPP could not overcome its minority status in the Legislative Yuan for the lack of support from the press and the public. Again, this proves the importance of strong support from the public opinion to the ruling DPP in pushing through its reform agenda under divided government.

²⁴⁰ Ohmae, *M-xing shehui* [M-shade society].

²⁴¹ Kuang, “M-xing shehui lai le!” [M-shade society is coming!].

Conclusion

In this chapter, the case of new private bank policies confirms again the key role played by domestic politics during the rapid democratisation in shaping banking reform and financial governance in Taiwan since the late 1980s.

In the KMT era, the KMT was initially forced to open the tightly controlled banking sector due to multiple challenges in politics and the economy. Among which, the rising business class played a crucial role. Although the KMT had tried to ensure a prudent opening in the first place, its efforts stumbled in a surprisingly wide opening.

Since then, the KMT was not only incapable of effectively managing these new banks but even encouraged more other banking institutions to upgrade into commercial banks, creating constant financial turmoil like bank runs and mounting NPLs. One of the key factors for the KMT's failure in maintaining a prudent open and managing the new private banks was its concern of staying in power in a new political environment.

In the face of growing challenges from the DPP, whose gains of all votes in various national elections gradually consolidated at around 38 per cent in average, the KMT needed to ally itself with local factions and business groups to sustain its ruling status.

As many of its allies were involved in some new private banks or other financial institutions, the KMT was forced to adjust financial policies and exert lenient

financial supervision.

In the DPP era, the DPP's first time in power brought mixed results on the issue of new private banks. On the one hand, despite its lack of majority in the Legislative Yuan, the DPP managed to defuse the NPL crisis and created a relatively friendly environment for M&A among financial institutions with the support of public opinion. On the other hand, the DPP's later rush to consolidate the banking sector by releasing shares of state-controlled financial institutions raised public concern about the domination of private business groups in the financial sector. After its failure in addressing the public concern, the DPP was forced to terminate its efforts in encouraging the private players to undertake M&A with state-controlled financial institutions.

To sum up, if the main function of the developmental state was effective economic governance in the pursuit of long-term national interest through competent technocrats enjoying high autonomy, we can say that it was not the case for the KMT regime in terms of its policies on new private banks in the 1990s. The imperative to prevail in a new political environment shaped by rapid democratisation had undermined the KMT regime's capacity and autonomy in dealing with the issue. As for the DPP, its initial success in overhauling the financial sector seemed to

demonstrate that the developmental state was slightly recovering. But its failure in pushing for consolidating the banking sector in later years made the recovery diminished. Looking ahead, no matter which party is in power, one of the most critical issues of the state's financial governance on the private financial institutions is --- how to effectively integrate different reform opinion and reach consensus on the role played by the new private financial institutions in the financial sector. There is no doubt that the developmental state in Taiwan is still facing tremendous challenges and tests in a democratic era.

Chapter Six

The Rise and Fall of the Bad Debt Storm (1998-2004)

Taiwan's non-performing loan (NPL)²⁴² crisis emerged in late 1998, peaked in March 2002 and virtually subsided in 2004. In terms of its scale and impact, it was not as huge and devastating as what other East Asian countries suffered in the regional financial crisis of 1997-98. From the domestic perspective, however, it was the biggest and most systemic banking crisis in the post-war financial history of Taiwan. Why such an unusual crisis erupted in the late 1990s and how it was effectively controlled between 2000 and 2004 are the two main questions that this chapter aims to address.

The importance of these questions can be further highlighted with three related and crucial issues in the evolution of Taiwan's political economy. First, given the stronger power position that KMT had in the 1990s, why did it fail to prevent the crisis from happening? To put it another way, why it was not able to keep the crisis at bay after it finally erupted? Second, in contrast, how could the much weaker DPP, in power after May 2000, defuse the crisis more efficiently than expected, as it lacked a majority in parliament? To be more specific, as the DPP was struggling to push through its

²⁴² See the NPL definition at footnote 1 on page 4 of the thesis.

policies under divided government, how could it make a difference in disposing of bad loans in the banking sector? Third, to go back to the discussion on the status of the developmental state in Taiwan, can we still contend the decline or demise of the developmental state after the DPP government effectively staved off the banking crisis? The case provides us fresh material to reflect on the evolution and prospect of Taiwan's developmental state. Thus, unlike the two previous case chapters, which mainly focus on the declining side of Taiwan's developmental state in handling financial reform and governance since the late 1980s, this chapter uses a more recent case – the rise and fall of the NPL crisis – to demonstrate a more balanced diagnosis.

Accordingly, the rest of the chapter is divided into three parts for further examination.

The first part is a brief overview of the bad debt crisis from its onset to its end. With this introduction as a base, the next two parts are in response to the two major questions of the chapter. Firstly, I discuss what contributed to the NPL crisis. Through a brief review, I find that the current literature has rightly pointed out the key factors: the state's mishandling of financial liberalisation in the initial stages over the 1990s.

Nevertheless, I also notice a missing part in the existing literature – a reasonable explanation of why the state went wrong. The alternative, I propose, is to explore the politics behind the state's failure in tackling financial liberalisation. My focus, again, is on how democratisation affected financial governance of the ruling KMT in the

1990s and how this led to a NPL crisis. With a view to demonstrate the argument, three main political sources of irregular increase of bad loans are examined in detail: over-banking, political loans and lax financial supervision. On top of that, new variables emerge in this particular case. I will argue that economic globalisation and cross-strait relations exacerbated the crisis and made it more difficult for the state to confine damage.

Then the final part of the chapter sheds some light on the causes of the “unexpected” effectiveness of the DPP in tackling the looming NPL crisis. It is argued that a crisis-driven mandate, resulting from the public’s deep fear of financial chaos, effectively strengthened the state’s autonomy and capacity to address the crisis. Thus, even though the DPP was in a weaker position of power than its predecessor the KMT, it significantly benefited from the mandate to defuse the crisis with boosted legitimacy.

1. The bad debt crisis

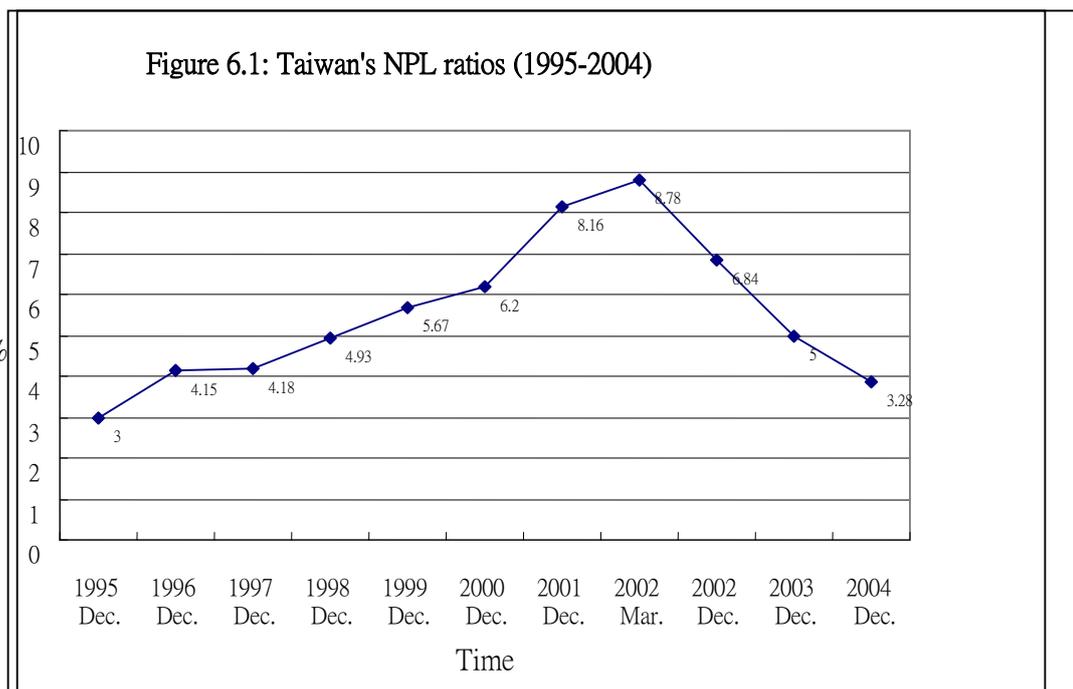
Almost no one expected that Taiwan would show signs of surging NPLs before late 1998. At the time, Taiwan was still praised by the international media as an economy strong enough to weather the East Asian financial crisis of 1997-1998.²⁴³ Ironically,

²⁴³ *Economist*, “In Praise of Paranoia.”

all of a sudden, at the end of 1998, a bad debt crisis was looming. As Figure 6.1 shows, Taiwan's NPL ratio spiked to 4.93 per cent, nearly touching the alert line of 5 per cent. The total amount of NPLs jumped to NT\$ 730.3 billion from NT\$ 586.5 billion of the previous year. The immediate cause for the surge in NPLs was a series of outbreaks of financial turmoil in some publicly listed companies. Owing to their high leverage of financing on reckless investments, those listed companies were vulnerable to the unexpected economic slowdown at that time. As they ran into financial troubles, their loan providers were immediately dragged into the storm. In response, those loan providers, in a panic to reduce losses, instantly restricted their credit and managed to liquidate the collateral behind the overdue loans. But this only made the whole situation even worse. On the one hand, the measures of tightening credit led to a general credit crunch, which in turn further discouraged economic activities and thus delayed economic recovery. On the other hand, the rush to liquidate collaterals of loans against a backdrop of a sluggish economy only made the value of collateral drop further. Eventually, the NPL problems, instead of being alleviated, deteriorated further.

Under such circumstances, not only did the overall level of NPLs in the banking sector continue to escalate but also public concern over the stability of the financial system in general. A number of financial institutions even experienced panic runs as

their depositors worried about the potential crisis of insolvency. In order to restore public confidence, the government under the KMT took prompt measures to relieve the situation. It instructed the state-controlled financial institutions to take over the troubled ones. Also, it interfered in the negotiations between banks and their financially troubled clients, whose collapse would have the potential to trigger the immediate meltdown of public confidence and financial stability. The timely actions worked, as runs on banks quickly subsided and the stock market soon turned around in 1999, which were clear signs of regained public confidence.



Source: The Banking Bureau (<http://www.banking.gov.tw/dp.asp?mp=10>; accessed September 10, 2005).²⁴⁴

²⁴⁴ The NPL ratios are calculated as: total NPLs of all domestic banks in Taiwan divided by all loans these banks have given out at the end of each year.

However, the bad debts in the banking system were still piling up and soared from 2000 to 2002. The climax came in March 2002 as total NPLs reached NT\$ 1.4 trillion, the equivalent of a NPL ratio of 8.78 per cent. The reality of the crisis, according to some observers, was even worse, because the government applied a laxer definition of NPLs to downplay the issue.²⁴⁵ If not promptly addressed, they further argued, the bad debt bomb would explode soon.²⁴⁶

In the meantime, two unusual concurrent events added more uncertainty to the prospect of Taiwan's political economy. On the political side, the DPP took power for the first time in May 2000, ending the KMT's five-decade long rule. The DPP, however, merely won the presidential election with nearly 40 per cent of votes and the defeated KMT and its political allies still controlled the Legislative Yuan. As a result, even though the newly-elected President Chen Shui-bian of the DPP could nominate the premier without the consent of the Legislative Yuan according to the constitution, a minority in parliament meant that he had insufficient power to effectively push through his policy agenda. On the economic front, an unprecedented economic downturn --- -2.18 per cent of GDP growth --- occurred in 2001 after the bursting of the IT economic bubble in the US. The disappointing growth rate imposed fresh

²⁴⁵ Before July 2005, the financial authority in Taiwan did not regard those loans "under surveillance" as non-performing, which was a huge grey area. But since then, the rule has been revised to be in line with international norms. Now loans will be seen as non-performing when their repayment of principal or interest have been overdue for more than 3 months.

²⁴⁶ *Economist*, "Too many debts to settle." Balfour and Namgyal, "Defusing a Debt Bomb."

pressure on the DPP, as it had been under criticisms for its lack of experience and ability in delivering a sustainable economy since the beginning of its rule. To no one's surprise, the opposition parties seized the opportunity to reinforce their attacks on the impotence of the DPP in economic governance.

As a result, it appeared that the DPP was in a dire situation as it was confronted with a sluggish economy, a looming financial disaster and a lack of majority in parliament at the same time. However, eventually, a devastating banking crisis, triggered by mounting bad debts, did not arrive. Instead, the NPL ratios began to drop. By the end of 2004, the ratios were reduced to less than 4 per cent, the pre-crisis level.

2. Why did the bad debt crisis emerge in the late 1990s?

2.1 Existing explanations and unsolved puzzles

Although the looming banking crisis did not develop into a disaster beyond control, still, a puzzle rises: why did such an unprecedented event take place in the late 1990s?

As just mentioned, the immediate trigger of the crisis was the financial turmoil among a number of publicly listed companies and financial institutions in late 1998. But if we look at a bigger picture of the accumulating process of NPLs, there was a gradual warm-up period from 1995 to 1998 as Figure 6.1 shows. How can we explain the NPL rise before late 1998? Besides, while corporate financial troubles and economic

slowdown were not uncommon before the late 1990s, why was a similar crisis not triggered off as a result?

At present, the dominant explanations, mainly by mainstream economists, have focused on the KMT government's mismanagement in liberalising the banking sector in the early years. For example, Chen Po-chih, an economics professor at the National Taiwan University and the former chairperson of the Council for Economic Planning and Development (CEPD), a cabinet-level agency, argues that the KMT government made six key policy mistakes in the opening-up process of the banking sector:

1. It got the sequence wrong in the liberalisation of banking sector. It should have privatised the state-owned banks (SOBs) before it allowed new private banks to be established.
2. It allowed too many new private banks to be set up in the early 1990s: 15 banks were permitted to open their business at the same time, sowing the seeds of over-banking.
3. It imposed overregulation on new financial products: despite more players joining the banking market, the government did not leave enough space for the banks to develop new financial service and products. The banks ended up in a vicious competition where too many banks competed for the same customers with similar services and products. Consequently, marginal clients were accepted in the loan markets, making the banks more vulnerable to bad loan risk.
4. It adopted loose monetary policies which led to oversupply of credit and

creation of economic bubbles: the bursting of economic bubbles contributed to a sluggish property market and dragged the banks into mounting bad loans.

5. It undertook lax financial supervision.
6. It hesitated to essentially fix the banking problems. Instead, it bailed out troubled enterprises and financial institutions, creating more serious problems afterwards.²⁴⁷

A similar view, but with more systematic evidence and a focus on the fundamental weakness of Taiwan's banking sector, is provided by Heather Montgomery.²⁴⁸

According to her research, the looming banking crisis stemmed mainly from two factors: the extremely volatile movement in asset markets and the improper financial liberalization of both capital markets and the banking sector. The first factor originated in the crash or recession in Taiwan's stock and real estate markets in recent years. As Taiwanese banks favoured taking stocks and real estate as collateral for their lending, they were more vulnerable to plummeting values of stocks and real estate amid market downturns when they wanted to reduce the losses of bad loans by selling collateral. More NPLs emerged after the efforts to minimize the losses failed. Moreover, as many stock investors took part in "leveraged stock purchases,"²⁴⁹ the

²⁴⁷ Chen, "Jiasu jinrong gaige cujin jingji fajhan" [Speed up financial reform to improve economic development].

²⁴⁸ Montgomery, "Taiwan's looming Banking Crisis." Another reason to single out her paper is because it was widely cited by the Taiwanese media at the time as an academic backup for the claim of a looming financial crisis. Thus it raised public concern and drew protest from the government officials in the Central Bank and Ministry of Finance at the same time. Montgomery worked at the Asian Development Bank Institute.

²⁴⁹ Investors use bank loans to speculate on stocks.

level of equity markets was more directly linked to the asset quality of the banking sector. When the stock markets crashed, it inevitably led to the surge of NPLs in banks as a great number of stock investors were unable to meet their bank loan obligations.

As for the second factor, improper financial liberalization of both capital markets and the banking sector since the late 1980s, it had created two negative effects on Taiwan's banking market. On the one hand, as the liberalised capital markets provided another source of financing for private enterprises, the banks had to confront an unavoidable reality that a significant part of their clients would leave for cheaper credit in the capital markets. On the other hand, to privatize the banking sector and allow the entry of 15 new private banks in the early 1990s had contributed to over-banking. As competition intensified between banks, many, in the endless cut-throat fights, were forced to not only reduce the margins of profits from individual loan cases but lower their criteria for lending. The consequences: first, almost all banks benefited far less from traditional loan business; second, accepting less qualified clients enhanced banks' risk of facing more foreclosures in the future. Thus, as a whole, over-banking had undermined the business environment of and assets quality for all banks, greatly increasing the potential of generating more bad loans.

Convincing as they are, these explanations invite more fundamental questions. For example, why did the KMT government make the six mistakes that Chen has identified? Why was it unable to correct the fundamental weakness of the banking sector that Montgomery has shown? Given that the KMT was still by and large overwhelmingly powerful amid Taiwan's democratic transition in the 1990s and thus in a better position to push through systematic financial reform and embark on sound financial governance, these mistakes and failures required further explanations.

2.2 Political democratisation and the rise of NPL crisis

In my view, to respond to these puzzles, firstly, we have to expose the politics behind the surge of NPLs. That is, while the existing explanations are right that the NPL crisis stemmed from the mishandling of banking liberalisation and lack of sound financial governance by the KMT government, we have to ask further questions regarding the issue: What went wrong with the KMT? What prevented it from making wiser decisions all the way? Here I highlight again the impacts of political democratisation on the state's financial governance as the root cause of the rise of the NPL crisis. For, since the crisis is the product of the state's earlier mistakes, the roots of its rise are inevitably linked to what we have discussed in the SOB reforms and policies on new private commercial banks. The argument will be further clarified by

examining the three main political sources of irregular increase of NPLs from the mid 1990s to 2002.

2.2.1 Over-banking

As over-banking has been widely blamed for the rise of NPLs in the banking sector in the late 1990s, a political explanation of over-banking begins by asking a simple and fundamental question: why did the government allow over-banking to happen in the first place? Actually, if we put the main findings of the two previous chapters together, then the answer will emerge. That is, *over-banking was the consequence of the state's failure at engineering a new banking sector*. Despite the effort of the state to push for the two essential parts of Taiwan's banking "Big Bang" --- the SOB liberalisation and entry of new private commercial banks, its failure was crystallised in the forming over-banking. On the one hand, if the SOB reforms had not been seriously delayed by the Legislative Yuan and Taiwan Provincial Government and its assembly until the late 1990s, the surge of new private banks might have been more modest.²⁵⁰ On the other hand, if the Ministry of Finance had not yielded to the rising political influence of private business groups, the reform to lift the ban on the entry of new private commercial banks would not have deviated from its initially prudential tone. In short,

²⁵⁰ For potential new private players, they would hesitate to join the market after most SOBs became more competitive through deregulation or privatisation. For the government, if it had finished the SOB reform much earlier, it might be able to use that as a reason to resist the pressure for allowing too many new banks to enter the market.

the double failure had resulted in a loss of control of the government on engineering a new and ideal banking sector. As the government's original agenda and plan for banking liberalisation had been significantly affected, changed or blocked by the new political forces rising with democratisation since the late 1980s, the new banking sector was doomed for over-banking and surging NPLs.

2.2.2 Political loans

The second source of NPLs related to political democratisation was political loans involving the state-controlled banks (SCBs).²⁵¹ The loans indicated those approved by the SCBs on the ground of political considerations or linkages and would not have been approved by normal lending procedures and criteria. To be more specific, there were two kinds of the political loans: one was lawmaker-related; the other was KMT-related.²⁵² For the former, it referred to the loans gained by lawmakers due to their growing influence over the SCBs after democratisation. With their power in reviewing the budgets and overseeing the operations of SCBs, lawmakers, particularly those who joined the financial committees, were able to force the SCBs to lend to those private projects of their concerns with irregularly loose terms. In most cases, the

²⁵¹ Instead of using state-owned banks (SOBs), here I use SCBs to include those banks that had been privatised but still run by the government. The lawmakers could still have influence over them though not in the same powerful way as before.

²⁵² In many cases, the two were intertwined as the KMT was the ruling party and thus it was easier for its lawmakers to exert pressures over the SOBs and get special loans.

special terms involved a large amount of loans but without required collaterals as back up. The irregular practices stemmed from the worry of the top managers of SCBs that some lawmakers might deliberately boycott the budget of their banks, give them a tough time during the question time sessions in the Legislative Yuan or block their promotion in the future if they did not meet to lawmakers' special demand for loans. This sort of political loans, unfortunately, was prone to early default and turned into NPLs. With little concern of facing legal charges or repayment responsibility, the lawmakers behind the loans tended to have malicious foreclosures of their bank loans. For as long as their political influence was still in place, the involved SCBs would hesitate to seek compensation and file lawsuits. In fact, even though the SCBs did take actions; it was often too late or insignificant. As there were insufficient collateral for those loans in the first place or the applicants of loans were just the proxies of the lawmakers,²⁵³ the SCBs often ended up suffering massive losses.

In spite of frequent media coverage on this kind of financial scandals between the lawmakers and the SCBs over recent years, it was very difficult for the outsiders to get the whole picture of the total impact of lawmaker-related political loans on producing bad loans.²⁵⁴ Thanks to an in-depth investigation by a journalist on the

²⁵³ Very often, the lawmakers would use other people's names to get loans from the SCBs, making them immune to legal responsibility for the loans. For more details on how legislators force the SCBs to lend, please see Li, "Liwei zui zhongai de yinhang" [The most favoured banks of the legislators], 28-37.

²⁵⁴ In most cases, the SCBs were too intimidated to speak up.

issue, however, we can at least get a clue. According to Li Hao-chung,²⁵⁵ a journalist of *Hsinhsinwen* [The Journalist], loans directly related to legislators among the top ten banks which had lent to legislators amounted to more than NT\$ 4.5 billion by July 2001.²⁵⁶ In addition, as Table 6.1 has shown, 8 of those top 10 banks were under state-control. This proves how the legislators liked to borrow from the SCBs. The legislators' special favour for loans from the SCBs could be also found on Table 6.2. The table shows that there were 70 lawmakers who had borrowed from the same SCB - Taiwan Cooperative Bank, a big SCB with strong business in community banking. Of all the 225 lawmakers in the Legislative Yuan, this meant that nearly one third directly involved borrowing from the SCB. Besides, Table 6.2 demonstrates that the top 6 banks from which the lawmakers most liked to borrow were again all state-controlled.

It was true that these lawmaker-related loans from the SCBs would not necessarily end up as NPLs. But, why did so many legislators particularly favour to borrow so much money from the SCBs? Moreover, a great number of indicted cases had revealed the dark side and rationales behind this kind of loans.

Finally, in Li's report, among the top 21 lawmakers who had taken out loans

²⁵⁵ Li, "Liwei zui zhongai de yinhang" [The most favoured banks of the legislators], 28-37.

²⁵⁶ The investigation did not include those loans that the lawmakers made in other people's names. For this kind of loans are not easily detectable on the records of banks. Thus, the real number of lawmaker-related bad loans was much higher.

exceeding NT\$ 100 million from banks and faced troubles in their repayments, more than 90 per cent of them belonged to the KMT.²⁵⁷ That is, KMT legislators were more likely to take advantage of not just their power but their party's ruling status to borrow from the SCBs. In short, though Li's report could not directly show the specific amount of NPLs that lawmakers had contributed, it had revealed significant clues about the impact that the lawmaker-related political loans had on the pile-up of NPLs.

Table 6.1: The top 10 lenders to the legislators in terms of loans

Ranking	Name of Banks	State-controlled or not	Amount*
1	Taipei Bank	Yes	817.3
2	Taiwan Business Banks	Yes	687.0
3	First Commercial Bank	Yes	668.9
4	Land Bank of Taiwan	Yes	473.6
5	Taiwan Cooperative Bank	Yes	471.0
6	Chang Hwa Commercial Bank	Yes	382.4
7	Farmers Bank of China	Yes	291.2
8	Cosmos Bank	No	255.1
9	Bank of Overseas Chinese	Yes	239.9
10	Union Bank of Taiwan	No	239.7
		**Total	4,526.1

*Unit: NT\$ million. ** The sum is the author's own calculation.

Source: Li, "Liwei zui zhongai de yinhang" [The most favoured banks of the legislators], 32-33.

As for the KMT-related political loans, they specifically indicated the loans from the

²⁵⁷ Li, "Liwei zui zhongai de yinhang" [The most favoured banks of the legislators], 28-37.

SCBs to a number of big private enterprises close to the KMT and their effects on creating NPLs were even stronger. With hindsight, the loans appeared to be the KMT's powerful tools for rewarding its faithful supporters in the business circle. In an attempt to reinforce an essential part of its power base in the times of democratic transition, the KMT allowed its political adherents which owned business conglomerates to not only get much higher-than-usual amount of loans with limited collateral requirements but special terms for repayment of loans in the midst of the credit crunch. The consequences of these irregular loan practices, in most cases, produced more bad debts. For if those business giants stumbled in bad investments or economic recessions, their loan providers would immediately find it impossible to essentially make up losses from the collateral behind the defaulted loans. Or the lenders would suffer even more losses when the big borrowers' business still failed to turn around in the end under special repayment terms.

Table 6.2: The top 6 lenders to the legislators in terms of borrowers

Ranking	Name of Banks	State-controlled or not	Amount of borrowers
1	Taiwan Cooperative Bank	Yes	70
2	Land Bank of Taiwan	Yes	50
3	Taiwan Business Banks	Yes	30
3	Bank of Taiwan	Yes	30
5	First Commercial Bank	Yes	29
6	Farmers Bank of China	Yes	25

Source: Li, "Liwei zui zhongai de yinhang" [The most favoured banks of the legislators], 32-33.

Again, while this type of political loans had been repeatedly reported by the Taiwanese media in the forms of financial scandals, the scale of its real damage as a whole was not clear to outsiders. The lack of disclosure came mainly from banks' legal duty to protect the information of their clients. But the political nature and irregularity behind the loans also made it less likely for banks to speak out. It was not until the outbreak of the Chinese Bank scandal in early 2007, which caused a large-scale run on the bank and threatened to destabilise financial stability as a whole, that the related authorities began to take actions to publicly reveal the main defaulters of bank loans. Under public pressure,²⁵⁸ in March 2007, the Financial Supervisory Commission (FSC) under the DPP administration finally required all banks to publish their lists of major defaulters with overdue loans exceeding NT\$ 100 million. The disclosure showed that among the 42 local banks and 33 foreign lenders in Taiwan, there were around 1500 loan accounts matching the criteria as of June 2006 and they had contributed bad debts of NT\$ 370 billion in total.²⁵⁹ Also, the disclosure demonstrated that the most damaged banks, again, were all run by the government. For instance, the first four most serious cases were all SCBs: (1) Chang Hwa Bank with bad loans of NT\$ 52 billion,²⁶⁰ (2) Mega International Commercial Bank NT\$

²⁵⁸ Li, "Su: yanyi yi RTC jingshen gongbu daizhang dahu" [Premier Su: consider to reveal big NPL account details with the RTC principles].

²⁵⁹ As some of the total bad loans accumulated over the past decade had been liquidated by banks, the real amount was much higher than revealed.

²⁶⁰ Chung and Lin, "Chang Hwa tops bad debts list."

33 billion,²⁶¹ (3) Bank of Taiwan NT\$ 32.1 billion and (3) Taiwan Cooperative Bank NT\$ 30 billion.

Furthermore, the list of top defaulters revealed more profound political implications when all accounts in the names of individuals and their associated firms were put together. Take the top three defaulters as examples. The number one was Chu An-hsiung and his An Feng Group with defaulted loans of NT\$ 16.4 billion.²⁶² The second was Yang Tien-sheng and his Ever Fortune Group. They had incurred bad debts of NT\$ 14.2 billion. The third was Chen Yu-hao and his Tuntex Group. They had loans of NT\$ 11.3 billion in default. Together, the top three defaulters had contributed bad debts of NT\$ 41.9 billion, the equivalent of more than 10 per cent of the total NPLs disclosed this time.

The ability of the Top Three to borrow and default so much money, mostly from the SCBs, was the best illustration of how business tycoons close to the KMT were accountable for mounting bad debts in the banking system during the KMT era in the 1990s. The rise and fall of the Top Three, in business and politics, shared some common features. First, with their initial success in business, they began to build their political influence over the KMT. They either ran for political offices (by themselves

²⁶¹ The bank's figures were a combination of its predecessors, China International Commercial Bank and Chiao Tung Bank, which merged in 2006,

²⁶² *Tzuyou shihpao* [Liberty Times], "An-feng 164 yi Chang-yi 142 yi Dong-di-shi 113 yi," [The top three defaulters: An-feng 16.4 billion, Ever Fortune 14.2 billion, Tuntex 11.3 billion].

or their family members) or became the main business partners with the KMT-run firms and contributors to the KMT election campaign funds. Second, by taking advantage of their growing weight in politics, they managed to get unusual supplies of credit, predominantly from SCBs, to rapidly expand their business territory. As their business boomed further, they gained more resources to lift their political power or influence to a higher level. Third, their fortune began to reverse when their business was so overstretched in a short period of time that their high leverage of financing could not be sustained any more. As a result, their business empires began to collapse and so did their political clout.

Table 6.3 Backgrounds of the Top Three Defaulters*

Business Groups	NPLs**	Owners	Political connections
An Feng	16.6	Chu An-hsiung	KMT local faction leader in Kaohsiung. Member of the Control Yuan. Speaker of Kaohsiung City Council.
Ever Fortune	14.2	Yang Tien-sheng	The leader of the third KMT political force in Taichung County. He and his son Yang Wen-hsin developed their political careers as local representatives or legislators for more than a decade.
Tuntex	11.3	Chen Yu-hao	KMT's business partner. Major contributor to KMT's election campaigns

* as of June 2006 ; ** in NT\$ billions

To be more concrete, take the number one defaulter Chu An-hsiung as an example.

Based on his wealth, he made his political debut as a Kaohsiung City councillor and

then became a member of the Control Yuan. The peak of his political career arrived

when he was elected as the speaker of Kaohsiung City Council. Meanwhile, his wife Wu Der-mei also had a successful political career as a legislator. Together, the couple crafted one of the most powerful political families among the KMT local factions in Kaohsiung City. Over the years of their political success, their business territory rapidly expanded. Thanks to their surging political weight, they got easy access to credit from banks, mostly SCBs, to enlarge their business investments which mainly involved the steel industry. Chu's business stumbled badly in late 1998 during a nationwide financial crisis triggered by a bursting of economic bubble. But, through a rescue package endorsed by the KMT government, his business did not fall apart immediately and his political career lasted until late 2003. Eventually, he fled to China after he was convicted on a bribery charge for buying votes during the Kaohsiung City Council election of 2002.²⁶³ With his escape, inevitably, an enormous financial mess – defaulted loans of NT\$ 16.6 billion - was left to his loan providers.²⁶⁴

2.2.3 Lax financial oversight

Lax financial oversight has been widely regarded as one of the key factors that spurred the irregular surge of NPLs in the late 1990s. The KMT government's ability in implementing financial supervision had been compromised by the KMT's concern

²⁶³ Meanwhile, in a separate bribery case, Chu was also alleged to have bought votes from his peer councillors for NT\$ 5 million each during his campaign for the position of city council speaker.

²⁶⁴ For the other two of the Top Three all followed similar pattern, their details are neglected here. But Table 6.3 above is provided for more information to further highlight the similar pattern.

of staying in power during the democratic transition. Through exercising “selective” financial oversight, it hoped to secure the support of its political allies that had a stake in banking business.²⁶⁵ The cases of political loans in the previous section are clear examples. The practices of political loans would not have existed for so many years, if the government seriously checked and oversaw banks’ operations all the time. But the cases of political loans were chiefly associated with SCBs. Here in this section the attention will turn to another big hole of the government’s financial oversight – new private commercial banks established by KMT politicians after 1991, which had caused no less damage in terms of engendering bad debts.

Among the 15 private commercial banks which got permission to begin their business in 1991 under the government’s policy of opening up the banking sector, at least one third was controlled by individual KMT politicians with business backgrounds. Since then, it turned out that most of this kind of banks went through scandals, bank runs and financial difficulties in later years. The consequence was by no means a coincidence. Official investigation²⁶⁶ had shown their common problem: shaky

²⁶⁵ The effectiveness of regular checks on financial institutions by the financial authorities was one of my main questions to government officials and senior bankers in my field study. The general reply is: “It depends.” For the issue was a little sensitive, not everyone was willing to talk much. But one thing was for sure from their replies: “If the financial authority was serious, it could definitely find something,” to quote Mr. Lai Der-Liang, the former deputy director of financial supervision Bureau at the Central Bank in the late 1980s. In my interview with Mr. Lai, he did not want to give me details. But from his talk, I could sense his dissatisfaction with the ways the MOF conducted financial supervision in the 1990s. In other words, he implied a downgrade of quality of financial oversight of the government after his era.

²⁶⁶ For convicted cases, see details on the website of the Judicial Yuan at <http://jirs.judicial.gov.tw/FJUD/> (accessed March 30, 2008).

corporative governance. Disregarding related laws, regulations and procedures, their owners used depositors' money at will to finance other investments until the "magic formula" could not be sustained any more. These owners' reckless behaviour simply relied on their political weight inside the KMT. Due to their political influence, their banks were immune to the government's regular checks and supervisions. When their banks eventually failed, they just left the mess to the government and fled to overseas. As a result, they not only seriously undermined financial stability and caused social panic but also cost an enormous amount of public funds to bail them out. For instance, according to the Central Deposit Insurance Corporation (CDIC), which is charge of dealing with insolvent financial institutions, it has spent NT\$ 58.5 billion and 47.5 billion of tax payers' money respectively in cleaning up the mess for Chung Sing Bank and Chinese Bank, the two most notorious banks of this kind.²⁶⁷

To be more specific, let us begin with Chung Sing Bank. Its chairman Wang Yu-yun was an economic and political powerhouse in Kaohsiung City. The KMT had to rely on his support, along with the other two influential political families (Chu and Chen)²⁶⁸, to consolidate its power base there. On the eve of the transfer of power from the KMT to the DPP in 2000, Chung Sing Bank was caught with irregularity in using

²⁶⁷ Ho, "Hu Sheng-zheng: Taiwan chuli wenti jinrong jigou chengben busuangao" [Hu Sheng-zheng: the cost of addressing troubled financial institutions in Taiwan is not high].

²⁶⁸ The Chu family's leader was Chu An-hsiung; the Chen family's leader was Chen Tien-mao.

its funds by the Ministry of Finance, causing a run on the bank. Later on, according to the prosecutor of the case, Wang had conducted irregular lending business with a certain number of clients who would not be qualified for massive borrowings by normal procedures. By using his power as chairman of the bank, he often bypassed normal procedures and let these irregular cases get through for years without being stopped by the financial supervision authority.²⁶⁹ The outcome was a mountain of NPLs of nearly NT\$ 80 billion and the government had to take over the bank and used public funds to address its collapse.

The second infamous case was the Chinese Bank. The bank was established by Wang You-theng who owned a business conglomerate - the Rebar Asia Pacific Group – and the bank was part of it. As a business tycoon, Wang had been closely connected with the KMT for mutual cooperation for decades. As Wang was the head of the General Chamber of Commerce of the Republic of China, one of the top three business and industrial organisations in Taiwan, for more than 20 years, he assisted the KMT to control a significant number of business groups and corporations through the umbrella organization. In return, Wang was rewarded as a member of the KMT Central Standing Committee for several years. Moreover, in order to further enhance his

²⁶⁹ Chen, “Weifa fangdai babaiyi yuan jinri zhenjie: zhongxingyin an Wang Yu-yun jiangbei qiuchu zhongxing” [Illegal loans NT\$80 billion case close soon: Wang Yu-yun will be indicted for long sentence in Chung Sing Bank case].

family's political influence, his son Wang Ling-lin held a political office as a KMT parliamentarian for three terms. Against such political strengths and connections, Wang You-theng's business territory expanded rapidly in the 1990s. However, news regarding the financial "black hole" of Wang's business had never ended since the late 1990s because of Wang's extremely speculative ways of doing business. The final straw came as two affiliates of the Rebar Asia Pacific Group filed for insolvency protection in late December 2006. As Wang and his wife fled to China right before the legal action, the move immediately triggered a run on the Chinese Bank and eventually led to the collapse of the whole business group in early 2007. In later investigation, the prosecutor found that for more than a decade Wang had not only embezzled a huge amount of money from his own business group including the Chinese Bank but also borrowed heavily from a number of banks without required qualifications.²⁷⁰ In estimation, Wang gained more than NT\$ 73 billion from his financial crimes²⁷¹ and incurred debts of NT\$ 55.2 billion with numerous banks.²⁷²

2.3 External factors

Nevertheless, unlike the given literature and explanations provided above, the domestic perspective of analysis alone is not sufficient in accounting for the rise of

²⁷⁰ Lin, "Liba an qisu 107 ren Wang You-theng qiuxing 30 nian" [107 people prosecuted in Rebar case while Wang You-theng indicted in jail for 30 years].

²⁷¹ Ibid.

²⁷² Lin, "Banks to cooperate on collecting debts from big defaulters."

the NPL crisis. In this particular case, external factors – economic globalisation and cross-strait relations - also played their significant parts. Due to economic globalisation, the Taiwanese government, like many governments around the world, has found that it is getting more difficult to manage the flow of capital. Because of the freer movement of funds, Taiwan has experienced massive outward capital flight to South East Asia and China since the second half of 1980s. According to statistics, from 1987 to 2006 the total amount of FDI from Taiwan to China alone has reached US\$ 100 billion.²⁷³

This vast outflow of capital results in two problems concerning NPL accumulation. Firstly, with the outflow of capital, the domestic investment shrinks and industries move out, creating a rising unemployment rate and long-term recession of the property market. Indirectly, the banks suffer growing NPLs as the value of their collateral --- real estate in most loans --- decline sharply as a result of the property market downturn. Secondly, in the process of capital outflow, a host of businessmen not only bring their own money with them but also the money they borrow from the banks in Taiwan. In some cases, the borrowers deliberately default their payment for bank loans from Taiwan and stay in China for their new business. As Taiwan is still in

²⁷³ The real amount of the FDI is not clear as many Taiwanese enterprises do their investment without the permission of the government. By the end of April 2006, Taiwan's official statistics show almost 50 billion US dollars. But From the China's side, the amount is almost 100 billion US dollars. See a news report on the issue at Chang, "Taishang dui zhongguo dalu touzi shangqianyi meiyuan?" [Have Taiwan businessmen invested in Mainland China for US\$ 300 billion?].

political standoff with China, it is difficult for the Taiwanese government to bring these economic outlaws to justice through mutual coordination and cooperation between the two sides. Thus, some businessmen can capitalize on the special cross-strait relations by relentless borrowing from Taiwan without the intention to pay off their loans. This is the so-called “Borrow to invest in China; Leave debts in Taiwan.”

The most notorious case is Chen Yu-hao, the founder of the Tuntex group and KMT funder. Chen’s group was one of the top 10 enterprises in the 1990s in Taiwan. Due to an over-expanding and highly-leveraged way of investment, the Tuntex group ran into financial trouble in the late 1990s. Eventually, the group collapsed in 2002. Chen fled the country and defaulted on loans of more than NT\$ 50 billion.²⁷⁴ Ironically, instead of becoming bankrupt, he now runs another business empire on the other side of Taiwan Strait: China.

Chen’s case drew public attention again in 2004 during the presidential election campaigns. Chen Yu-hao emerged to hold press conferences in the US to accuse DPP candidate Chen Shui-bian of denying accepting his political donations for several times during the 1990s. As the accusation was about Chen Shui-bian’s integrity and

274 In March 2004, eleven banks together urged Chen Yu-hao, who defaulted a syndicated loan of over NT\$ 50 billion, to come up with a repayment plan soon. See Huang, “Group of Bankers Tells Chen Yu-hao to Stop Hiding and Pay His Bad Loans.”

credibility, it raised intensive media and public attention for weeks. But, Chen Yu-hao's statement was being questioned by many due to his huge debts left in Taiwan and his close connections with the KMT in the past. While it is not clear whether Chen Yu-hao's move has affected the final result of the election, his involvement has reminded us again the domestic roots of some financial problems that appear to be contributed by external factors.

3. The NPL crisis under the DPP

After its peak in 2002, as Figure 6.1 has shown, the overall level of bad loans in Taiwan's banking sector dropped sharply during the subsequent two years. The result was a big surprise to many as the ruling DPP had been in deep trouble in pushing through its main policies after it won the presidency in 2000 because of its minority status in parliament. The unexpected efficiency raises a puzzle: How could a weaker government under the DPP perform better than its stronger counterpart under the KMT considering that the DPP did not control the majority in parliament despite its hold of presidency? So far, there is scant academic literature on this question. But Brück and Sun's case study on the successful passage of "Financial Holding Company Law" in 2001 has provided a partial answer.²⁷⁵ They argued that effective governance

²⁷⁵ Brück and Sun, "Achieving Effective Governance under Divided Government and Private Interest Group Pressure: Taiwan's 2001 Financial Holding Company Law."

could still be achieved under divided government. The key factors were strong media pressure to pass the law and no obvious opposition from related interest groups. On the one hand, the strong media pressure to pass the law forced the opposition parties to cooperate with the ruling DPP, as the opposition parties were worried that their lengthy blocking tactics might backfire and damage their party image and support among the public. On the other hand, it seemed that the potential opponents who might suffer from the proposed bill happened to be the same people who would benefit after it was passed. Thus, there was no obvious opposition from related interest groups, making strong lobbying force against the bill rare.²⁷⁶

Although Brück and Sun's paper is not directly related to the study of NPL reform, their work is still relevant for two reasons. Firstly, the enacting of the Financial Holding Company Law was part of the DPP government's plan to strengthen the quality of most financial institutions by increasing their business scale and scope. The government assumed that the newly-established financial holding companies would be stronger to handle NPL problems. Secondly, the whole NPL reform actually proceeded under similar conditions. To swiftly write off the NPLs and put the banking sector in order also had widespread support from the media and the public.

²⁷⁶ These people were owners of private insurance companies, banks and security houses. Most of them expected to expand their financial business by setting up their own financial holding companies.

Nevertheless, because the NPL crisis is a much broader issue than the Financial Holding Company Law, there are limits in applying the main argument of the Brück and Sun's paper. First, the opposition parties did constantly use their parliamentary majority to force the DPP government to revise its plans for NPL reform. Second, while the DPP may have suffered fewer problems from the opposition parties on the issues of financial reform, it failed to push through quite a few of its crucial bills in other policy areas. Third, Brück and Sun did not further explain where the strong media support and public consensus on the need for reform came from, thus ignoring more fundamental factors. Finally, a related question, which is beyond the discussion of Brück and Sun's paper, is why the more powerful KMT government, which controlled both the presidency and parliament, could not stop NPL piling-up before it stepped down in 2000, albeit it did temporarily restore economic order in 1999.

My argument for the puzzle is that a looming crisis like the NPL one would significantly boost the state's autonomy and capacity in delivering necessary reforms on this specific issue through a crisis-driven consensus shared by the whole society. In other words, as the consensus crippled opposing forces against reform, it also made the state regain its strength. Thus, while the state under the DPP might still appear less capable in delivering sound governance on many other policy issues, it was ironically powerful and efficient with strong mandate in defusing a crisis which had the huge

potential to destabilize the society and economy.

The argument above is not completely new. A handful of scholars have contended that the rise of the developmental state in East Asia was in part due to the overwhelming imperative of national security.²⁷⁷ Because of the threat of invasion from the enemy, the state could apply a top-down approach to manage the economy without worrying about its people's opposition. Taiwan and South Korea in the 1950s are all typical examples. For the topic of this chapter, the NPL crisis, in my view, plays the similar role in granting a powerful mandate to the state under the DPP for necessary reforms.

Taiwan has been in the shadow of the potential invasion from China since 1949. Its diplomatic isolation in the international community has reinforced the shadow. As a result, *to maintain socio-economic stability and keep economic prosperity has become the priority of every governing administration.* A NPL crisis was a sensitive issue from this perspective. Firstly, it would cripple the economy when most banks tighten their credit policy because of the fear of confronting more bad loans. Secondly, if banks turned insolvent because of too many bad debts, panic bank runs would gravely affect socio-economic stability. Thirdly, no administration could survive the consequence for not being able to solve a NPL crisis in time and no political party is

²⁷⁷ Woo, "National security and the rise of the developmental state in South Korea and Taiwan." Cumings, "The Origins and Development of the Northeast Asia Political Economy: Industrial Sectors, Product Cycles and Political Consequences"

willing to be regarded as the main obstacle in the way of tackling the crisis.

But if so, then why did the KMT seem not to handle the issue well before it lost power in May 2000? Ironically, it was simply because the NPL problems were not serious enough at that time and the rescue measures adopted by the KMT in late 1998 and early 1999 effectively relieved public concern for the time being. In contrast, no sooner had the DPP ascended to power, the crisis deepened and public concern escalated again. The DPP had no choice but to do its best to dampen the looming crisis.

In order to dispose of the NPLs as soon as possible, six main measures were taken by the DPP government without meeting with strong obstacles. First of all, it provided incentives for the banks to actively write off their bad loans. The MOF announced it would reduce its Gross Business Revenue Tax and Deposit Reserve Ratio requirements on the banks with the condition that they had to use the reductions completely for writing off their NPLs. Besides, the banks which had lower NPL ratios would be rewarded with fewer business restrictions from the financial authority. Thus, the banks were more willing to use their own annual revenues to write off their bad loans. As Table 6.4 shows below, with these two sources, the banks had totally disposed of NPLs of nearly NT\$ 1.4 trillion from 1999 to January 2005.

Secondly, learning from the experience in handling the NPL issue in the US, Japan and South Korea, the CDIC was given the authority to establish and run the Asset Management Companies (AMC) and Financial Restructuring Fund (FRF)²⁷⁸. The AMC was used to speed up the procedure that banks could get rid of their non-performing assets; the FRF would allow the CDIC to develop a public fund of NT\$ 140 billion to bail out those seriously troubled financial institutions and force them to exit the banking market by closures and mergers.

Table 6.4: Writing off NPLs in Domestic Banking Institutions

NT\$ million

Period / Items	The subtotal of write-offs (A+B)	Savings from the GBRT and DRR reductions (A)	The banks' own revenue been used in write-offs (B)	Average amount of banks' own revenue been used in write-offs
1999/01 ~ 1999/12	140,176	20,686	119,490	9,958
2000/01 ~ 2000/12	163,501	38,344	125,157	10,430
2001/01 ~ 2001/12	256,891	34,195	222,696	18,558
2002/01 ~ 2002/12	413,853	26,822	387,031	32,253
2003/01 ~ 2003/12	236,848	20,183	216,665	18,055
2004/01 ~ 2004/12	162,235	20,408	141,827	11,819
2005/01	9,340	1,814	7,526	
Total	1,382,844	162,452	1,220,392	

Source: the Banking Bureau, <http://www.banking.gov.tw/ct.asp?xItem=57696&CtNode=708> (accessed June 15, 2006)

- Notes: 1. "Domestic banking institutions" includes domestic banks and trust & investment companies.
 2. GBRT: Gross Business Revenue Tax
 3. DRR: Deposit Reserve Ratio

Thirdly, the MOF encouraged the acquisitions and mergers among the financial institutions in an attempt to strengthen their capacity to handle the NPLs by increasing

²⁷⁸ It was the Taiwanese version of Resolution Trust Corporation (RTC). The RTC, a US government agency, was established in 1989 to administer federal savings and loan institutions that were insolvent between 1989 and 1992 by either bailing them out or merging them. It was disbanded in 1996 after it successfully accomplished its mission.

their business scope and scale. Thus, key reform bills like the Financial Institutions Merger Act and the Financial Holding Company Act were passed by the legislature.

Fourthly, the Central Bank launched a project of low interest mortgages of more than NT\$ 300 billion for the youth and those who would purchase their first property. Apart from the intention to help those who were with middle or low incomes to own property, the main purpose of the project was to boost the demand for property and sustain the property market. Thus, indirectly, the banking sector would not have more bad loans generated from the downturn of the property market. But Lin Chin-lung, Director General of Department of Banking at the Central Bank tended to play down the role of the Central Bank. “We are just like the manager of a reservoir. When the market needs ‘water’, we open the gate and vice versa. We do not target particular policy issue.”²⁷⁹ However, Chang Jing-Sen, vice chairman of Council for Economic Planning and Development (CEPD), made it clear: “The role of the Central bank in the NPL issue was to make sure the property market would not crash. As the market was highly related to bank loans and collaterals, its stabilisation would be crucial in alleviating the NPL problems. And, this was where the Central Bank could exercise its power.”²⁸⁰ Therefore, overall, the central bank played a key role in addressing the

²⁷⁹ Lin made this explanation in my interview in late 2003.

²⁸⁰ Chang revealed this point in my interview made in September 2004. His views were similar to my another interview with Mr. Tseng Chao-ming, a former economic policy staff of Chen Shui-bian and later a staff at the chairperson office of CEPD.

NPL problems albeit these given various interpretations.

Fifthly, in August of 2001, President Chen set two specific goals for the next stage of financial reform to highlight his reform agenda: lowering NPL ratios to below five per cent and raising capital adequacy rates to eight per cent of domestic banks within two years, which was known as “258 financial reform.”

Sixthly, to strengthen financial governance, the DPP government overhauled the financial regulation system by apparently following the example of UK Financial Services Authority. The Financial Supervisory Commission (FSC) was established to independently supervise and monitor the operation of the whole financial system.²⁸¹

In the past, the power of financial supervision was divided and shared between the Ministry of Finance and the Central Bank.²⁸²

At the end of DPP’s first term in power, the efforts to effectively dispose of NPLs in the banking sector were realized. The average NPL ratio of all domestic banks had fallen from the peak of 8.78 per cent in early 2002 to 4.32 per cent at the end of May 2004.²⁸³

But to say that there was no boycott from the opposition parties on these reform

²⁸¹ The FSC officially started its operations in July 2004.

²⁸² The implication of this move to the state’s role will be discussed in the final chapter.

²⁸³ Actually, the number continued to drop after 2004. For example, the NPL ratio was only 2.90 per cent in April 2005.

measures is by no means true. For example, under the insistence of the opposition parties, the government's efforts to significantly increase the size of the FRF failed. In addition, the FSC could only start to operate after the end of President Chen's first term for the opposition was concerned that the DPP might still control the powerful agency if the DPP lost in the presidential elections in March 2004.²⁸⁴ But, overall, the opposition parties could not derail the main direction of the reform and it seemed that their views on how to effectively reduce the swelling bad loans were not very different from the ruling DPP. Besides, as Taiwan's economy bounced back from the 2001 recession quickly, the recovery between 2002 and 2004 greatly helped ease the NPL crisis as well. Consequently, the failure to increase the size of the FRF did not halt the reform on restructuring the banking sector too much.

Conclusion

The exploration of the rise of the bad debt storm in the late 1990s has confirmed again the negative impacts of democratisation on financial governance of the state in Taiwan, the main argument of the two previous cases and this dissertation. From the examination of three main political sources that spurred the surge of NPLs --- over-banking, political loans and lax financial supervision --- it was evident that the

²⁸⁴ The independence of the FSC embodies in the protection of the term of the FSC chairperson and members. Once they are nominated, they can not be forced to resign without adequate causes.

ruling KMT in the 1990s had compromised its ground on financial reform and governance in exchange for the lasting support of its own lawmakers and crucial political allies at the local level and in business circles. The price of the compromise, consequently, was a new but ill-regulated banking sector and the surge of bad loans. Nonetheless, unlike previous cases, external factors were singled out for the first time in the thesis and this particular case. It was found that economic globalisation and cross-Strait relations had affected the state's attempt to contain the bad debt storm. Based upon these findings, it seems that Taiwan complies with the popular claims on East Asian developmental states: "the eclipse of the state"²⁸⁵ or "the demise of the development state."²⁸⁶ On the other hand, however, the case of NPL crisis has also presented a quite different dimension about the state's financial governance. The case shows that when the devastating crisis loomed, the state could regain its autonomy and capacity through a strong mandate imposed by the public. Thus, despite the difficulty of divided government, the weaker DPP government could still defuse the bad loan crisis effectively.

Hence, while it is true that the developmental state in Taiwan has shown obvious signs of weakening from the current and two previous cases, it might be too early to declare its end at this stage. Indeed, some research on other policy area such as Taiwan's

²⁸⁵ For example, see the related discussion at Evans, "The Eclipse of the State? Reflections on Stateness in an Era of Globalization."

²⁸⁶ Lee, "Democratization and the Demise of the Developmental State."

industrial policies in recent years also offer positive evidence about the resilience of the Taiwanese state in adapting to the changing political and economic environment over the past decade.²⁸⁷ Accordingly, in future studies, it might be better to focus on figuring out the conditions that are positive to the function of the developmental state. In other words, Taiwan's developmental state is an evolving entity. While there is no doubt that it is in a transition, its direction and prospects, however, are not that clear.

²⁸⁷ For example, see Chu and Amsden, *Beyond Late Development: Taiwan's Upgrading Policies*. Also see the contributing papers in a special issue on Wade's *Governing the Market*. Wade, "The Reprinting of *Governing the Market: A Dinner Table Conversation*." Weiss & Thurbon, "*Where There's a Will There's a Way*": Governing the Market in Times of Uncertainty."

Chapter Seven

The Policy U-turn on the Reform of Rural Credit Unions (2000-2002)

In contrast to the relative success at handling the NPL crisis in 2004, the DPP government actually failed to implement a risk-management system for the credit departments of farmers' and fishermen's associations (CDDFAs) in late 2002.²⁸⁸ The failure was a huge shock since the DPP had strongly held the view that the reform was reasonable, achievable and irreversible for a long time before the final policy U-turn. Overall, the policy flip-flop was widely regarded as a huge setback to the DPP's ambitious plans to overhaul Taiwan's financial system in the early stage. Apart from the resignation of two ministers as a result of the incident, the far more serious consequence was that the image of the DPP as a reformist party was tarnished. Given these calamities, a puzzle arises: Why did the DPP eventually melt down in the reform?

To put the puzzle in the perspective of the thesis, the following related questions are expected to be clarified through examining this particular case. Compared with the previous case, why did the strong mandate that the DPP had in tackling the NPL crisis not work as effectively in coping with the CDDFAs? Judging from the failure of the

²⁸⁸ Put it in a simple way: those with higher NPL ratios would be punished with more restrictions on their business scopes. More details of the measure will be mentioned later in this chapter.

CDFFA reform, can we stay positive on the effects of democratisation on financial governance of the developmental state after 2000? Or, does the first transfer of ruling parties in Taiwan's post-war history in 2000 make a difference in strengthening financial governance of the developmental state in Taiwan?

To explain the policy U-turn and answer these related questions, I argue the need to situate them in the political context of the DPP's emergence to power before 2000 and its motivation to push for the reform from 2000 to 2002. I contend that the immediate cause of the dramatic policy change lies in the unrealistic expectation of the DPP when it decided to launch the reform in the first place. The DPP was so indulged in its own overconfidence that it was not able to recognize the fundamental flaws inherent in its reform project. This fundamental misjudgement, however, had deeper origins that could be attributed to the rising process of the DPP on its way to power.

Accordingly, the rest of the chapter is divided into three parts to elaborate the argument. The first part is a short review of existing explanations for the policy U-turn. Then the second part focuses on the account of what had fuelled the unrealistic expectation of the DPP before it launched the reform. The third part goes to the deeper roots behind the deadly choice of reform projects for the rural credit unions. Finally, in the conclusion of the chapter, the implications of the case to the

questions mentioned above regarding democratisation and change of ruling parties as well as financial governance of the developmental state are discussed.

1. The explanations for the failure of the reform

When we look back at the first term of the DPP government from 2000 to 2004, its dramatic policy U-turn on the reform for rural credit unions in late 2002 is one of the most embarrassing events to confront the DPP. Shortly after the U-turn, the approval rate of President Chen Shui-bian dropped sharply to 38 per cent, a record low since the beginning of his presidency.²⁸⁹ Then it was followed by the resignation of Premier Yu Shyi-kun to take responsibility for the failure of the reform. Though, eventually, Yu remained in office after talks with Chen, two cabinet-level ministers, Lee Yung-san of the Ministry of Finance (MOF) and Fan Chen-tzung of the Council of Agriculture (COA), soon stepped down to take the blame. The political fallout even led to infighting inside the DPP, as some heavy weight figures of the DPP openly challenged Chen regarding his decision of the policy U-turn.²⁹⁰ Moreover, the effects of the policy U-turn also spread to the economic front. For instance, Standard and Poor's, a well-known international rating agency, decided to downgrade Taiwan's

²⁸⁹ *Chungkuo shihpao* [China Times], "Benbao zuixin mindiao bian shengwang zhongcuo zhi sanchengba wei shangrenlai zuididian" [Latest polls by this newspaper shows Chen's approval rates drop sharply to 38 per cent lowest since in office].

²⁹⁰ For example, DPP lawmakers Tuan Yi-kang and Hong Chi-chang jointly wrote a newspaper article to challenge the rationale of the policy U-turn and worried that the DPP was going to pay a price for the setback of its financial reform. See Tuan and Hong, "Women hai neng bu neng kandao zhenzheng de gaige?" [Can we expect a real reform?].

credit rating over the concern that the DPP government had changed its basic direction of financial reform.²⁹¹ The move would inevitably increase the cost of raising funds in capital markets by Taiwanese businesses. However, the worst damage of the policy U-turn went to the reformist image of the DPP. For years before 2000, the image was one of the most valuable political assets that the DPP had in its competition with the conservative and corrupt KMT. Now, suddenly, as a result of the policy U-turn, the value of the asset sharply depreciated. Given these consequences, a puzzle emerges: What contributed to the DPP's failure on the reform?

The dominant and direct account, mainly provided by Taiwan's media, focuses on the personality of the key decision maker --- President Chen Shui-bian. It attributes the collapse of the reform to Chen's eventual concession to the pressure of farmers and fishermen when they threatened to launch a huge rally of protest in front of the Presidential Palace.²⁹² One senior commentator, for example, described Chen as "vacillating, treacherous, and weak, easy to panic and liable to give in to threats."²⁹³

²⁹¹ Taiwan was given an AA+ rating in 2000. But the economic situation began to deteriorate in December of that year and Taiwan's rating was cut to AA in 2001. In light of the policy flip-flops on reform of the CDFAs, which caused people to believe that the government was backing away from restructuring the country's financial system, the rating agency cut Taiwan's rating again to AA-. See Taipei Times, "Editorial: Let S&P's Downgrade Be a Warning."

²⁹² So far the author has not found academic researches specifically discussing the causes of the policy U-turn. But there is a huge literature on why the CDFAs should be reformed and how to do it by agricultural and financial economists in Taiwan. Here are a few examples. Wu, *Zouchu Taiwan Nongye De Xinlu* [The New Approach for Taiwan's agriculture development], ch 3. Hsu, "Taiwan De Nongye Jinrong Wenti Zhi Tanta" [An Investigation to Taiwan's Agricultural Finance]. Yao, "Jiceng Jinrong Jigou: Nonghui Xinyongbu De Xiankuang Yu Gaige" [Community Financial Institutions: the current situation and reform of the credit departments of farmers' associations]. Chen, "Taiwan Nonghui Xinyongbu De Difang Tezhi" [The "community" characteristics of the credit departments of farmers' associations in Taiwan].

²⁹³ Eyton, "Taiwan: Reform debacle costs Chen big." Eyton lived in Taiwan for more than a decade and used to be the managing editor of the *Taipei Times* from 1998 to 2005.

No doubt, this kind of explanation is simple, clear and convincing given that policy flip-flops are common in democratic countries. Out of the concern of losing popularity or power, indeed, it is not rare that politicians or political parties cave in to pressures and back down from their original policy positions. This, however, still leaves the following puzzles unanswered in this particular case. First, after Chen's concession, why did the protest of farmers and fishermen still take place as planned? It was estimated that more than 100,000 farmers and fishermen angrily went to the street in Taipei on the planned day even though they had learned about the policy U-turn days ago. Second, as many of those who were in favour of the reform were the DPP supporters attracted by the party's progressive ideas, why did the DPP prefer to upset its own supporters with the U-turn decision? From the perspective of pursuing self-interest, it is hard to make sense of the self-inflicted damage. Third, how could it account for the strong confidence of the DPP in the reform prior to the U-turn? The deep faith in the success of the reform could be best demonstrated in Chen's open defiance to former President Lee Teng-hui for his negative comments on the reform. Lee, also an agricultural economist by training, contended two months before the policy U-turn that the policymakers of the MOF did not really understand agricultural finance. If they insisted to implement the wrong policy, he predicted, the DPP would pay for it by risking to lose its power. But Chen immediately responded by saying "if

(we) stop reform because of fear of losing power, it is the behaviour of a coward. ...

We will be more likely to lose power if we stop reform.”²⁹⁴ The response was very unusual considering Lee was the “spiritual leader” of the Taiwan Solidarity Union (TSU),²⁹⁵ an important political ally of the DPP at that time. Fourth, why did the DPP government only realize the scale of the pressure from the farmers and fishermen so late? As a political party which was known for its sophisticated skills at opinion polls and prompt reactions to public opinions, the DPP’s late response in this particular event was hard to understand. Finally, as the reform on the rural credit unions was actually only a part of the broader reform on Taiwan’s banking sector, in contrast to its relative success with the other financial institutions such as commercial banks, why did the DPP only fail so badly in this part?

In light of these puzzles, alternatively, I argue to ascribe the failure of the CDFAs reform to two main factors: the DPP government’s overconfidence and a fundamental flaw inherent in its reform project. For the former, it can be further traced back to two sources: (1) the DPP believed that it had a strong mandate to push reform in *every* financial issue; (2) the encouragement of early success. The interplay of the two

²⁹⁴ Lin and He, “Chen zongtong: wei bao zhengquan bugan gaige shi nuofu ”[President Chen: it is a behaviour of a coward to stop reform for the fear of losing power].

²⁹⁵ Most of the time, the TSU was in alliance with the DPP because it shared similar ideology of pro-Taiwan independence with the DPP. However, due to its own interest and stance on some particular policies, the TSU would join the KMT and PFP to be against the DPP. The financial reform on the CDFAs was a good example, especially when the “spiritual” leader of the TSU Lee Teng-hui came out to heavily criticize the reform in public occasions.

sources contributed to an overconfident ruling party, which saw all the opposition to its CDFFAs reform as merely a backlash from conservative forces and vested interests, and assumed that the mandate it enjoyed would allow it to win the battle in the end. It was against this backdrop that the DPP did not heed any warning or advice on its CDFFAs reform until it was too late. For the latter, the flaw points to the undetected false assumption underlying the reform project, which assumed that there was no difference between the CDFFAs and the commercial banks, and that projects working well on the latter would also be applicable to the former. But why was the DPP so determined that it could not see this fundamental flaw? I argue that it was due to the DPP's distance and unfamiliarity with the farmers' and fishermen's associations on its rise to power over the past years, and this made the DPP choose a reform project proposed by the MOF instead of the COA,²⁹⁶ whose project was more acceptable to most farmers and fishermen.

2. The overconfident DPP government

2.1 Mandate to reform

The first angle to address why the DPP government could be so confident about its reform on the CDFFAs in the first place is from the evolution of the DPP's election

²⁹⁶ These two government agencies had very different ideas about how to reform the CDFFAs before the DPP came to power in 2000. Their differences lasted, but the DPP sided with the MOF shortly after it was in government. Later in this chapter I will explain why in details.

campaign strategy and how it won the presidential election in 2000. On its way to power, the DPP used two key weapons to appeal to voters and compete with the KMT: (1) a pledge to pursue reform, and (2) the promotion of pro-Taiwan consciousness. These were respectively set against, (1) the pervasive corruption created by uninterrupted one-party rule under the KMT, and (2) the pro-China ideology advocated by the KMT from 1945 to 2000. Nevertheless, under Lee Teng-hui's leadership, the KMT also gradually underwent a transformation to make itself more like a "native party" in the 1990s, giving the DPP less room for manoeuvre on the Taiwan consciousness issue. Thus the DPP increasingly put more emphasis on fighting corruption and "black gold politics" with promises of bringing cleaner politics and efficient government.²⁹⁷ This was also crucial to Chen Shui-bian's victory in 2000. His achievement in improving the administrative efficiency of Taipei City Government as the Taipei mayor, from 1994 to 1998, had won him a reputation as a reformer, a great political asset for him to run for the presidency afterwards. Not surprisingly, the campaign focus of Chen in the presidential election of 2000 was reform again, which could be summarized by his two main slogans: "A young Taiwan with a vigorous government" and "A government governed by clean forces for all

²⁹⁷ If we review each election campaign focus of the DPP from 1989 to 2004, we could find this tendency easily. See details of these campaign issues at the DPP's website: www.dpp.org.tw (accessed July 2, 2005).

people.”²⁹⁸ Obviously, Chen was trying to define his image as a symbol of efficiency and reform in contrast to an aging and corrupt KMT regime.

His strategy worked against the backdrop of a divided KMT²⁹⁹ and the verbal intimidation from Beijing before the election. However, Chen won narrowly, with a vote share of only 39 per cent. With a KMT-dominated legislature, financial reform was singled out by the Chen administration as the priority issue on the reform list for the following reasons. The first was to carry out Chen’s campaign promise on financial reform. During his election campaign, Chen used a TV commercial to intensely attack the KMT government for spoiling its cronies with privileged bank loans, causing massive bad loans in the banking sector.³⁰⁰ Now that Chen was in power, people were watching to see whether he could really “defuse a debt bomb.”³⁰¹ Secondly, there were serious concerns in the international media about Taiwan’s looming banking crisis. They warned of the possibility of a small version of the Asian financial crisis

²⁹⁸ There was another slogan to portray himself as a peacemaker with Beijing not a hawk bringing war as his KMT rival tried to define him: ‘A new century of peace for stability and prosperity’. But this is a defensive slogan and not relevant with the reform issues.

²⁹⁹ Former TPG governor James Soong left the KMT and ran for the presidency against the KMT’s official candidate Lien Chan.

³⁰⁰ In the TV commercial, Chen pledged to bring clean politics like a modern Bao Gong, a legendary politician in ancient China who has been well-known for exposing scandals and bringing bad guys into justice. He promised, if elected, to prohibit people with criminal records from running for political office. Also, he stated he would not allow political parties to get involved in running business. On financial issues, he specifically promised to launch a thorough investigation and review on the financial system and tighten financial supervision. The TV commercial could still be accessed through Youtube at:

http://www.youtube.com/v/orFkFF4z74M&color1=0xb1b1b1&color2=0xcfcfcf&hl=zh_TW&feature=player_embedded&fs=1 (accessed April 3, 2009).

³⁰¹ Balfour and Namgyal, “Defusing a Debt Bomb.”

breaking out in Taiwan if some urgent measures were not taken.³⁰² Their reports put tremendous pressure on the Chen administration because negative foreign media reports would discourage foreign investment, which was critical to a small and open economy like Taiwan. In addition, due to Taiwan's international isolation status, foreign media reports also had significant impacts on the public's confidence.³⁰³

Thirdly, the financial turbulence had reached the point that there was no room for a delayed response when the DPP just took power. According to the Banking Bureau under the Financial Supervision Committee (FSC), at the end of 2000, as Table 7.1 shows, the total NPLs of all domestic banks (including the Trust and Investment Co.) in Taiwan was NT\$ 798.3 billion and the NPL ratio was 5.47 per cent, almost double the figure of 1995. What was even worse was the much higher NPL ratios among the community financial institutions including the credit cooperatives and the CDFFAs.

In contrast, the NPL ratio was 12.45 per cent for the credit cooperatives and 17.91 per cent for the CDFFAs in average; their NPLs were NT\$ 66.2 billion and 138 billion respectively.³⁰⁴ In other words, when Chen Shui-bian took office, the whole banking sector was already in trouble. There was a potential "time bomb", which, if not

³⁰² *Economist*, "Too many debts to settle."

³⁰³ Because of Taiwan's international isolation, people are longing for international attention and approval. As foreign media reports have been regarded by the public as more reliable and objective news sources because of their relative non-partisan stance, any positive or negative foreign media coverage on Taiwan would be viewed as a kind of international approval or disapproval to Taiwan.

³⁰⁴ These official figures actually underestimate the bad loan problem for Taiwan used a less strict definition regarding what would be counted as overdue loans and NPLs.

defused in time, threatened the whole economy and social stability of Taiwan. And the CDFFAs were the most likely part to detonate first. Given this, it was reasonable for Chen to target those troubled community financial institutions as the priority for financial reform especially when he was so desperate to prove his ability to lead the county and secure his power base.

Table 7.1: NPL Ratios Among Different Financial Institutions (Unit: Per cent)

End of Period	Total	Domestic Banks*	Local Branches of Foreign Banks	Sub-total	Credit Cooperatives	CDFFAs
1995 Dec.	3.00	2.88	0.82	4.02	3.12	5.07
1996 Dec.	4.15	3.74	1.00	7.10	6.13	8.24
1997 Dec.	4.18	3.74	1.07	8.53	6.19	10.68
1998 Dec.	4.93	4.41	1.65	10.57	7.55	13.10
1999 Dec.	5.67	4.96	3.20	13.70	10.54	16.03
2000 Dec.	6.20	5.47	3.22	15.68	12.45	17.91
2001 Dec.	8.16	7.70	3.53	16.39	11.66	19.37
2002 Mar.	8.78	8.28	3.77	17.88	12.69	21.15
2002 Dec.	6.84	6.39	2.36	15.37	10.34	18.62
2003 Dec.	5.00	4.57	1.51	13.29	6.91	17.57
2004 Oct.	3.85	3.50	1.24	10.93	3.80	15.50

Source: Financial Supervisory Commission, Taiwan, 2004

*Include Trust and Investment Co.

2.2 Encouragement of early success

The other source of the DPP's overconfidence came from the encouragement of its initial success in dealing with a number of community financial institutions which were on the brink of insolvency. On 14 September 2001, under the command of the MOF, the Central Deposit Insurance Corporation (CDIC), which was mainly in charge the Financial Restructuring Fund, suddenly took over 29 CDFFAs and 7 credit

cooperatives. Then again in July 2002, the CDIC seized control of another seven CDFFAs. The plan was to use the Financial Restructuring Fund to cover the loss of these 43 community financial institutions and then put them into the market for sale through public auctions. So eventually, if everything went smoothly, these 43 community financial institutions would be sold to the highest bidders³⁰⁵ and drop out the banking market permanently.

It turned out that the DPP government did not run into too much difficulty and resistance in taking over these troubled institutions. The success was mainly based on the high legitimacy of the intervention as the 43 community financial institutions all had alarming NPL ratios, huge deficits and even negative net worth of their assets. Besides, as the crackdown was only confined to a relatively small part of the community financial institutions, opposition forces were not strong enough to derail the project. As a matter of fact, the move even strengthened the reputation of the DPP for its determination in pushing through a painful reform. Comments such as “It’s definitely a step in the right direction, though it should have been done a long time ago”³⁰⁶ were widespread in the media. As a result, the DPP government’s confidence to carry on its agenda of financial reform was significantly boosted. This was why

³⁰⁵ Normally, the highest bidders were those commercial banks which wished to significantly increase their branches in a short period of time.

³⁰⁶ Huo Teh-ming, a finance professor at the National Chengchi University, made this comment. See *Taipei Times*, “200 Officials Pay Visit to Cooperatives.”

Chen Shui-bian could reject Lee Teng-hui's criticism of the reform on the CDFFAs so resolutely, quickly and confidently. In short, the early success not only reinforced the DPP's faith in its strong mandate to undertake financial reforms but also reassured itself about the correctness of its methods in tackling the challenge. This, however, only paved the way for the subsequent setback and policy U-turn.

3. A fundamentally flawed reform project

But overconfidence was not the fundamental root of the DPP's failure on reforming the rural credit unions. The deeper root was that the DPP chose a reform project whose assumption was fatally flawed. The project incorrectly assumed that the CDFFAs could be treated like commercial banks while in fact they were quite different except that they all took deposits and undertook loan business. As most farmers and fishermen were not in favour of this assumption in principle, the project was doomed to fail even before it was introduced. This was why those farmers and fishermen who were organized to be against the project refused to accept any compromise offered by the DPP government in negotiations before the policy U-turn, and insisted on going ahead with the planned protest even though the policy U-turn was already in place. Thus, in the following two sections, firstly I will explain why the assumption of the DPP's reform project was so problematic and unacceptable to

most farmers and fishermen; then I will elucidate why the DPP chose such a project without noticing its inherent flaws at all.

3.1 The MOF project and its fundamental flaw

The problems of the CDFFAs surged in the final years of the KMT rule before 2000. According to a study, between 1991 and 2001, 83 bank-runs occurred and 57 of them were related to the CDFFAs around Taiwan.³⁰⁷ Besides, the average ratios of NPLs of the CDFFAs were alarming. As noted earlier, while overall the whole banking sector suffered from surging NPLs from 1995 to 2000, the average NPL ratios of the CDFFAs were much higher than the other kinds of banking institutions (as Table 7.1 shows). However, the KMT government never essentially fixed these problems. Its reluctance, in large part, stemmed from its close connections with agro-associations and local factions, which were a critical power base of the KMT. Thus, even though there were a variety of policy options proposed by the MOF and the COA from 1995 to 2000 (see Table 7.2 for details) regarding how to reform the rural credit unions, few of them were acted upon.

³⁰⁷ Lin, “*Taiwan Jiuling Niandai De Jinrong Jidui Hebing Yu Jinrong Zhixu*” [bank-runs, bank mergers and financial order on Taiwan in the 1990s]. In the 57 cases, a bank-run usually began with a financial scandal committed by a leader of a CDFFA or rumours revealed by rival local factions that wanted to seize control of the CDFFA.

Table 7.2: Reform proposals issued by the MOF and COA (1995-2000)

Year	MOF	COA
1995	Let credit departments become independent institutions of agricultural finance and no longer a part of the associations of farmers and fishermen.	1. In order to facilitate capitalization of credit departments, the shareholder system should be restored. 2. Enhance the qualifications for becoming members of board, auditors and executive directors of the associations of farmers or fishermen 3. The COA will help to establish a national bank for agriculture, which will become a de facto “central bank” of all credit departments. Thus, the new bank can supervise and help all credit departments in a concerted way to deal with their management and NPL problems.
1996	An executive director of an association of farmers or fishermen will not be allowed to be in charge of the credit department. Instead, a professional general manager will be recruited to manage it in the hope of ending political interference.	
1997	Plan to establish regional agricultural banks which will be invested in and owned by the associations of farmers or fishermen in a specific region, and credit departments will become the branches of these newly established regional agricultural banks.	
1998	Encourage mergers between credit departments; commercial banks will take over the badly-managed ones.	
1999	Plan a budget of NT\$ 30 billion to subsidize credit departments for assisting them to write off their bad loans, and consider allowing big state-run banks to take over those credit departments in trouble.	
2000	Suggest setting up a national agricultural bank to forcibly merge troubled credit departments and the government will provide public money to compensate the loss of the newly established bank. For those normal credit departments, they can invest either in the national agricultural bank or a new regional bank.	

Source: Central Deposit Insurance Corp (CDIC), *Qianghua woguo wenti jinrong jigou chuli jizhi zhi yanjiu* [A Study on How to Strengthen the Mechanism of Dealing with Troubled Financial Institutions in Taiwan], 429-431.

The KMT’s hesitation, somehow, in small part, was also related to the disagreements between the MOF and the COA in terms of the key principles and contents of their reform proposals. While the MOF and the COA did share some consensus, such as improving professionalism in running the CDFAs, the biggest difference was that the

MOF did not think there was a need to maintain a dual banking system: one system based on commercial banks and the other one based on the CDFFAs, the so called “farm credit system.” The argument was that since the banking sector was already suffering from over-banking, a separate farm credit system only made the situation worse. Besides, the contribution made by the agricultural sector to Taiwan’s GDP had declined to less than 2 per cent. Given this, why did Taiwan need a huge and separate farm credit system?³⁰⁸

Using this logic, the MOF assumed that the CDFFAs were just like commercial banks. The rationale of its reform policies was simple. If some CDFFAs were poorly managed, they could only be merged or closed through the government’s help and order. The MOF did not care whether there was an alternative financial institution available for a certain rural area once the original one exited the market. Neither did it care whether farmers had special financing needs which commercial banks would or could not provide from the perspective of making profits. In contrast, the COA tried to reform the CDFFAs with the assumption that agriculture was a unique industry and needed its own farm credit system. As a result, its reform policies were built upon

³⁰⁸ In my interviews, the bankers with commercial banking background all expressed similar views about the farm credit system. In contrast, the agricultural economists and rural credit union staffs in my interviews all dismissed the “naive” (in their words) views about the farm credit system. This big gap of opinions between the two camps, to a large extent, accounts for the different approaches between the MOF and the COA in dealing with the rural credit unions.

how to establish a healthy farm credit system in which the CDFFAs were the basic units.

The dispute came to an end after the DPP won the presidency in 2000 and decided to carry out the long-awaited reform with the MOF project. With the strong consensus inside the DPP, three waves of reforms targeting the community financial institutions were launched shortly after the DPP took power. The first two waves, noted earlier, successfully took over 43 community financial institutions (36 of them were the CDFFAs) and public opinion in general was supportive of the reforms. Despite disquiet in some rural areas, the DPP government was encouraged by the initial success and felt upbeat about the prospect of the reforms. Hence, the third wave of reforms, the boldest ever, followed in less than two months. On 22 August 2002, with an eye to enhancing the overall soundness of operations of the rural credit unions, the MOF announced the application of a *three-tier system of risk-management* to “punish” those CDFFAs with too many NPLs by limiting their scope of business. The details of the new measure were:

1. Those CDFFAs with NPL ratios between 10 per cent and 15 per cent would be barred from accepting deposits from non-members, offering interest rates on savings that were higher than those of the Taiwan Cooperative Bank or granting unsecured loans or loans to their own board members.

2.Those with NPL ratios between 15 per cent and 25 per cent would be also forbidden from granting new loans of more than NT\$ 3 million to those who invested in the association.

3.Those with NPL ratios above 25 per cent would not be allowed to extend old loans or establish new branches and could only grant new loans up to NT\$ 1 million.³⁰⁹

This time, in contrast to the previous reform measures, the new policy would have much bigger impacts as it immediately affected the operation of 124 CDFFAs. Out of the total 278 rural credit unions in Taiwan, this meant that more than 40 per cent of them would be forced to cut back their business unless they could reduce their NPL ratios to less than 10 per cent. With so many CDFFAs involved, the backlash against the reform was beyond the government's imagination.

On 5 September 2002, in a meeting for all the general managers of the associations of farmers and fishermen, the participants soon formally organized a self-help group, Taiwan Agro-Fighters United (TAFU), and passed a resolution to ask the government to:

- 1.Abolish the new policy.
- 2.Return the 36 CDFFAs which were taken over by the CDIC to their original associations or let similar associations run them.
- 3.Propose and enact the Agricultural Financial Act.

³⁰⁹ Ko, "Yu defends U-turn on credit units."

4. Establish a national bank specifically for agricultural finance and development.

If the DPP government did not properly respond, they claimed, all the associations of farmers and fishermen would stop providing insurance services to farmers and fishermen for the government. In their eyes, the *three-tier system of risk-management*, in the name of reform, was actually aimed to *eliminate* their associations. Therefore, they would fight for their rights until the government accepted their requests.

Obviously, what the TAFU asked for in principle was in line with the project that the COA proposed and advocated. If we make a comparison between the request list of the TAFU and the original policy proposal of the COA in Table 7.2, we can find that they are similar. This is not a coincidence. From the users' perspective, all the farmers and fishermen cared about was whether they could get good and convenient financial services. They were not opposed to reforms. But, it was absolutely unacceptable to them to replace credit unions with commercial banks or even nothing at all. Nevertheless, the DPP did not comprehend this simple expectation. It did not anticipate that the MOF project would raise so much resentment and opposition from the farmers and fishermen. It even thought the farmers and fishermen would appreciate its efforts to get rid of the "rotten apples" inside their associations for them.

Facing such a strong challenge from the TAFU plus the powerful support behind it from former president Lee Teng-hui and two main opposition parties, the KMT and PFP, the DPP government's first reaction was to pledge to stick to its guns and tended to regard all opposition opinions as just the backlashes from the invested interests and the political calculations of other political parties. Nevertheless, the DPP started to take a more conciliatory attitude toward the TAFU in the hope of a compromise which would not change the basic tone of the reform but could reduce the dissatisfaction of the angry farmers and fishermen at the same time. After all, the DPP understood the need to smooth the reform process through compromise and did not really want to be in confrontation with the farmers and fishermen considering their support to the DPP, especially in the south of Taiwan, over the last decade.

Therefore, the DPP government proposed several more flexible projects to the farmers and fishermen in less than two months before the final policy U-turn:

On September 25:

The Executive Yuan decided to implement the risk management measures on the CDFFAs as scheduled, but would adjust the projects with supporting measures to make them less aggressive. The government would encourage those troubled CDFFAs to merger with more healthy ones to form a regional bank or national agricultural bank by a 10 per cent investment in the new unit, but their NPL ratios had

to be reduced below 10 per cent and the ill CDFFAs had to turn their negative net worth into positive first.

In early October:

The Executive Yuan announced its intention to enhance its investment to 20 per cent to assist the CDFFAs to establish a national agricultural bank.

In mid October:

After a meeting with the farmers' leaders in the south, Premier Yu remarked that a troubled credit union would be allowed to increase its loan business with an additional quota ranging from NT\$ 0.5 to 1 million in each lending whenever it reduced three percentages of its NPL ratios.

On November 14:

The Executive Yuan agreed to relax its risk management measures against those CDFFAs (66 of them in total) whose NPL ratios were more than 25 per cent as long as they could propose their plans for management improvements.

On November 16:

The Executive Yuan reached an agreement that the authority for agricultural finance would be transferred from the MOF to the COA.³¹⁰

But none of these were accepted by the representatives of the TAFU. The key was that in the negotiation process for nearly two months the DPP government did not change the core of its reform project --- to separate the credit departments with their affiliated farmers' and fishermen's associations, and treat them as commercial banks.

³¹⁰ *Central News Agency, 2003 Taiwan Nianjian* [Taiwan Yearbook 2003], Chapter 6.

With hindsight, the DPP government's efforts to try to strike a deal with the TAFU were futile due to its ignorance of the essential differences between rural credit unions and commercial banks. It made at least three main mistakes in this respect in its judgement in pushing through the reform. Firstly, it overestimated its leverage over the CDFFAs. In dealing with the commercial banks, the government could use its shares in many commercial banks to pressure them to follow its financial policies, and the government had significant power in regulating the business scope in which a bank could operate. If a bank did not follow the government's policies, it would suffer administrative interventions in its business.³¹¹ By contrast, the government held no shares in the CDFFAs. In fact, a credit department did not operate on the concept of shares. It was just one of the departments in a farmers' or fishermen's association. It was only directly subject to those who control the association (i.e., the director or the general manager) and indirectly to the members of the association.³¹² In this case, though the government still had regulatory power over the CDFFAs, it had less substantial leverage over them.

Secondly, the DPP overemphasized the power of market forces in disciplining the CDFFAs. Most commercial banks were publicly listed companies on the stock market.

³¹¹ For example, if a bank failed to significantly write off its bad loans, the government could freeze its right to set up new branches or take deposits with high interest rates.

³¹² They could vote who would be the board members and these board members would vote among themselves to choose the director. At last, a general manager would be appointed by the director.

If they maintained a high amount of NPLs, they would be punished by a fall in their share price. In addition, high NPLs would affect their operating performance in taking deposits and giving loans. Smart consumers would not want to risk losing their savings in a high NPL ratio bank. And, too many bad debts would make a bank vulnerable in risk management. In contrast, the credit departments were not purely profit-oriented. As long as their revenues were the main incomes for the operation of their affiliated associations and their members were in need of their financing services in the daily lives, they could sustain operations even when facing mounting NPLs. As such, they were relatively insulated from market forces.

Thirdly and most importantly, the DPP government seriously underestimated the crucial role played by the agro-associations in the rural areas and the importance of a credit department to the function of its affiliated agro-association. There are three main agro-organizations in rural Taiwan. Apart from two single-purpose organizations, the irrigation associations and the fruit-marketing cooperatives, the farmers' associations coupled with the fishermen's association³¹³ are multi-functioned institutions based on a township unit basis. Consequently, the farmers' associations have comprehensive and crucial influence on almost every aspect of farmers' lives. There are four major departments in a farmers' association:

³¹³ Since the farmers' associations outnumber their fishermen's counterparts and are similar in functions and organization, I treat them as the same organizations. In the following paragraphs, the term "the farmers' associations" will indicate to include the fishermen's associations.

distribution, education, insurance and credit. The department of distribution is in charge of providing pesticides, fertilizers and agricultural machinery, shipping produce and livestock. The education department aims to transfer the latest agricultural technology to farmers and promote ideas about how to run farming business. The insurance department handles farmers' insurance, pensions, and national health insurance. The credit department deals with taking deposits from its farmer members and providing loans to them for financing their agricultural business. Briefly, it is not an exaggeration to say that farmers' associations are central to farmers' day to day life. But if we examine the operation of farmers' associations more carefully, we have to further emphasize that the credit departments are the hearts of these associations. For among the four chief departments, only the departments of credit and distribution can generate revenues to keep the whole association functioning, and in most cases the credit departments are accounting for more than 90 per cent of those revenues. In other words, if the credit department goes wrong, the whole association will come to a halt owing to the shortage of funds.

As a matter of fact, the reform measures towards the CDFFAs were also launched at a wrong time. The CDFFAs suffered dramatic difficulties over the 1990s after the government massively deregulated the banking sector and allowed 16 new private commercial banks to be established after 1991. The newcomers significantly eroded

the CDFFAs' market share and revenues. The CDFFAs' market share shrank from its peak at 8.17 per cent in 1995 to 4.41 per cent in 2000. Consequently, apart from the high NPL ratios mentioned earlier, the net revenues of all CDFFAs declined from NT\$ 10.8 billion in 1996 to NT\$ 0.14 billion in 2001.³¹⁴ Meanwhile, due to Taiwan's bid to join the GATT/WTO, increasing competition from imported agricultural products further worsened farmers' business and as a result put the CDFFAs' loans at risk. The CDFFAs were suffering from their members' inability to pay back their loans and the plummeting value of the collateral securing these loans.

Against this backdrop, many farmers' associations were already struggling to maintain their normal operations when the DPP came to power in 2000. But instead of assisting them to strengthen their credit departments, the DPP government made the farmers and fishermen feel that its reform project was like "a bullfighter who carried a sword to pierce a bull's heart."³¹⁵ The heart was the credit department and the bull was its affiliated association. That was why the farmers and fishermen kept saying that the DPP government wanted to abolish their associations in the name of reforming their credit departments. Consequently, since the government did not change the core of its reform projects for the CDFFAs, the TAFU rejected any

³¹⁴ For credit departments of fishermen's associations, the number decreased from NT\$ 6.5 million in 1996 to 1.4 million in 2001. Source: the Banking Bureau's website: www.banking.gov.tw/dp.asp?mp=10 (accessed September 10, 2005).

³¹⁵ This metaphor was used by some farmers when they joined the huge protest against the DPP government in late November. See Gao and Wu, "Nongcunqu dailu bupowang shouwei nongyu dayouxing cong tou dao wei jitoutou" [Thousands of Farmers and Fishermen Took the Street].

concessions, even when the Executive Yuan announced the immediate and total suspension of its *three tier risk management system* over the CDFFAs. The TAFU had very little confidence in the promises of the government and insisted on proceeding with its planned protest.

This lack of confidence was confirmed by WANG Hsueh-hui, the President of Pan Chiao Farmers' Association in Taipei County. In response to the question why the TAFU still went ahead with the protest, she simply replied: "Judging from all signs, we just could not feel the sincerity of the MOF!" As the leader of one of the biggest farmers' associations in Taiwan, she felt:

"There is obvious discrimination against the rural credit unions by the MOF." ... "We are not allowed to do many banking services that other community cooperatives can do." ... "The MOF just wanted to punish those bad CDFFAs but did not provide anything to reward the good ones at the same time." ... "The whole process to take over those 36 CDFFAs and implement the new risk management system was just too rough and reckless." ... "When there was no mutual trust between the two sides (the MOF and the TAFU), the protest was just unstoppable."³¹⁶

CHEN Kun-sung, another chief of a farmers' association in Taichung County, also responded with resentment:

³¹⁶ The interview was made in late 2004 at Wang's office in Pan Chiao.

“Why did the DPP government always like to associate us with ‘black gold politics’ and local factions? We are just doing our job to provide service to our farmers. You must understand one thing: we can provide loans to those farmers who have troubles in getting a mortgage from other financial institutions for their farming investment. After all, we know better about those farmers and their special financial needs for farming than commercial banks.”³¹⁷

The large gap of perception between the DPP government and the TAFU, regarding the functions of farmer’s associations and how to address their credit unions, could be easily recognized from these reactions from the two heads of farmers’ associations. Perhaps, this was also why Chen Shui-bian blamed some government officials for the policy U-turn on the eve of the protest --- he accused them of not providing *correct* information about the CDFFAs to him, making him misled.³¹⁸ Nevertheless, Fan Chen-tsung, the head of the COA, responded that he had warned Premier Yu not to misjudge the situation long time ago. “I found the strong opposition were not just from the farmers’ associations but also among the general farmers.”³¹⁹ This confirms again the assessment of the COA to the reform had been ignored or dismissed for a long time before the policy U-turn.

³¹⁷ Chen was the President of Da-an Farmers’ Association in Taichung County. The interview was made at his office in late 2004.

³¹⁸ Jen, “Nonghui jingai shizhen Chen Shui-bian buman zhengyuan” [Chen Shui-bian upset about the Executive Yuan for inaccurate information of the financial reform on farmers’ associations].

³¹⁹ Tsao, “Fan Chen-tsung: zao jinggao zhengyuan bie cuogu xingshi” [Fan Chen-tsung: I warned the Executive Yuan not to misjudge the situation long time ago].

But, why did the DPP choose a problematic project in the first place and why was it so blind to the flaws of the project all the way? The answers, I argue, were related to the DPP's unfamiliarity with the farmers' and fishermen's associations on its way to power. This lack of understanding misled the DPP into selecting the MOF project and then sticking to it until the policy U-turn. The following section aims to elaborate the argument in details.

3.2 A new ruling party unfamiliar with the farmers' and fishermen's associations

When it comes to the associations of farmers or fishermen in Taiwan, many political scientists regarded them as grassroots institutions controlled by local factions to mobilize support for the KMT through vote-buying or other mechanisms during elections especially under the KMT rule before 2000.³²⁰ In order to ensure the political support of local factions, the KMT allowed them to run the grassroots institutions as a mechanism for economic feedback. In return, local factions would mobilize farmers and fishermen to vote for KMT candidates³²¹ through the network of the associations they controlled. This again confirms a typical patron-client

³²⁰ For instance, See Chen, *Paixi zhengzhi yu Taiwan zhengzhi bianqian* [Factional Politics and Political Change in Taiwan]. Chao, *Taiwan difang zhengzhi de bianqian yu tezhi* [The Transformation and Characteristics of Local Politics in Taiwan]. Ho and Lee, "The Political Economy of Local Banking in Taiwan." This is not to say that all local factions are connected to the KMT. Some of them have their own autonomy or even have connections with the DPP or the PFP. But in terms of number, the majority of local factions are close to the KMT.

³²¹ Although many are independents, they tend to be politically closer to the KMT.

relationship between the KMT and local factions, making the KMT's rural power base relatively stable.

Democratisation and urbanization over the past two decades saw this special relationship wane but it remained significant. Its on-going importance could be inferred from the election outcomes in the local elections for city municipality mayors/township magistrates and county/city councillors in 2002. As the level of these elections was more community-oriented, local factions could maximize their influence through their interpersonal networks. In the elections of city municipality mayors/township magistrates, the KMT prevailed with 195 of the 319 seats. Independent candidates won 92. The DPP only got 28. In the elections of county/city councillors, the KMT was still dominant with 382 of 897 seats. The independents followed at second place with 316 and the DPP just got 147. If compared with the previous election outcomes, as Table 7.3 shows, the KMT had lost seats but still occupied the biggest share of seats in the local political landscape. In contrast, the DPP's seat gains were very limited even after it won the presidency in 2000.

Of course, the KMT's success in these local elections cannot be only attributed to its close relationship with local factions, factors like the strength of the KMT election machines and its dominance in most local civil organisations and government

agencies due to its past corporatist control have to be considered as well. However, the large presence of the independents and the poor performance of the DPP all imply the nature of these local elections: to rely on the characteristics of individual candidates and their ability to mobilize support through their personal connections and networking, a nature that definitely favours the KMT and the local factions it cooperates with.

**Table 7.3: Change of seats among political parties
in recent two local elections (1998/2002)**

elections for	mayors/magistrates		county/city councillors	
	1998	2002	1998	2002
KMT	236	195	473	382
Independents	55	92	235	309
DPP	28	28	114	147
Other parties	0	4	11	59
Total	319	319	833	897

Source: Election Study Centre, National Chengchi University,
<http://vote.nccu.edu.tw/cec/vote4.asp> (accessed November 9, 2005).

Thus, these local elections results go some way to showing that the DPP did not enjoy the same close relationship with grass roots organisations as the KMT. In fact, they also suggest that the rise of the DPP relied far more on its campaign strategy than institutional mobilization. Given this context, the DPP not only lacked a clear idea of how these agro-organizations were run, but also had very negative images of them. The stereotype from the DPP's perspective was that, corresponding to most political scientists' research findings and general media coverage, they were the hotbed of corruption and cronyism, as well as the roots of local factions and the KMT.

Furthermore, because the credit departments provided funding and interpersonal networks for their affiliated associations of farmers or fishermen to serve for local factions and the KMT, the DPP had every reason to think that a reform focusing on credit departments was the shortcut to restructure the agro-institutions behind them.

In addition, if the reform succeeded, it could indirectly but significantly reduce the rural power base of the KMT. Now that public opinion was very concerned about the rapidly mounting NPLs of the CDFFAs, it had sufficient legitimacy to quickly impose reforms on them. It would be very difficult for the KMT and PFP to defend the CDFFAs considering the strong resentment of the public, so the DPP government had almost a free hand to implement its series of projects.

In short, due to its unfamiliarity with the farmers' and fishermen's associations and their closeness with the KMT, the DPP had superficial understanding and strong negative impressions of the CDFFAs. In this context, it is not surprising that the DPP chose the MOF reform project, which was in line with its political goals and ideological preconceptions.

Conclusion

Instead of just summarizing the main finding of the chapter, this section is expanded to compare the current case with that of the NPL reform in the previous chapter. As

the two cases were the two major financial reforms during the DPP's first term in power from 2000 to 2004, the purpose of the comparison is to see whether the first change of ruling parties in 2000 has made a difference in strengthening the state's financial governance.

Without doubt, the first transfer of power in 2000 was the high tide of Taiwan's democratisation since its inception in the late 1980s. It created a window of opportunity for a test: whether the first non-KMT ruling party, the DPP, in Taiwan's post-war history could enhance the performance of the state in governing. In terms of financial governance, the reforms on the NPLs and the CDFFAs have provided abundant materials for us to get some clues. Against the success of the former and the failure of the latter, a key question arises for our discussion: what has contributed to the huge difference as the DPP was deeply committed to both reforms at the same time?

At the core of the question is concerning the strong mandate that the DPP had in both reforms. In the case of tackling the NPL crisis, as examined in the previous chapter, the strong mandate helped the DPP overcome its minority status in parliament and thus greatly facilitated the reform process. In contrast, as we have just seen in this chapter, the same mandate did not have the same effects on the CDFFAs reform. The

key to the difference, I contend, stems from one vital distinction: to have a strong mandate is one thing; to be able to effectively use the mandate and reach the targeted goals is another.

In the case of the reform on the rural credit unions, actually, the DPP enjoyed not only the strong mandate but also the advantage of weaker links with local factions and their agro-associations. This was why it could swiftly undertake the reform without the hesitation of its predecessor the KMT. In the meantime, however, it also suffered from a lack of understanding about the rural credit unions and their associations. Owing to its unfamiliarity with the agro-associations on its way to power, the DPP in general had held a strong negative view against them for years. It saw them just as the breeding grounds of local factions and the power base of the KMT. Not surprisingly, once it took power and got the mandate to reform the rural credit unions, it rushed to start the reform and chose the MOF project that did not favour their operation and existence. In a word, the DPP's given bias against the CDFAs led to its misjudgement and eventually cost its strong mandate and advantages on the reform.

Based on the analysis, a few points can be made on the effects of democratisation and change of ruling parties on the state's financial governance after the DPP came to power at its first term. First, democratisation played a key role in offering an

alternative to the KMT's uninterrupted rule for decades. It brought a chance for a fundamental reform on the urgent financial issues including the NPL crisis and the deteriorating CDFFAs, which would have been less likely to happen if the KMT was still in power considering its close connections with the concerning parties involved in the reforms. Second, as a new ruling party without the majority in parliament in its first term, the DPP, desperate to boost its popularity and legitimacy, was highly motivated to rapidly build its credit of governing through a rush to engage in financial reforms. Under certain circumstances, this attitude was necessary and constructive to the success of a financial reform such as defusing the NPL crisis. But if there was no cautious preparation in advance, the attitude would result in the failure of a financial reform like the one on rural credit unions. The lesson is: a successful reform must be based on more than the will of political leaders or the good intention of reform of a political party. It is also very important to assess the context of the problem carefully and comprehensively before a reform project is instigated. Third, accordingly, the effects of the change of ruling parties should not be exaggerated. Things will not change overnight because of the transfer of power if the fundamental problems are not really addressed. Government agencies, policies and policy environments, to some extent, all have continuities. In the case of the CDFFAs reform, despite the DPP's strong commitment, it was unrealistic for the DPP to think it could start its rule free

from the structural constraints and institutional legacies. The DPP was not only conditioned by its own given perceptions about agro-associations but also by its ignorance to the importance of the credit unions in the rural area. As a result, it picked a problematic reform project and ended up facing the embarrassing policy U-turn.

Finally, despite the policy U-turn on the CDFFAs reform, there is still room for us to stay positive on the function of Taiwan's developmental state in financial governance after 2000. Apart from new challenges, democratisation has also brought new opportunities for the developmental state at the same time. The future of the developmental state will depend on whether all main related actors can adapt to the changing political environment and reach new consensus about new policy goals as well as political norms and practices. The final news about the CDFFAs reform after the policy U-turn seems to confirm a positive view. The DPP government eventually reached several consensuses with the TAFU and the opposition parties. The Agricultural Financial Law was enacted in July 2003. Based on the law, the Agricultural Bank of Taiwan (ABT) has been established and begun to operate in May 2005 under the supervision of the COA not the MOF.³²²

³²² *Taipei Times*, "ABT to fill service gaps: Hsieh."

Chapter Eight

Conclusion

Many forms of Government have been tried and will be tried in this world of sin and woe. No one pretends that democracy is perfect or all-wise. Indeed, it has been said that democracy is the worst form of government except all those other forms that have been tried from time to time.

Winston Churchill, Speech in the House of Commons, November 11, 1947

After the Asian financial crisis of 1997-1998, many countries in the region were forced to implement the neo-liberal reform projects that advocated by the IMF and the West. While the results of those projects, dubbed by some as “Washington Consensus,”³²³ are controversial and mixed, the latest global financial meltdown of 2008-2009 has delivered a fatal blow to the dominant status of the neo-liberal doctrines for economic and financial governance. In the meantime, the rapid rise of China as a political and economic powerhouse on the world stage over the recent two decades seems to provide an alternative for economic development to the developing countries in the rest of the world. The “Beijing Consensus,” coined by a westerner³²⁴ and implicitly advocated by the Chinese government, puts much emphasis on constant

³²³ Williamson, *The Political economy of policy reform*.

³²⁴ Ramo, *The Beijing Consensus: Notes on the New Physics of Chinese Power*.

experimentation and diverse and practical ways for economic development. It has not only strongly appealed to some developing countries but also recalled the old magic of the developmental state in East Asia before the late 1990s. Under such circumstances, the search for the right answers of “good governance” or governing model for the East Asian countries is far from being easy. Is the East Asian model for economic development still working in contemporary world economy in the 21st century? Should it be all dismissed? Or maybe it just needs some adjustment? This case study on the process of Taiwan’s financial reforms and governance changes from 1988 to 2008 is an effort in helping answer those questions. After examining the four key issues in the process over the previous chapters, now I will first summarize the main findings and their implications. Then I will provide policy suggestions to revamp the developmental state in Taiwan in a democratic era on the basis of this study and the guidance of related research in existing literature. Finally, I will evaluate the prospects for the developmental state in Taiwan and East Asia. Also, judging from the progress of the research and its limitations, a brief discussion on what could be done to expand the research in the future is addressed at the end of the chapter.

1. Main findings: Old governance machine vs. new political arena

Over the preceding chapters, I have tried to address the core questions of the thesis:

What has accounted for the surge of financial turmoil since the second half of the 1990s in Taiwan? How and why have most of the main reform measures proposed by the government been either seriously delayed or even totally failed since Taiwan began to undertake large-scale financial reforms in the late 1980s? What implications can we see from the reform process regarding the evolving status and prospect of the Taiwanese developmental state? Here is a summary of my findings to these questions from the previous case chapters.

Concerning what led to the increasing financial turmoil in the late 1990s, i.e. runs on banks, NPLs and scandals of financial institutions, the study finds that the mishandling of financial reforms by the KMT government in the initial years of deregulating the banking sector was the original cause while the continued delay of necessary reforms as well as the lack of effective financial supervision in the later years added more fuel to financial instability.

In the early years, as chapter five shows, the biggest mistake made by the KMT government was to allow too many new private banks to enter the banking sector at the same time, resulting in over-banking. The intensified competitions as a result of oversupply of lenders not only squeezed the originally disadvantaged small players but eroded the profits of normal or big players as they were competing against each

other in a cut-throat way for a limited domestic market. Another significant mistake made by the KMT government, as mentioned in chapter four, five and six, was lifting the ban on the entry of new private commercial banks before the SOB privatisation was finished.³²⁵ The sequence was problematic because it would have been better for the government to have figured out the proper room left for new private players after the end of SOB privatisation since most SOBs were major players in the given banking sector.

In the later years, as chapter five, six and seven have all shown, despite all the rhetoric and plans announced by the government, persistent reoccurrence of incidents of financial disorder only exposed the limitations of progress and effort made by the KMT government on carrying out financial reforms and supervision. The lack of effective response made people even see the government itself as a main cause for the enduring disorder of the financial sector. The government, according to its critics, had acted too little and too late on overhauling the financial system.

These explanations, however, are not complete. For we cannot help asking: How did the KMT government end up making those big mistakes in the initial years? Why did it run into difficulty in taking necessary measures to correct mistakes in time

³²⁵ The two reforms were launched at the same time in 1989. While the entry of new private banks was approved in 1991, the SOB privatisation only began to have genuine progress in 1998.

afterwards? These questions require further explanations, which also have much to do with the second core question of the thesis - why did the government either delay or fail in most of its major financial reform measures?

The study argues that the fundamental root to these questions is the impact of rapid political democratisation on the financial governance of the state since the martial law, imposed by the KMT government in 1949, was lifted in 1987. Based on the previous four case chapters, I find that political democratisation has affected the state's financial governance in the following aspects:

1. The power of the central administration in pushing through its crucial policies of financial reform is more seriously constrained by other newly influential actors rising after democratisation in the political arena. Among which, the legislatures, opposition parties and local governments are chief challengers due to their surging autonomy and influence empowered by the public through regular elections. The concern of individual interest, reaction from constituencies and strong lobby by influential interest groups such as business groups often outweighed the instructions from the central authority in the democratic era. Consequently, major financial policies as well as other important public policies are subject more and more to the scrutiny of the forces outside the central administration. For example,

in the case of SOB privatisation during the KMT era before 2000, the biggest obstacle was not only from the rising opposition DPP but also from the inside of KMT itself. In appearance, the KMT seemed to be still in control of everything. But, in fact, it had serious troubles in convincing its own lawmakers in the Legislative Yuan, officials in the Taiwan Provincial Government, and councillors in the Taiwan Provincial Assembly to approve SOB privatisation until the late 1990s.

2. The KMT's constant attempts to survive in a new political environment, where winning elections was key to staying in power, had compromised the integrity and effectiveness of its measures for financial reform and supervision before it lost power in 2000. The KMT sought to win elections and consolidate its rule by giving away more political power and economic privileges to local factions and business groups, its main political partners since the authoritarian years, in exchange for their continued support. As many of these political partners were deeply involved in a great number of financial institutions, essential progress of financial reform or serious implementing of financial supervision became much more difficult for the KMT administration. The most evident case for this situation was the bad debt problems of some struggling financial institutions emerging in the late 1990s. The KMT government often intentionally "tolerated" and

“ignored” the problems out of concern that rushed reforms might “upset” its political partners and thus damage its relationships with them and its electoral prospects.

3. The mass media and public opinion have played much more important roles in shaping public policies than they did before the democratic breakthrough in the late 1980s. The mass media has mushroomed ever since with surging influence as public opinions are affected, expressed and transmitted by it. Like their counterparts in the Western democracies, politicians and political parties in Taiwan are getting more conscious of the coverage of the mass media regarding their performance and paying more attention to public opinions as these are crucial for their public images and election results. In terms of financial reform, mass media and public opinions were so powerful to help a ruling party like the DPP overcome its minority in the parliament and push through timely measures to defuse the bad debt crisis from 2000 to 2004. At other times, they could also hold back controversial but perhaps vital reforms for consolidating the banking sector like merger and acquisition among banks.
4. Democratisation has motivated political parties to propose and push financial reforms in an effort to mobilize the support of public opinion and win elections with the image as reformists. But, in the meantime, this attitude at times prevents

political parties from taking a patient, careful and thoughtful approach in launching financial reforms. This is most evidenced by the case of rural credit union reforms. Despite its strong mandate in the beginning, the DPP government's rush to overhaul the agro financial system ended up as a policy U-turn. It stumbled badly as a result of not recognizing that the power and economic structures in the rural area had not changed much even after years of democratisation. As old structures persist, swift and essential reforms towards the rural credit unions are almost impossible.

5. As far as the prospect of financial reform in Taiwan is concerned, the most urgent issue is to forge a consensus on the role of the state in the financial system. Should the state need to continue to run financial institutions by itself? If yes, what is the proper market share of state-run financial institutions? Or, perhaps the state needs to completely withdraw from running financial institutions and only play the role as a regulator of financial markets? Due to the lack of consensus on these questions among the public and political elites, we have seen the swing of public opinion, making the state lose its directions and principles in pushing for financial reforms. From Taiwan's financial history over the past five decades and the public's reactions to recent controversies of financial reform, my prediction for the most likely answer to the questions above is that the state will continue to run

financial institutions with significant market shares, say around 20 per cent. The fundamental reason for this judgement is the continued threat of military invasion from China and Taiwan's exclusion from most of the important international organizations for financial rescue, like the IMF. The continued presence of state-controlled financial institutions is needed to reassure the public that the government could always efficiently restore financial stability even without any international aid if financial crises or turmoil break out. Nevertheless, the future performance of the state-controlled financial institutions will be still the concern of the public.

In short, the old top-down approach used by the central administration in dictating financial policies during the authoritarian years has become history. Democratisation has created a new political environment where financial policies as well as other crucial public policies are made, reviewed and shaped in a more complicated way. It becomes increasingly difficult for the state to control the agenda of financial reforms and achieve policy outcomes as originally planned. While Taiwan has embraced liberal democracy of the West and the government's accountability has been greatly improved over democratisation, the delay, distortion and even complete failure of crucial measures relating to financial reform and governance are new challenges to the young democracy. Thus, how to upgrade the "old machine" for economic

governance to meet the demands and changes in a new and more complicated political arena will be a difficult and urgent task for Taiwan.

Political democratisation aside, the impacts of economic globalisation on financial governance of the state are also slightly singled out by the study under certain circumstances. While its impacts are far less significant than democratisation in the four case chapters, economic globalisation, however, has imposed more constraints on what the state could do in controlling the movement of private capital and investment, which has devastating effects on the banking business environment. For instance, in the discussion of the origins of mounting NPLs among the banks in Taiwan in the late 1990s, two factors are particularly linked to economic globalisation: capital flight and relocation of industries from Taiwan to China. Motivated by looking for cheaper land and labour as well as targeting the massive Chinese market in a global economy, Taiwan's enterprises have aggressively invested in China since the late 1980s despite the constant brakes put on by the Taiwanese government. The China-bound investments have significantly eroded the momentum of economic growth in Taiwan as they have reduced available funds for investing in the homeland. As a result, two negative side effects emerge. Firstly, demands for loans from banks significantly shrink, thus endangering the whole banking business. Secondly, the cases of "leave debt in Taiwan and invest in China" increased as the Taiwanese government has

difficulty in bringing economic outlaws who stay in China to justice due to the political standoff between Taiwan and China.

Overall, we have to recognize the fact that Taiwan is situated in a dynamic and global economy, where the great powers like the US, EU and Japan are dictating the global rules of regulating financial industries. As a small and open economy, that is diplomatically isolated, Taiwan has little resistance to those financial norms and regulations set by those big players. In other words, with these outside constraints, what the Taiwanese state can mostly do is focusing on domestic reforms and getting itself ready for possible changes and challenges from the outside world.

2. Implications: Searching for an effective state in a democratic era

The findings above will not be new to those observers who are following Taiwan's politics and economic development as there are many similar symptoms pervasive in other policy areas. But a more fundamental question coming from the findings is whether the developmental state is compatible with democracy. Or, put the question in another way: if Taiwan is not going back to its authoritarian past, how can it still keep its economic prosperity in a democratic era with or without the developmental state? The question is not only important to Taiwan, but also many emerging democracies in East Asia as they are all encountering similar challenges and looking for their own

answers. Before proposing solutions, let's first briefly review the problems of economic governance and democracy in Taiwan over the recent two decades.

In fact, overall, the assessment to economic governance and democracy in Taiwan of the 1990s was more positive than negative. For example, right after the Asian financial crisis of 1997-1998, Hsiao and Cheng reflected on Taiwan's experience of a decade of democratisation in the 1990s and concluded:

“...after a decade of democratization, the authoritarian party-state has been transformed into a liberal multi-party system.”...“In the path toward democratic consolidation, the government is going to play a less dominant role in the economy, and the ruling KMT no longer has the absolute power to control the economic sector that it did in the authoritarian era. Nevertheless, *the government is still effective in governing and regulating economic activities, and the continuing consensus on the framework of the developmental state is reflected in the platforms of the different parties.*”...“The impact of the financial crisis of 1997 on Taiwan has not been as serious as on other countries of East and Southeast Asia. *The government's various financial policies and measures in response to the crisis have been rather cautious, and have not become a political issue with the opposition parties. The economic bureaucracy is considered to be strong and capable of dealing with the sudden external shock.*”³²⁶

Wade also highlighted the achievement of economic governance of the state in Taiwan by the early 2000s. He praised as below:

³²⁶ Hsiao and Cheng, “Taiwan,” 134, emphasis added.

“The case of Taiwan shows how governments can --- even in conditions of a globalized world economy and even when subject to real democratic accountability --- impart directional thrust to the economy in line with an exercise of foresight about the economy's future growth.”³²⁷

Fell concurs on the issue with similar verdict:

“Despite internal national identity divisions, its authoritarian past and the military threat from China, Taiwan went through a remarkably smooth and peaceful democratic transition.”...“Taiwan’s democracy went beyond just conducting free and fair elections. Compared to other new democracies, it had strong and institutionalized political parties. Moreover, in the competitive multi-party system there was intensive electoral debate over political issues.”³²⁸

Fell’s own research on content analysis of Taiwan’s election advertising in the 1990s also supports his verdict above.³²⁹ His research finding shows “the issue-rich nature of political communication” and “voters were highly knowledgeable about party positions on core issue cleavages.” “...electoral debate did force the government to address key policy areas of concern to the general public, such as creating a more equitable welfare system, tackling political corruption and working on environmental protection.”³³⁰ In a word, to many observers and researchers including myself, it seemed that democracy in Taiwan was working and delivering in the 1990s.

³²⁷ Wade, “INTRODUCTION TO THE 2003 PAPERBACK EDITION: CREATING CAPITALISMS,” xlii. Also see his similar views in Wade, “The Reprinting of *Governing the Market: A Dinner Table Conversation.*”

³²⁸ Fell, “Taiwan's Democracy: Towards a liberal democracy or authoritarianism?,” 188.

³²⁹ Fell, *Party Politics in Taiwan: Party Change and the Democratic Evolution of Taiwan, 1991-2004.*

³³⁰ Fell, “Taiwan's Democracy: Towards a liberal democracy or authoritarianism?,” 188.

However, such an upbeat tone about Taiwan democracy gradually waned after 2000.

For example, Richard C. Bush III³³¹, a senior expert on Taiwan, and his colleague

Carlos Pascual expressed their assessment about Taiwan democracy in a newspaper

article in 2007: “Formal democratic institutions may exist but they don't work

well.”³³² They contended that Taiwan’s transition to democracy was successful “but it

has not been followed by a full consolidation of democracy.”³³³ They elaborated

further:

“Taiwan's institutions --- semi-presidentialism, the legislature, the party system, the

electoral system, and the mass media --- work together in a perverse way that rewards

political gamesmanship over good policy. They reduce accountability, foster a

zero-sum political psychology, promote policy deadlock, ensure suboptimal policy

performance, and defer consensus on the rules of the game.”³³⁴

These assessments, to get more evidence, are confirmed by empirical surveys.

According to a survey conducted by East Asia Barometer in Taiwan in 2006, 41.2 per

cent of respondents expressed dissatisfaction with how democracy was working in

Taiwan while only 31.5 per cent held trust in the president, 21.6 per cent in parliament,

and 17.6 per cent in political parties.³³⁵ In other words, “the backsliding in popular

³³¹ He was also the Chairman of the Board of the American Institute in Taiwan (AIT, the de facto U.S. embassy in Taiwan) from 1997 to 2002.

³³² Bush and Pascual, “The Four Faces of Taiwan Democracy.”

³³³ Ibid.

³³⁴ Ibid.

³³⁵ East Asia Barometer, A Comparative Survey of Democratization and Value Change Online Data Analysis (Step 2): Question Index, Selected countries/samples: Taiwan 2006.

support for democracy³³⁶ in Taiwan is obvious. Some even worry about the rise of authoritarian nostalgia, which is generated from an exceedingly high expectation about the performance of the new democratic regime.³³⁷

One of the main factors in dampening the people's confidence in the legitimacy of democracy is Taiwan's lackluster economic performance in the past decade. In 2001, people suffered from the worst economic recession since the first oil crisis of 1972-73 as the economy contracted by 2.2 per cent in that year. Similar economic recessions happened again in 2008 and 2009 as Taiwan was under the shadow of the global financial meltdown. Economic growth rates were only 0.7 per cent and -1.9 per cent individually in those two years. The unemployment rates swung from the scale between the lowest 3.91 per cent in 2006 and 2007 and the highest 5.85 per cent in 2009. Although these rates seem not too bad by the Western standards, they are the worst in Taiwan's history if compared with the same statistics in the 1980s and 1990s, not to mention that the social safety net is still rudimentary in Taiwan. Besides, the growth of salary for most employees has been almost stagnant from 2000 to 2010. The average monthly earnings only slightly increased from NT\$41,861 (GBP£905) in 2000 to NT\$44,430 (GBP£960) in 2010.³³⁸ The increase, 6 per cent over ten years,

³³⁶ Chu, "Taiwan's Democracy at a Turning Point," 906.

³³⁷ Ibid, 907. Also see more related discussion in Rigger, "The Unfinished Business of Taiwan's Democratization."

³³⁸ The statistics are from the Directorate General of Budget, Accounting and Statistics under the Executive Yuan. Visit <http://eng.stat.gov.tw/lp.asp?ctNode=1615&CtUnit=765&BaseDSD=7> for whole

was near nothing. At the same time, income disparity continues to deteriorate. The Gini coefficient³³⁹ jumped from 0.326 to 0.345 from 2000 to 2009. With all the economic hardship behind these numbers over the past decade, people's growing frustration with the government and their politicians is no surprise. "Suddenly, in the public eyes Taiwan's political system lost much of its capacity in steering the national economy and delivering material security and prosperity, something the citizens had almost taken for granted."³⁴⁰

Actually, Hsiao and Cheng had sensed the coming challenge regarding economic governance and democracy in Taiwan as they predicted in the late 1990s: "... it is inevitable that the government will face greater pressures and challenges from both opposition parties, politicians, capitalists, and various conflicting forces in civil society."³⁴¹ But they did not expect the KMT would be soon out of power from 2000 to 2008. Nor did they expect the DPP administration would be so constrained, unstable and ineffective as a minority government. What was even more unlikely for them to see was that the KMT's return in power with decisive parliamentary and presidential election victories in 2008 did not boost the government's performance in governance as shown in the persistent low approval ratings of the Ma administration

data (accessed June 23, 2011).

³³⁹ The Gini coefficient is a measure of the inequality of distribution. A value of 0 indicates total equality while a value of 1 expresses maximal inequality.

³⁴⁰ Chu, "Taiwan's Democracy at a Turning Point," 908.

³⁴¹ Hsiao and Cheng, "Taiwan," 134.

over the past three years.³⁴² Actually, in a more recent paper, Hsiao has implored that the KMT has wasted “a window of opportunity for the party to demonstrate that it had indeed reformed and that Taiwan’s politics had matured and is ready to overcome the political gridlock that dominated the previous administration.”³⁴³

Thus, why did Taiwan which was often touted as “a best-case scenario of democratization”³⁴⁴ in the 1990s suddenly strike a downbeat tone over the past decade? Some external factors in challenging the government’s economic governance, like the two global economic downturns in 2001 and 2008-2009 and the surging influence of China over Taiwan, are all too obvious to ignore. But as these factors are universal to all countries in East Asia, especially the global economic downturns, we need more direct and powerful explanations.

Based on the findings of this research, I argue the main challenge is from inside. To be more specific, Taiwan has not figured out how to set up a new state apparatus which is both capable in economic governance and complying democratic rules and norms.

Basically, I agree with the analysis of Bush and Pascual that “the problems here are

³⁴² For example, in a recent opinion poll conducted by the Global Views Survey Research Centre indicated that only 33.9 per cent of respondents approved President Ma Ying-jeou’s performance while 54.3 per cent disapproved. The result was released on 20 May 2011. See the whole release at: <http://www.gvm.com.tw/gvsrc/20110515S01AP00PR1R.pdf> (accessed June 24, 2011).

³⁴³ Hsiao and Hsiao, “The Challenges and Prospect of Taiwan’s Democracy,” 109.

³⁴⁴ Rigger, “Democratization in Greater China: Taiwan’s Best-Case Democratization.”

mainly structural and systemic.”³⁴⁵ “One political camp or the other can be blamed for mistakes that each has made over the last decade to contribute to the current state of affairs. But political actors are acting within a structure that encourages these unfortunate types of behaviour. Until systemic reforms are devised to correct these systemic problems, the dysfunction will continue and politicians will continue to perform according to the cues that the system creates.”³⁴⁶

Also, I contend that today’s problems have their roots in the 1990s. Hsiao and Cheng and many observers including myself at the turn of the 21st century obviously underestimated the negative effects of those “unfinished business of democratisation” that the KMT left in the 1990s despite all the signs they had seen. The change of ruling parties in 2000, in my view, only exposed the negative effects more clearly. My case study has shown that the surging influence of business groups over major financial policies commenced in the 1990s and went on being unchecked in the 2000s. The same applies to the KMT’s business empire and massive party assets. Despite all the efforts of the DPP during its eight years in office from 2000 to 2008, the KMT is still rich and powerful in terms of the resources available for political competitions and elections with other major political parties in Taiwan. “Transitional justice” has not been fully realized to create a level playground. Thus, the KMT still has huge

³⁴⁵ Bush and Pascual, “The Four Faces of Taiwan Democracy.”

³⁴⁶ Ibid.

advantages over other political parties, not to mention its long-term relationship with local factions around Taiwan. The list could extend to include money politics, the judicial system, corruption, constitutional reform and so forth. The point is that *it is unlikely for the state to be effective in a democratic era when itself is penetrated, constrained or even captured by other new powerful players.*

3. Solutions: Retrofit the developmental state

So, what can be done to improve democratic governance of the state in Taiwan? In spite of all those given problems just mentioned, Taiwan's has a good chance to turn the tables. After all, over the past two decades, democratic transition and consolidation has its merits and achievements --- a vigorous civil society and a mass of highly educated citizens have taken root in Taiwan. What is mostly needed now is a public deliberation on what and how to do with the reform plan of boosting democratic governance. In my opinion, the core of the plan is to extract and maintain the essential and constructive part of the developmental state from Taiwan's own experience and history and embed it in a democratic system. In other words, instead of completely dismissing its past success formula, Taiwan only needs to revamp its developmental state in a democratic era. Accordingly, the rest of this section is divided into two parts for more details: what to extract from the past and how to rebuild it in the new political environment.

3.1 State capacity matters

Fukuyama is right by saying that “politics in the twentieth century were heavily shaped by the controversies over the appropriate size and strength of the state.”³⁴⁷ For most East Asian countries including Taiwan, they have followed, more or less, the neo-liberal doctrines to reduce the intervention of the state in the market by pursuing economic liberalization since the late 1980s. The trend had been reinforced after the Asian financial crisis of 1997-98 until the outbreak of the global financial meltdown of 2008-2009. Still, the voice for the reduction of the state’s role in “governing the market”³⁴⁸ in the name of efficiency and profit is echoed all the time albeit with a less dominant tone. The road ahead for Taiwan in improving its democratic governance, to be honest, will never be easy, fast and clear. Douglass C. North, the co-winner of the 1993 Nobel Prize in Economics, has reminded us from his study on economic history that:

“It is the admixture of formal rules, informal norms, and enforcement characteristics that shapes economic performance. While the rules may be changed overnight, the informal norms usually change only gradually. *Since it is the norms that provide ‘legitimacy’ to a set of rules, revolutionary change is never as revolutionary as its supporters desire, and performance will be different than anticipated.*”³⁴⁹ ... “Both institutions and belief systems must change for successful reform since it is the mental

³⁴⁷ Fukuyama, *State-Building: Governance and World Order in the 21st Century*, 3.

³⁴⁸ Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*.

³⁴⁹ North, “Economic Performance Through Time,” 366, emphasis added.

models of the actors that will shape choices.”³⁵⁰

With this in mind, plus if the theory of path dependence is right, the most likely and acceptable reform project will bear strong legacy from the past and take effect in a gradual way. Still, there is no guarantee of success for such an approach. After all, North has also warned us that:

“It is adaptive rather than allocative efficiency which is the key to long-run growth. Successful political/economic systems have evolved flexible institutional structures that can survive the shocks and changes that are a part of successful evolution. *But these systems have been a product of long gestation. We do not know how to create adaptive efficiency in the short run.*”³⁵¹

But, at least, we could try to grasp the way out from the past lessons, especially from those numerous trials and errors in practice and countless debates and discussions over the past decade.

The most important lesson, from my point of view, is that strong state capacity matters for sound economic governance. State capacity, as well defined by Linda Weiss, is a “transformative capacity” referring to “the ability of a state to adapt to external shocks and pressures by generating ever-new means of governing the process

³⁵⁰ Ibid, 366-367.

³⁵¹ Ibid, 367, emphasis added.

of industrial change.”³⁵² Or, simply put it as “the ability of policy-making authorities to pursue domestic adjustment strategies that, in cooperation with organized economic groups, upgrade or transform the industrial economy.”³⁵³ However, Weiss rejects “the notion that the state’s ability to impose its decisions is central to its transformative capacity.” Instead, her focus is about “the state’s ability to use its autonomy to consult and to elicit consensus and cooperation from the private sector.” Weiss coins a term “governed interdependence” to refer to this negotiated relationship and calls this a special kind of infrastructural power of the state.³⁵⁴ Besides, she emphasizes that “when possessed of domestic adjustment capability, the state can provide a potentially more powerful locus for coordinating change.” “This is because the state’s institutions can offer the most encompassing organizational complex for overcoming a number of widely recognized obstacles to change, including problems of collective action³⁵⁵, bounded rationality³⁵⁶ and short-term horizons, as well as unprecedented time compression in technological transformation.”³⁵⁷

In fact, this kind of state capacity was exactly what the East Asian developmental states used to have in engineering their industrial catch-up with the advanced

³⁵² Weiss, *The Myth of the Powerless State: Governing the Economy in a Global Era*, 4.

³⁵³ *Ibid*, 5.

³⁵⁴ *Ibid*, 38-39.

³⁵⁵ Olson, *The Logic of Collective Action*.

³⁵⁶ See how transaction cost has affected bounded rationality in Williamson, *The Economic Institutions of Capitalism*. Plenty of studies have examined the role played by the developmental state in reducing transaction cost and thus alleviating the problem of bounded rationality. For example, see Kang, “Transaction Costs and Crony Capitalism in East Asia.”

³⁵⁷ Weiss, *The Myth of the Powerless State: Governing the Economy in a Global Era*, 5-6.

economies. Indeed, a key of the economic success of East Asia in the past is the strength or capacity of their state institutions. This is also why a host of scholars like Polidano are often contending that “The [Asian financial] crisis should not blind us to the lessons, such as they are, of the last 40 years of economic growth in East Asia.”³⁵⁸

Fukuyama and Marwah, in their comparative study on East Asia and Latin America, have also highlighted that “the reason for the superior performance of East Asia over the past forty years is likely due more to the superior quality of state institutions.”³⁵⁹

Root is even more direct in pointing out that “The hard truth is that authoritarianism, whatever its sins, did foster well-developed organs of public administration.”³⁶⁰ In effect, in an essential part, the legacy of East Asian experience has contributed to the formation of “the new conventional wisdom”: *institutions matter for an effective state to deliver economic development and reduce poverty with a special attention on the politics of transforming and building institutions, and local culture as well as history.*³⁶¹

The problem now for Taiwan and other East Asian countries is what Fukuyama has warned to many developing countries --- “...in the process of reducing state scope

³⁵⁸ Polidano, “Don’t Discard State Autonomy: Revisiting the East Asian Experience of Development,” 514.

³⁵⁹ Fukuyama and Marwah, “Comparing East Asia and Latin America: Dimensions of Development.”

³⁶⁰ Root, “What democracy can do for East Asia,” 118. For more other researches on the past success of East Asia, please see the literature review on the developmental state in Chapter 2 of this thesis.

³⁶¹ Leftwich, “Developmental states, effective states and poverty reduction: the primacy of politics.” Fukuyama, *State-Building: Governance and World Order in the 21st Century*. Levy and Fukuyama, “Development Strategies: Integrating Governance and Growth.” World Bank, *World Development Report 2002: Building Institutions for Markets*.

[over economic liberalisation] they either decreased state strength or generated demands for new types of state capabilities that were either weak or nonexistent.”³⁶²

For example, “While privatization involves a reduction in the scope of state functions, it requires functioning markets and high degree of state capacity to implement.”³⁶³

More importantly, as Polidano has emphasized, “...even if states opt for market liberalization, as did many developing countries in the 1980s and 90s, their ability to carry it through successfully will often depend on their ability to assert a degree of autonomy relative to domestic social interests. To become an agent of economic globalization a state needs *more* autonomy, not less.”³⁶⁴ As well argued by Rodrik, open markets succeed only when embedded within social, legal and political institutions that provide them legitimacy by ensuring that the benefits of capitalism are broadly shared.³⁶⁵ In this respect, the state is essential in its role in doing the balancing act all the time. In short, while “states needed to be cut back in certain area, they needed to be simultaneously strengthened in others.”³⁶⁶

3.2 Institution building

There is no question that this will be a huge and difficult task in overcoming the

³⁶² Fukuyama, *State-Building: Governance and World Order in the 21st Century*, 15.

³⁶³ *Ibid*, 18.

³⁶⁴ Polidano, “Don’t Discard State Autonomy: Revisiting the East Asian Experience of Development,” 515.

³⁶⁵ Rodrik, *The Globalization Paradox: Democracy and the Future of the World Economy*.

³⁶⁶ Fukuyama, *State-Building: Governance and World Order in the 21st Century*, 5.

challenge and revitalizing the capacity of the state. It will involve a comprehensive and sophisticated reform in improving the quality and function of the new democracy. But the bottom line is: "...there is no doubt in many citizens' mind that democracy is still considered a desirable and feasible form of government for Taiwan, in spite of all the recent threats and challenges faced for this new democratic system."³⁶⁷ With people's general support for democracy, it should be more likely to strengthen the state capacity while simultaneously pushing further consolidation of democracy against the background of the strong legacy and legitimacy of state-led development in Taiwan. What is urgently needed now is fixing or building main target institutions to shore up and enhance state capacity. And, for this task to be implemented adequately and persistently, strong political entrepreneurship is indispensable.

Actually, lists for the task of institution building or fixing for better democratic governance in Taiwan or East Asia are never in short supply. For example, Root has proposed a list of institutions for sound democratic governance to be sustained in East Asia:

"They need institutions that will increase the costs to individuals of engaging in corruption. They need watchdog agencies and multiple layers of accountability that allow agencies of government to scrutinize one another and that allow the electorate and civil society to monitor the officials of the state. The judicial system must be able

³⁶⁷ Hsiao and Hsiao, "The Challenges and Prospect of Taiwan's Democracy," 114.

to impose penalties without interference by money or influence. Citizens must be assured that public accounts will be subject to independent, systematic, and regular reviews. Legislators must have the tools to assess and design legislation. Voting procedures must be safeguarded by independent electoral commissions. Tax collection must be fair, predictable, and comprehensive, with proper legal processes and grievance procedures in place. The media must be credible, and independent and professional organizations must be able to ensure that their members derive their stature from the integrity with which they serve the public.”³⁶⁸

Diamond has also followed similar lines by suggesting:

“...sustainable democracy and development require active ‘civic communities,’ in which citizens trust one another and interact as political equals. In sustainable democracies, institutions of good governance --- such as impartial judicial systems and vigorous audit agencies --- induce, enforce, and reward civic behaviour. The tendency toward corrupt governance and the monopoly of power is checked by the rule of law (both culturally and institutionally) and a resourceful civil society.”³⁶⁹ ...

“...for democratic structures to endure --- and to be worthy of endurance --- they must listen to their citizens' voices, engage their participation, tolerate their protests, protect their freedoms, and respond to their needs.”³⁷⁰

In general, the basic principle behind this kind of proposal, as Diamond has pointed out, is to “restructure and empower the institutions of accountability and bolster the rule of law. Changing the way government works means changing the way politics

³⁶⁸ Root, “What democracy can do for East Asia,”125.

³⁶⁹ Diamond, “The Democratic Rollback: The Resurgence of the Predatory State,” 44.

³⁷⁰ Ibid, 39.

and society work, and that, in turn, requires sustained attention to how public officials utilize their offices.”³⁷¹ In this context, the proposal is linked to the view seeing democracy as an institution to promote growth and development. Through democratically organised public deliberation, development strategies and policy can be more in line with people’s well-being and capabilities.³⁷² Thus, as Rodrik has argued, it is helpful to think of participatory political institutions as meta-institutions that elicit and aggregate local knowledge and thereby help build better institutions, which in turn promote high-quality growth.³⁷³

While these general advices help us to get the right picture of reform directions and solid justification of reform agenda for the future, in a sense, they are too broad for application in Taiwan. To narrow the gap, we need to identify more specific problems of democratic challenges and ways to address them in the context of Taiwan. Fell has suggested that Taiwan need to undertake reform of the electoral system for the legislature and presidency to strengthen the legitimacy of Taiwan’s democracy. He also proposes the need for Taiwan to revive political consensus through cross-party negotiation and compromise as it did in the 1990s. Besides, he highlights the importance of a diversified and strong party system which can deliver viable

³⁷¹ Ibid, 46.

³⁷² Sen, *Development as Freedom*.

³⁷³ Rodrik, “Institutions for High-Quality Growth: What They Are and How to Acquire Them,” 14.

alternatives for the public, and the need to tackle political corruption and create a fair judicial system.³⁷⁴

Among so many crucial reforms needed ahead, in terms of priority, I would argue that the most critical issue is political reform. Diamond has made a point by arguing that “IT’S THE GOVERNMENT, STUPID.”³⁷⁵ “Without legal and political institutions to control corruption, punish cheating, and ensure a level economic and political playing field, pro-growth policies will be ineffective and their economic benefits will be overshadowed or erased.”³⁷⁶ Here I offer more details in this respect.

The first issue for political reform is about the operation of the central government including the executive and legislative branches. A capable and efficient central government is the strong base of the state capacity. Before the KMT returned to power in May 2008, the paralysis of the Legislative Yuan was too obvious to ignore. It had seriously undermined the function and effectiveness of the government by blocking key budgets and bills. Now the problem seems to be resolved as the KMT controls both the Legislative Yuan and the presidency. Still, further political reforms are still desperately needed. Among them, the most urgent issue is to make institutional designs to reduce the standoff between the executive branch and the legislative branch

³⁷⁴ Fell, “Taiwan’s democracy: Towards a Liberal Democracy or Authoritarianism,” 194-199. Also see similar suggestions at Rigger, “The Unfinished Business of Taiwan’s Democratization.”

³⁷⁵ Diamond, “The Democratic Rollback: The Resurgence of the Predatory State,” 41-42.

³⁷⁶ Ibid.

of the government. Even though now the possibility of the standoff has been significantly reduced under the KMT dominance in both branches, its resurgence is still very likely once the KMT loses its control of any one of them. Thus, the main point is to let the premier always need to get the backing of the majority in the Legislative Yuan. Currently, the president can appoint the premier without the approval of the Legislative Yuan, making divided government more likely.

Secondly, in responding to Fell's suggestion of electoral system reform, the new electoral rules for electing legislators have to be revised. According to the results from a recent general election in January 2008, the main opposition party DPP is seriously underrepresented in the Legislative Yuan. The DPP only won 27 seats out of the total 113. Namely, it occupies just 23.8 per cent of the all seats. But actually it got support from 41.8 per cent of votes from party lists and 36.1 per cent from districts. The disproportional nature of current system has not only obviously violated the basic principle of democracy (one vote one value) but also undermined the DPP's power in the Legislative Yuan. To improve, there is a need to increase the shares of seats from party lists.³⁷⁷ It is believed that this will strengthen the quality of approved bills as checks and balances are improved.

Furthermore, the mechanism of direct democracy like referendum has to be greatly

³⁷⁷ At present, only 34 seats out all the total 113 are from the party lists.

improved to deal with the most controversial issues that the Legislative Yuan is not able to resolve. As this will help to reduce the paralysis of the legislature, it will be also helpful in forging national consensus regarding controversial issues.

Fourth, a series of “sunshine bills” for clean politics and fair political competitions has to be revised or made.³⁷⁸ It is an attempt to minimize the damage brought by the so-called “black gold politics” to the function of the government, and restore the public’s confidence in the government.

Fifth, it is about the issue of “stop wealthy minorities from distorting public policy to serve their own ends.”³⁷⁹ My case study has shown how the business groups have affected the outcome of financial policies through their surging influence over politics during Taiwan’s democratic transition and consolidation. The power base of the wealthy comes from their financial support to politicians and political parties. As politicians and political parties need to raise enough money to win in regular elections, they are forced to appease the wealthy. “As a result, governments that once enjoyed unchallenged authority have become hostage to corporate elites....Aspiring leaders cannot get elected if they pledge to reform failed economic policies because the

³⁷⁸ Four bills aimed at enhancing clean governance have been added to Taiwan's legislation since the 1990s: the Public Functionary Assets Disclosure Act in 1993, the Legislators' Conduct Act in 1999, the Public Officials' Conflicts of Interest Prevention Act in 2000 and the Political Contribution Act in 2004. Currently, the two most important sunshine bills pending review in the Legislative Yuan are a draft bill to regulate political parties, and a draft lobbying law. See Tsai, “Ruling, opposition parties launch sunshine bills.”

³⁷⁹ Root, “What democracy can do for East Asia,” 118.

beneficiaries of those policies hold the purse strings.”³⁸⁰ Therefore, reforms regarding electoral financing are also crucial for sound democratic governance. If elections could be less costly and other sources of financing like public funds from the government are available, then the influence of the wealthy could be significantly reduced and checked and diverse and different voices could be easier to come out and be heard.

Six, political entrepreneurship is indispensable. As well argued by Ngo, agential capacity does not derive automatically and exclusively from organizational characteristics; political entrepreneurship is instrumental in the creation of effective agency.³⁸¹ The prospect of effective political reform, actually, also relies on the existence of political entrepreneurship. It is not just because “Political stars are needed to find new cross-cutting issues to campaign on where the main parties have failed” as Fell suggests.³⁸² It is also because strong leadership are needed to 1) get the right vision for reform, 2) actively integrate different reform opinions through negotiation and compromise, and 3) effectively carry out reform projects.

For all the proposals above to happen, to make a short conclusion, the presence of a strong civil society is fundamental. For political reforms only become likely when the

³⁸⁰ Ibid, 117.

³⁸¹ Ngo, “Governing Rapid Growth in Asia: State-led Development in Historical Perspective,” 9.

³⁸² Fell, “Taiwan’s democracy: Towards a Liberal Democracy or Authoritarianism,” 198.

general public is willing to express their opinions, organize citizens for change, and monitor their governments and politicians all the time. While a sense of pessimism over Taiwan's democracy is emerging in recent years, there are also increasing signs that Taiwan's civil society is engaging in the push for change and reform. The recent policy U-turn of the Ma administration on the issue of establishing a Petrochemical Park near the coastline in central Taiwan is a good example for reference. Through countless campaigns, protests and struggles, which are organized by local civil groups, university professors and college students and joined by many citizens, the civil society has significantly shaped the outcome of a controversial public policy. The late U.S. president John F. Kennedy used to say that "The Chinese use two brush strokes to write the word 'crisis.' One brush stroke stands for danger; the other for opportunity. In a crisis, be aware of the danger - but recognize the opportunity."³⁸³ From this perspective, a glimmer of hope for improving democratic governance in Taiwan is rising with the newly awakening civil society. However, sudden and massive changes are almost unlikely. In Huntington's words, "Political reform succeeds best if it occurs incrementally, in the spirit of 'one soul at a time'."³⁸⁴

³⁸³ John F. Kennedy was the 35th president of US from 1961 to 1963. This quotation is from his speech made in Indianapolis, April 12, 1959.

³⁸⁴ Huntington, "One soul at a time: political science and political reform," 3.

4. Towards a regulatory state?

Judging from the findings of the thesis, I contend that it is too early to make a conclusive judgement about either the status or outlook of the developmental state in Taiwan. On the one hand, I agree with the view that the developmental state in Taiwan has declined after demonstrating how it become less dominant and capable in overhauling the financial system and delivering effective financial governance. Nevertheless, on the other hand, there is no denying that somehow it has also made a big difference in effectively relieving the damage of financial turmoil and restoring financial stability, albeit at a high price.³⁸⁵ Therefore, in my view, it is better to see the developmental state in Taiwan as an unsettled entity. Notwithstanding those signs of decline, the state is also restructuring itself in a new political and economic environment. Its future will depend on how well the restructuring process will progress. If the strength of a developmental state, as the given literature have emphasized, lies in its ability to coordinate the cooperation between the public and private sector, the greatest challenge to the state in Taiwan is to recreate this ability within the context of a new political economy as just discussed in the previous section.

³⁸⁵ From 2001 to February 2008, the government spent NT\$ 20.6 billion from the public fund (the Financial Restructuring Fund) to bail out 55 financial institutions. If we take into consideration the loss of business tax revenue that the government used to encourage financial institutions to write off their bad loans, the taxpayers have paid more than NT\$ 60 billion to clean up the financial mess.

That being said, we need to pay more attention to some emerging signs regarding the prospect of the developmental state both in Taiwan and other East Asian countries.

Among them, one of the most salient signs regarding the role the state is the rise of independent government agencies. In terms of the focus of this study, government governance on the financial sector, a regional trend in East Asia to follow the example of UK Financial Services Authority (UKFSA) by establishing single and independent financial supervisory agencies is rising.³⁸⁶ For example, Japan's Financial Supervisory Agency was established in 1998 and later was restructured as Financial Services Agency (JFSA) in 2001 due to the reorganization of central government ministries. JFSA is an external organ of the Cabinet Office and assumes responsibility for inspection and supervision of private sector financial institutions and the surveillance of securities transactions as well as the disposition of failed financial institutions. During the same period of time, South Korea also established its Financial Supervisory Commission in 1998 and then the organisation was rearranged as Financial Services Commission (KFSC) under the current Lee administration. The KFSC is South Korean government's top financial regulator. It has taken over the policy-making authority from the Ministry of Finance with the duties similar to JFSA. Taiwan followed suit when its Financial Supervisory Commission (TFSC) was

³⁸⁶ See a concise report on this development in Asia at The Country Analysis Unit of the Federal Reserve Bank of San Francisco, "Regulatory Frameworks for Financial Services in Asia."

established in 2004. The goal of the TFSC is to promote integrated financial supervision, consolidate the supervision of banking, securities and insurance sectors, and to act as a single regulator for all of these industries.³⁸⁷

While each country has its unique background regarding the rise of its independent financial regulator, there are common features behind the trend. First, these new institutions were all established right after a series of severe banking failures and financial crises. Second, these countries all aim to strengthen their financial supervision through the integration of their formerly divided supervisory frameworks.

Third, these countries also want to enhance the competitiveness of their financial service industry through tightening and streamlining financial regulation and oversight. Overall, behind these common features, there is a profound message. It seems that these countries are all consciously following “the diffusion of independent regulatory agencies in Western Europe.”³⁸⁸ If this is the case, does this imply a transition of development regimes from developmental states to regulatory states in East Asia?

Let’s first look at the case in the West. The rise of the regulatory state or regulatory

³⁸⁷ See the introduction of the TFSC at its official website: http://www.fsc.gov.tw/Layout/main_en/AllInOne_Show.aspx?path=1871&guid=5da0af18-fb31-4ffb-8dfc-05c37d3d0d0e&lang=en-us (accessed June 30, 2011).

³⁸⁸ Gilardi, “The Institutional Foundations of Regulatory Capitalism: The Diffusion of Independent Regulatory Agencies in Western Europe.”

capitalism, according to Levi-Faur, is best captured by reference to 1) a new division of labour between state and society (e.g., privatization), 2) an increase in delegation, 3) proliferation of new technologies of regulation, 4) formalization of interinstitutional and intrainstitutional arrangements of regulation, and 5) growth in the influence of experts in general, and of international networks of experts in particular.³⁸⁹ He contends that “Regulation, though not necessarily directly by the state, seems to be on the increase despite efforts to redraw the boundaries between state and society.”³⁹⁰

Gilardi provides a further analysis on the surge of independent regulatory agencies in Europe by the end of the twentieth century. According to him, one of the main causes of the rise is “an attempt to improve credible commitment capacity when liberalizing and privatizing utilities and to alleviate the political uncertainty problem, namely, the risk to a government that its policies will be changed when it loses power.”³⁹¹

While similar rationale is showing behind the recent establishment of independent regulatory agencies in East Asia, I still see some differences. As Wada has found, behind policy diffusion of regulatory state, “each national government chooses the feature of regulatory organization independently from other nation’s decisions.”³⁹²

³⁸⁹ Levi-Faur, “The Global Diffusion of Regulatory Capitalism.”

³⁹⁰ Ibid.

³⁹¹ Gilardi, “The Institutional Foundations of Regulatory Capitalism: The Diffusion of Independent Regulatory Agencies in Western Europe,” 84.

³⁹² Wada, “The Globalization of the U.S.-Style Regulatory State and Domestic Institutional Diversity: A Comparative Study of the Financial Services Sector and the Communications Sector in Britain and Japan.”

For East Asian countries, their adoption of independent regulatory agencies, apart from the purpose of quality supervision and efficiency, is still mainly for boosting national competitiveness. In other words, independent regulatory agencies for them are means to better international competition advantage --- a mindset from the perspective of the developmental state. In short, the developmental state is still “very much an on-going entity” in East Asia. Lee and Han have a vivid observation about the case in South Korea:

“...although Korea, Inc. may have been vanquished for the most part, Korea's developmental state is very much an on-going entity. The transformation of Korea's developmental state has the appearance of inevitability, but such a notion would be misleading. In spite of all the changes in the past several years, by all measures and accounts, Korea remains far from the kind of open economy and liberal society seen in the West. Daily economic life in Korea (e.g. running a small business) continues to be heavily influenced by government policies, though to a much lesser degree than in the early days of development. The state still matters, a lot. More to the point, Korea's developmental state goes on because its goal remains the same: economic growth. And economic growth remains the single most important national objective because it is seen as a matter of survival, the best way to avoid all the crises it barely escaped time and again throughout its history. Rather than being an unavoidable consequence of a financial crisis, the transformation of the developmental state toward openness to foreign investment and participation was a *necessary* one.”³⁹³

Wade also observed similar situation in Taiwan:

³⁹³ Lee and Han, “The Demise of ‘Korea, Inc.’: Paradigm Shift in Korea's Developmental State,” 323.

“...the state in Taiwan continuing to act more as a developmental state than as an Anglo-American liberal market state. The state in Taiwan continues to exercise foresight about the future evolution of the economy and acts to pave the way; it takes a view about what industries are important for the economy's future growth, and has the legitimacy and the instruments to help shape the economy in line with this view.”³⁹⁴

Indeed, despite its recent decline of state capacity, Taiwan's President Ma Ying-jeou has launched his “i-Taiwan 12 Projects” --- an investment of NT\$3.99 trillion within eight years on twelve key public construction projects. His government believes that the gradual completion of these projects will not only significantly upgrade Taiwan's infrastructure, but also create enormous employment opportunities, provide a new force to drive economic development, and boost Taiwan's competitiveness.³⁹⁵ Also, President Ma took the initiative to sign a Memorandum of Understanding (MOU) on Cross-Straits Banking Supervision Cooperation with China and accomplished the objective in late 2009. With the MOU, Taiwan's banking industry now is allowed to open their branches in China and have joint adventures with local financial institutions there.

³⁹⁴ Wade, “INTRODUCTION TO THE 2003 PAPERBACK EDITION: CREATING CAPITALISMS,” xli.

³⁹⁵ The i-Taiwan 12 Projects include: 1) a Fast and Convenient Transportation Network; 2) Kaohsiung Port-City Reconstruction; 3) Central Region New High-tech Industrial Cluster Program; 4) the Taoyuan Aerotropolis; 5) Intelligent Taiwan; 6) Industrial Innovation Corridors; 7) Urban and Industrial Park Regeneration; 8) Farm Village Regeneration; 9) Coastal Regeneration; 10) Green Forestation; 11) Flood Prevention and Water Management; and 12) Sewer Construction. See the briefing of those projects at the official website of the Presidential Office of Taiwan: <http://english.president.gov.tw/Default.aspx?tabid=1150> (accessed June 25, 2011).

President Ma believes that Taiwan's financial institutions will make more profit and become more competitive through their business expansion in China. While the effects of these plans are still not clear now, what the state in Taiwan is doing now is definitely beyond the role as a pure regulator.

Hence, my assessment of the prospects of the developmental state in Taiwan and other East Asian countries in the foreseeable future is that it will have an outlook similar to a regulatory state while maintaining its essence as a governing regime which is continually dedicated to economic growth and national competitiveness and survival.³⁹⁶ The bottom line is: there is no sign of retreat of economic nationalism, the base and legitimacy of the developmental state, in Taiwan and other major countries in East Asia.³⁹⁷

5. Research in the future

Since the regional financial meltdown in 1997-98, Taiwan has received significant attention from those scholars who are concerned with the development and outlook of the East Asian model with the developmental state as its core. This dissertation is organized for a better understanding about what has happened to Taiwan's developmental state and its consequences over the past two decades by focusing on

³⁹⁶ As for a long-term prospect, as it involves a complicated and dynamic process in which many factors will affect its direction and outcome, I am restrained to make my assessment.

³⁹⁷ See how nationalism with its own economic imperatives has shaped the economic roles of the state in modern history at Levi-Faur, "Friedrich List and the Political Economy of the Nation-State."

the issue of financial reform and governance pursued and pushed by the Taiwan government. It is the first comprehensive study covering almost all the most important issues of banking reform in Taiwan over the last twenty years from the angle of a shifting political economy. Also, it is a significant complement to the current researches on financial reform and governance in Taiwan, in which they either tend to turn a blind eye to the political dimension or only focus on a single event. Overall, it has added more empirical research results into the debate on the prospects of the East Asian developmental states from the perspective of Taiwan's recent experience of financial reform and governance.

Still, for the research results of the dissertation to have more contributions and implications, the research in the future could be improved by the following three directions. The first is to look beyond financial governance. As economic governance involves broader consideration and more policies, to expand the scope of the research by covering diverse policy areas will make it more complete and convincing. Secondly, further comparative studies with other developmental states in East Asia will be needed. The goal will be to discover the common patterns and key factors in shaping the process of economic governance among the East Asian developmental states. It is expected that, by doing so, the whole debate on the future of East Asian developmental states could be more solid. Thirdly, the analytical framework will be

needed to expand to consider the impacts of external factors like globalisation, international rules and organisations, foreign powerful players. Also, the influence of ideology or other cognitive dimensions on policy choice is too important to ignore. Overall, with the expansion of analytical framework and special attention to the dynamic process among the interactions of key variables, the analysis will be more comprehensive. An inspiring case for reference is Dent's comparison study on foreign economic policies (FRP) of Taiwan, South Korea and Singapore.³⁹⁸ His focus on "network dynamics" with the consideration of various interactive functions that co-exist dynamically within wider "environment" and "development' contexts" is a breakthrough for the methodology on comparative political economy.

³⁹⁸ Dent, *The Foreign Economic Policies of Singapore, South Korea and Taiwan*. Also his paper "Transnational Capital, the State and Foreign Economic Policy: Singapore, South Korea and Taiwan."

Appendix A: List of Interview Cases

Serial Numbers	Names	Titles or professional backgrounds	Dates of Interviews
1	HUANG Tien-lin	National Policy Advisor to President Chen Shui-bian; Former Chairman of the First Commercial Bank.	July 2003
2	CHIEN Ming-ren	Chairman, First Financial Assets Management Co., Ltd.	July 2003
3	HUANG Cheng	Former Chairman of the Seventh Credit Co-operative of Taipei	July 2003
4	Johnson CHEN	President of Central Deposit Insurance Corp (CDIC)	November 2003
5	LIN Chin-lung	Director General of Department of Banking, Central Bank of the Republic of China (Taiwan)	November 2003
6	Joyce HUANG	Business reporter of Taipei Times	March 2004
7	CHEN Po-chih	Professor, Department of Economics, National Taiwan University; Former Chairperson of Council for Economic Planning and Development (CEPD)	July 2004
8	KO Chen-en	Professor, Department of Accounting, National Taiwan University; Member of Task Force on Financial Reform of the Executive Yuan	July 2004
9	CHANG Jung-feng	Vice President, Chung-Hua Institution for Economic Research (CIER); Former Deputy Secretary-General of National Security Council	July 2004
10	TU Wen-chang	Senior Vice President & General Manager, Credit Dept. Head Office, First Commercial Bank	July 2004

11	WANG Jiuun-chih	Executive Vice President, China Development Industrial Bank	July 2004
12	TSENG Chao-ming	Secretary, Office of the Chairperson, Council for Economic Planning and Development (CEPD)	August 2004
13	YANG, Ya-hwei	Research Fellow, Chung-Hua Institution for Economic Research (CIER)	August 2004
14	CHANG Chao-shun	Chairman, Bank of Overseas Chinese	August 2004
15	CHANG Jing-Sen	Vice Chairman, Council for Economic Planning and Development (CEPD)	September 2004
16	WANG Hsueh-hui	President, Pan Chiao Farmers' Association, Taipei County	November 2004
17	CHEN Kun-sung	President, Da-an Farmers' Association, Taichung County	November 2004
18	Stanley LIN	Deputy Director General, Bureau of Agricultural Finance, Council of Agriculture	November 2004
19	LAI Der-Liang	Former Deputy Director of Financial Supervision Bureau, Central Bank of the Republic of China (Taiwan)	November 2004
20	GUO Jiann-jong	Executive Officer, Taiwan Thinktank	November 2004
21	SUNG Chun-te	President, London Branch, First Commercial Bank	May 2005

Appendix B: Chronology of Key Political and Financial Events in Taiwan (1895-2008)

Year	Political Event	Financial event
1895 - 1945	<ul style="list-style-type: none"> ● According to Treaty of Shimonoseki, China cedes Taiwan to Japan in 1895. ● Japan maintains its colonial rule over Taiwan until 1945. 	Japan builds modern financial institutions in Taiwan and lays the major foundation for Taiwan's banking industry.
1945	<ul style="list-style-type: none"> ● Japan is defeated at the end of the Second World War. ● Taiwan reverts to the control of China, which is under the KMT government of General Chiang Kai-shek. 	<ul style="list-style-type: none"> ● Taiwan is dragged into the Chinese civil war between the CCP and the KMT from 1945-1949. ● Taiwan's economy breaks down fast and financial order is dismantled as a result.
1947	The "228 incident" breaks out as the KMT government launches a brutal crackdown on dissidents and protesters who rallied against government corruption and incompetence.	
1949	<ul style="list-style-type: none"> ● The CCP takes control of China and Chiang Kai-shek and his KMT flee to Taiwan with 1.5 million refugees. ● To claim to represent all China, the KMT regime transfers all the institutions of mainland China government to Taiwan, including the Legislative Yuan and National Assembly with representatives for all mainland China provinces. ● A decree imposing perpetual martial law is issued. Chiang's government imposes harsh restrictions on civil and political liberties, jailing or executing thousands of opponents and 	<ul style="list-style-type: none"> ● The KMT regime relocates the main state financial institutions to Taiwan. Coupled with those it took over from the Japanese colonial regime, these financial institutions become the backbone of Taiwan's financial industry. ● A state-dominant financial industry is formed.

	clamping down on the development of local culture and languages.	
1950	The outbreak of the Korean War makes U.S. government decide to block impending Chinese invasion of Taiwan.	● The substantial and lasting military and economic aid from the US stabilize Taiwan's economy and financial order.
1950-1970s	Taiwan as "Free China" joins the US in its effort to contain the expansion of communist influence in East Asia during the Cold War.	● Taiwan implements successful land and economic reform programs.
1971	With international favour shifting to Beijing, Taipei loses possession of China's seat in the UN.	
1975	Chiang Kai-shek dies.	
1978	Chiang Ching-kuo, son of Chiang Kai-shek, takes the presidency.	
1979	Opposition groups organise a protest rally in the southern city of Kaohsiung to mark International Human Rights Day. The rally is crushed by the KMT regime and several important opposition leaders are jailed. The event is the so called "Kaohsiung Incident" or "Formosa Incident."	
1980s	The continued one-party rule under the KMT regime draws growing criticism at home and abroad.	A series of financial scandals rock the KMT government. Among them, the Taipei Tenth Credit Cooperative Incident in 1985 is the most serious.
1986	In defiance of ban on new parties, the opposition forces formally establish their own party, the Democratic Progressive Party.	
1987	The KMT regime lifts martial law.	
1988	Chiang Ching-kuo dies and Lee Teng-hui assumes the presidency as the first native-born president.	
1989	Taiwan holds its first elections in which parties other than the KMT	● A significant revision of the banking law lifts the ban on entry

	are legally allowed to stand.	of new private commercial banks. ● Taiwan Provincial Assembly passes a resolution to block the privatisation of TPG-own banks.
1990		
1991	The surviving members of parliament representing provinces on mainland China are forced to retire, ending Taipei's claim to be the government of all China.	
1992	The first parliament whose MPs are fully elected by Taiwanese citizens is born.	15 new private banks open.
1994		Runs on banks surge since 1994.
1996	● The first popular presidential election is held. Lee Teng-hui becomes Taiwan's first democratically elected president. ● The National Development Conference takes place.	
1997		The Asian financial crisis breaks out
1998	Taiwan Provincial Government and its Assembly are dismantled.	● The key TPGA-controlled banks are privatised. ● A series of financial troubles emerge among listed companies and financial institutions. NPLs begin to pile up significantly in the banking sector.
2000	Chen Shui-bian of the DPP wins the presidential elections and the KMT loses power for the first time since 1945.	
2001	The KMT loses its parliamentary majority for the first time. But together with its allies, the pan-blue seats are still slightly more than the pan-green ones.	● The DPP government formally launches financial reform to deal with the looming banking crisis. The reform is called "258 financial reform," whose target is to lower non-performing loan ratios to below 5 per cent and raise capital adequacy rates to 8 per cent of

		<p>domestic banks within two years.</p> <ul style="list-style-type: none"> ● President Chen takes the initiative to summon the Economic Development Advisory Conference in seeking national consensus on economic and financial reforms.
2002		The DPP government fails its reform on rural credit unions.
2003		
2004	Chen Shui-bian wins a second term by a slender margin.	<p>“The second stage of financial reform” is launched. It aims to</p> <ul style="list-style-type: none"> - half the number of government-run banks to six by 2005 and the number of financial holding companies to seven by 2006, - increase the market shares of three domestic banks to above 10 percent, - encourage one financial institution to be taken over by a foreign counterpart or listed in overseas markets.
2005	Opposition KMT triumphs in municipal elections. The result is interpreted as a mid-term vote of no confidence in Chen Shui-bian.	
2006	Chen Shui-bian survives an attempt by parliament to force a referendum on his rule - the second in four months. His opponents and supporters take to the streets.	The DPP government announces abandoning the original reform timetable of the second stage of financial reform.
2007		
2008	Opposition KMT wins landslide victories in both parliamentary and presidential elections. Ma Ying-jeou is elected as president.	

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