Volume Title: Deregulation and Interdependence in the Asia-Pacific Region, NBER-EASE Volume 8

Volume Author/Editor: Takatoshi Ito and Anne O. Krueger, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-38674-0

Volume URL: http://www.nber.org/books/ito_00-1

Conference Date: June 19-21, 1997

Publication Date: January 2000

Chapter Title: The Reform of the Business Service Sector: The Case of Taiwanâ€™
Financial System

Chapter Author: Ching-hsi Chang

Chapter URL: http://www.nber.org/chapters/c8482

Chapter pages in book: (p. 227 - 254)

7

The Reform of the Business Service Sector
The Case of Taiwan's Financial System

Ching-hsi Chang

Reform of financial services has been one of the major development devices used in Asian newly industrializing countries (NICs) in the 1990s. Although the service sector has been recognized as a key to growth by many great economists, the sector is viewed with hostility by intellectuals and society in general. In Taiwan, the sector has long been discriminated against by industrial policy. The reform of the Taiwanese business service sector is treated as a key stimulus to the country's further economic development, but there are some structural dilemmas in the reform program. Using the financial system as an example, this paper illuminates the reform policies and the recent problems of the business service sector in Taiwan. Section 7.1 will briefly depict the significance of and the hostility to the business service sector. Section 7.2 reviews the financial system in Taiwan, followed by a brief account of the liberalization of the financial sector by the government in section 7.3. Section 7.4 compares financial development in Japan, Korea, and Taiwan. It is shown that a couple of Taiwan's structural problems have gone unnoticed. Section 7.5 addresses these problems. A final section provides some concluding remarks.

7.1 The Significance of and Hostility to the Business Service Sector

According to Adam Smith, economic development is driven by the division of labor and specialization, and the division of labor is limited by the extent of the market. To extend the market, money is used as a medium

Ching-hsi Chang is professor of economics at National Taiwan University.
The author is grateful to Kenneth Lin and Kelly Olds for their valuable suggestions, Hwang-Ruey Song and Ching-Chih Lu for their able assistance, and the National Science Council in Taiwan for its financial support.

of exchange to replace barter transactions (Smith [1776] 1976, chaps. 3 and 4).

Adam Smith is arguing that the market will be extended by decreasing transactions costs. In the reduction of transactions costs, using money as a medium of exchange is a revolution. The development and specialization of the business service sector is likewise vital. The business service sector concerned here primarily performs intermediation or *transaction services* and is closely related to what Wallis and North (1986) defined as the "transaction sector." The business service sector is important because gains from the division of labor and specialization are only realized through exchange. "The development of specialized banking, finance, trade, and other transaction functions are the necessary requirements of enhancing productivity" (Wallis and North 1986, 121). Economic growth is therefore closely tied to the reduction of exchange costs and the increase of the business service sector that permit the realization of gains from greater specialization and the division of labor.

Although the business service sector plays an important intermediating role in realizing gains of exchange, the hostility to the sector has long been widespread.

Chinese tradition discriminates against merchants, calling them the last of the four classes of people (intellectuals, farmers, artisans, and merchants). People are used to looking down on merchants, regarding commerce as a lowly occupation and using the terms "vile" and "mean" to describe it. This is not only prevalent in the East but also common in the West. Adam Smith stated that in the rude state of society, "to trade was disgraceful to a gentleman" (1976, 2:442). Throughout history, as F. A. Hayek cited William H. McNeill's statement, "merchants were objects of very general disdain and moral opprobrium . . . , a man who bought cheap and sold dear was fundamentally dishonest. . . . Merchant behaviour violated patterns of mutuality that prevailed within primary groupings." And Eric Hoffer once remarked, "The hostility, in particular of the scribe, towards the merchant is as old as recorded history" (Hayek 1988, 90).

In the advanced Western societies, such statements as "activities such as barter and exchange and more elaborate forms of trade, the organization or direction of activities, and shifting about of available goods for sale in accordance with profitability, are still not always even regarded as *real work*" (Hayek 1988, 92) may only be found in history. In Taiwan, the emphasis on industry at the expense of commerce is being revealed in industrial policy. The 1960 Act for Encouraging Investment and the subsequent 1992 Act for Upgrading Industry provide tax holidays, accelerated depreciation, and lower interest rates. Basically these acts apply only to the manufacturing sector, which is designated as "productive." Both acts preclude service industries from enjoying all benefits. It was not until 1995 that the construction industry was recognized as a "productive" industry and authorized to enjoy the privileges provided by the Act for Upgrading Industry. Electrical rates are set to discriminate against merchants. The manufacturing sector enjoys a one-third discount on the electricity bill paid by household, but service industries must pay one-third more. Until 1996, some cabinet members in Taiwan still publicly appealed to young people to not work for service companies such as McDonald's; they should instead work in "productive" factories.

7.2 The Financial System in Taiwan

The financial system in Taiwan has three significant features. The first is its "financial dualism." The dual financial system consists of a formal system and an informal system, or the curb markets (see table 7.1). The former includes all institutions and markets established according to financial laws or rules and subject to regulation by the financial authorities. The informal system is composed of all the markets not set up according to formal financial laws or rules. It engages in lending and borrowing activities without being under the direct regulation or supervision of the financial authorities, though it is tolerated by them.

The financial authorities regarding the formal system, with the exception of the credit associations and credit departments of farmer and fishery associations, are the Ministry of Finance (MOF) and the Central Bank of China. Prior to 1995, the Cooperative Bank of Taiwan was authorized by MOF and the central bank to be the auditing agency for credit cooperatives. The direct authorities over the credit departments of farmer and fishery associations are the Ministry of the Interior and the Council of Agriculture. Each of the three kinds of credit co-ops operates on a small scale in a fairly small geographic area. They were privileged substitutes for commercial banks when private banks were completely prohibited before 1990. The financial conditions of most co-ops are shaky. Many of them have had runs; a few have even suffered bankruptcy, especially after the liberalization of private banks. Some of them have been taken over by Cooperative Bank of Taiwan or merged into other institutions. There are still many frail credit co-ops that may fail in the near future.

Taiwan has had significant curb financial markets for a long time. After World War II, the Nationalist government expropriated all Japanese businesses, included organized financial institutions, to make up the state-owned enterprises that constituted more than 90 percent of medium-sized and large nonagricultural industries in the island at that time. Curb markets evolved from the traditional financial sector and were prohibited from becoming modern financial institutions. They grew along with the early development of the private nonagricultural sector, which overtook the public sector by the mid-1960s. In 1964–66, private businesses relied on curb markets for about half of the funds they needed, according to statis-

Table 7.1 Financial System in Taiwan

Formal Financial System	Informal Financial System
Financial institutions	Market-specific organizations
Monetary institutions	Installment credit companies
Central Bank of China (Taiwan)[p]	Leasing companies
(Full service) domestic banks	Investment companies
Commercial banks	Rotating credit co-ops
Specialized banks[p]	Credit unions
Foreign banks (local branches)	Other unorganized markets
Medium business banks	Types of transactions
Cooperatives	Secured borrowing and lending
Cooperative Bank of Taiwan[p]	Unsecured borrowing and lending
Credit cooperative associations	Loans against postdated checks
Credit departments of farmer associations[p]	Deposits with firms
Credit departments of fishery associations[p]	Mutual loans and savings
Other financial institutions	Financial installment credits
Postal Remittances and Savings[p]	Financial leasing
Investment and trust	Others
Investment and trust companies	Participants
Units of commercial banks	Moneylenders
China Development Corp.[k]	Pawnbrokers
Insurance companies	Others
Life insurance companies	
Property and casualty insurance companies	
Central Reinsurance Corp.[k]	
Financial markets	
Money market	
Bill financial companies	
Capital market	
Taiwan Stock Exchange Corp.[k]	
Fuh-Hwa Securities Finance[k]	
Securities dealers	
Brokers	
Traders	
Offshore banking centers	
Units of domestic banks	
Units of foreign banks	
Foreign exchange market	
Foreign currency call-loan market	

[p] Publicly controlled.
[k] KMT controlled.

tics gathered by the central bank (see fig. 7.1). Since then, the curb market ratio fluctuated around 35 percent through 1990 and dropped to below 25 percent after the new banks commenced operations in the early 1990s. The average interest rate of loans in the curb markets is about two and half times that in commercial banks, as shown in figure 7.2.

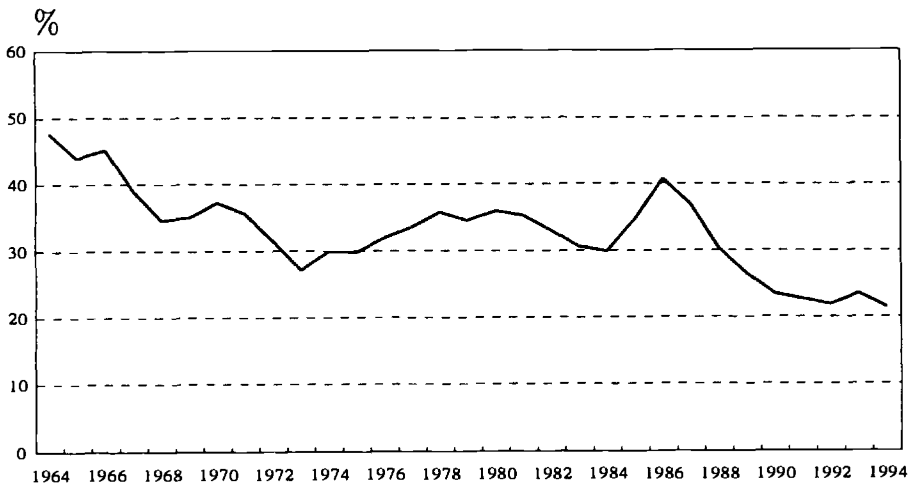

Fig. 7.1 Share of curb market in private sector
Source: Central Bank of China, Economic Research Department, *Flow of Funds in Taiwan District, Republic of China* (Taipei, 1995).

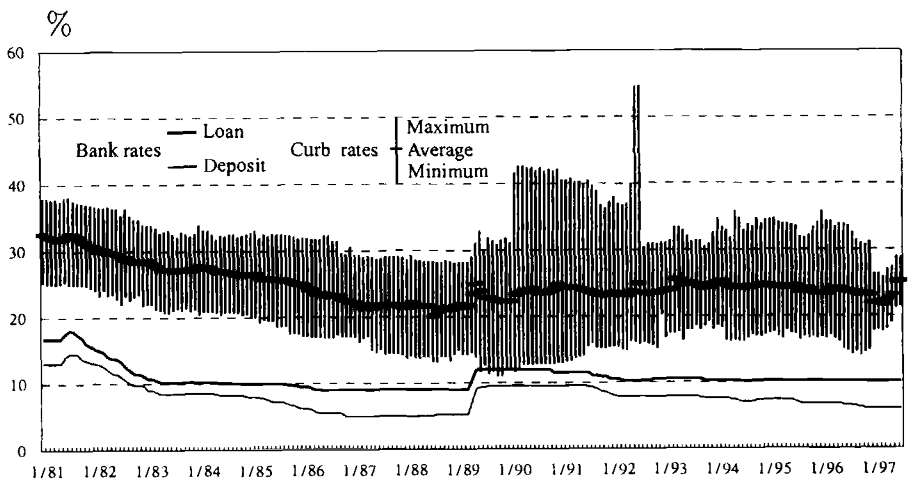

Fig. 7.2 Interest rates
Source: Central Bank of China, *Financial Statistics Monthly* (various issues).
Note: The bank loan rate is the maximum interest rate on short-term unsecured loans; the bank deposit rate is the interest rate on one-year time savings deposits. The curb rate is the interest rate on unorganized, unsecured loans in Taipei.

The curb markets themselves improved the efficiency of the financial system's operation and credit allocation. Shea and Kuo (1984) use 1965–82 data to estimate the contribution and costs of the informal system. They find that efficiency improvements by curb markets increased GDP by 1.23 percent on average during the period. At the same time, compared to the "most" efficient resource allocation under financial dualism, only 0.11 percent of GDP was lost. Shea (1994, 272) himself admits that the assumptions used for the estimation overstated the actual efficiency contribution. Besides, these estimates were done under prohibition of private banks and financial repression. Compared to a competitive market, there are two major costs of financial repression and dualism: inefficiencies and inequities.

The first effect is allocative inefficiency of funds. According to Shea's studies (see Patrick 1994), Taiwan's financial deepening was a cause of its rapid real economic growth (326), which was propelled by small business (358). However, despite rhetoric about helping small business, the relationship between the government and small business was especially negative (363). The focus of government credit programs was big enterprises and big projects (355). Small business was excluded from the organized market and had to bear the burden of substantially higher interest costs in the curb markets. Moreover, these static costs are surely smaller than the dynamic consequences of inefficient investment allocation.

The second effect is increasing inequality of income and wealth. Repression created economic rents. The huge rents created static distribution effects and dynamic development effects. The power to allocate credit on preferential terms creates potential for abuse, corruption, and other political economy problems. As Patrick observes "In Korea and Taiwan, . . . occasional scandals and anecdotal evidence . . . suggest . . . a considerable portion appears to have gone to support the state apparatus—the political parties and leadership in what were after all, rather authoritarian regimes"(1994, 337–38). Dynamically, rent-seeking activities exhibit very natural increasing returns, and rent seeking, particularly public rent seeking by government officials, is likely to hurt innovative activities more than everyday production (Murphy, Shleifer, and Vishny 1993). Further, because consumer loans, except housing loans which could be sought from formal institutions using the real estate as collateral, had to rely on the curb markets, there were further inefficiencies and inequities in the form of less improvements in welfare—less consumption—than in measured GNP performance (Patrick 1994, 367–68). These kinds of consumer loans were completely ignored in the central bank's statistics on curb markets, which are shown in figure 7.1.

The other two features characterizing the Taiwanese financial system are intertwined. The first of these features is the absolute majority of publicly owned institutions in the formal system. In fact, the financial dualism was due to the exclusive publicly owned banks in the formal financial system coupled with the fact that the government has turned a blind eye to the informal markets. Before 1990, there were only three private banks in the formal system, all of which were licensed to overseas Chinese. The second of these features is the many KMT-owned (or at least controlled) financial institutions. KMT is the abbreviation for the Kuomintang, the ruling party of Taiwan since the end of World War II.

Table 7.2 shows the number of Taiwanese formal financial institutions and branches between 1961 and 1995. Before the liberalization brought about the new Bank Law of 1989, which took effect after 1992, there were virtually no structural changes in the formal system, except the establishment of investment and bill companies, and the intrusion of KMT institutions. Table 7.3 shows the total assets of formal financial institutions in 1990 and 1995, reflecting their relative importance. In these two tables, the financial institutions are classified into three groups, namely, publicly controlled, KMT controlled, and privately controlled institutions. KMT-controlled institutions are isolated from the other groups because, on the one hand, the KMT is the ruling party, having possessed exclusive political power for fifty years in Taiwan, so that there is almost no difference between the KMT party and the Nationalist government, while on the other hand, the institutions controlled by the KMT are different from publicly controlled institutions in terms of their legal status.

The structure and development of the Taiwanese financial system, both formal and informal systems, has been well depicted by Shea (1994) and Yang (1994), except the misleading picture presented of KMT- and state-controlled enterprises and privatization, to be discussed below. Over time the share of publicly controlled financial institutions has been decreasing and those of the other two groups increasing. In 1995, the government controlled 67 percent of all kinds of formal financial institutions in number as well as in assets, the ruling party (KMT) held 3 percent in number and nearly 5 percent in assets and the private sector possessed 30 percent in number and 28 percent in assets.[1] In the financial service sector, the KMT operates almost all types of formal financial institutions, many of which are monopolies or oligopolies authorized by itself (the ruling party). Several informal financial institutions are also owned by the KMT, as shown in table 7.4 (see also Bruton 1993; Baum 1994). All these KMT financial businesses, and numerous other businesses, are under the control of its seven holding companies or investment companies like the China Development Corporation. The Central Investment Holding Company, one of the biggest holding companies in Taiwan, was listed in a political encyclopedia as the only example of a political party's receiving its funds through an enterprise (Delury 1987, 1077).

Government interventions in the financial sector can be classified into

1. Stock securities, including Taiwan Stock Exchange Corporation, which is controlled by the KMT, are not included in table 7.3.

Table 7.2 **Number of Formal Financial Institutions in Taiwan**

	1961				1970				1980				1990				1995			
Type and Control[a]	Co.	Bra.	Units	Ratio	Co.	Bra.	Units	Ratio	Co.	Bra.	Units	Ratio	Co.	Bra.	Units	Ratio	Co.	Bra.	Units	Ratio
Domestic banks																				
Public	9	247	256	1.00	11	365	376	0.98	12	505	517	0.98	13	678	691	0.94	13	929	942	0.68
KMT									1	1	2	0.00	1	16	17	0.02	3	91	94	0.07
Private	1	0	1	0.00	2	6	8	0.02	2	9	11	0.02	2	27	29	0.04	18	341	359	0.26
Sum	10	247	257	1.00	13	371	384	1.00	15	515	530	1.00	16	721	737	1.00	34	1,361	1,395	1.00
Local branches of foreign banks																				
Public																				
KMT																				
Private			1	1.00			7	1.00			21	1.00			43	1.00			58	1.00
Sum			1	1.00			7	1.00			21	1.00			43	1.00			58	1.00
Medium business banks																				
Public	1	41	42	0.50	1	46	47	0.41	1	71	72	0.42	1	91	92	0.33	1	110	111	0.24
KMT																	1	52	53	0.12
Private	7	35	42	0.50	7	61	68	0.59	7	91	98	0.58	7	184	191	0.67	6	284	290	0.64
Sum	8	76	84	1.00	8	107	115	1.00	8	162	170	1.00	8	275	283	1.00	8	446	454	1.00
Credit cooperative associations																				
Public																				
KMT																				
Private	80	73	153	1.00	83	139	222	1.00	75	199	274	1.00	74	399	473	1.00	73	556	629	1.00
Sum	80	73	153	1.00	83	139	222	1.00	75	199	274	1.00	74	399	473	1.00	73	556	629	1.00

Credit departments of farmer and fishery associations																				
Public	291	94	385	1.00	295	98	393	1.00	283	441	724	1.00	309	744	1,053	1.00	312	930	1,242	1.00
KMT																				
Private																				
Sum	291	94	385	1.00	295	98	393	1.00	283	441	724	1.00	309	744	1,053	1.00	312	930	1,242	1.00
Investment and trust companies																				
Public	1	0	1	1.00	1	0	1	1.00	1	0	1	0.04	1	6	7	0.13	1	9	10	0.19
KMT									2	1	3	0.12	2	6	8	0.15	1	2	3	0.06
Private									5	17	22	0.85	5	34	39	0.72	3	38	41	0.76
Sum	1	0	1	1.00	1	0	1	1.00	8	18	26	1.00	8	46	54	1.00	5	49	54	1.00
Postal savings system																				
Public	1	450	451	1.00	1	609	610	1.00	1	951	952	1.00	1	1,201	1,202	1.00	1	1,268	1,269	1.00
KMT																				
Private																				
Sum	1	450	451	1.00	1	609	610	1.00	1	951	952	1.00	1	1,201	1,202	1.00	1	1,268	1,269	1.00
Life insurance companies																				
Public	3	5	8	1.00	3	6	9	0.26	3	6	9	0.15	3	6	9	0.12	3	6	9	0.08
KMT																	1	0	1	0.01
Private					6	20	26	0.74	6	46	52	0.85	12	55	67	0.88	27	77	104	0.91
Sum	3	5	8	1.00	9	26	35	1.00	9	52	61	1.00	15	61	76	1.00	31	83	114	1.00
Property insurance companies																				
Public	2	7	9	0.50	2	10	12	0.29	2	12	14	0.20	3	14	17	0.17	3	16	19	0.16
KMT					1	0	1	0.02	1	1	2	0.03	1	4	5	0.05	1	5	6	0.05
Private	6	3	9	0.50	11	17	28	0.68	11	43	54	0.77	16	60	76	0.78	19	78	97	0.80
Sum	8	10	18	1.00	14	27	41	1.00	14	56	70	1.00	20	78	98	1.00	23	99	122	1.00

(*continued*)

Table 7.2 (continued)

Type and Control[a]	1961 Co.	Bra.	Units	Ratio	1970 Co.	Bra.	Units	Ratio	1980 Co.	Bra.	Units	Ratio	1990 Co.	Bra.	Units	Ratio	1995 Co.	Bra.	Units	Ratio
Bill and securities finance companies																				
Public									2	2	4	0.50	2	11	13	0.62	2	15	17	0.37
KMT									2	2	4	0.50	2	6	8	0.38	2	8	10	0.22
Private																	10	9	19	0.41
Sum									4	4	8	1.00	4	17	21	1.00	14	32	46	1.00
Total																				
Public	308	844	1,152	0.85	314	1,134	1,448	0.80	305	1,988	2,293	0.81	333	2,751	3,084	0.76	336	3,283	3,619	0.67
KMT					1		1	0.00	6	5	11	0.00	6	32	38	0.01	9	158	167	0.03
Private	94	112	206	0.15	109	250	359	0.20	106	426	532	0.19	116	802	918	0.23	156	1,441	1,597	0.30
Sum	402	956	1,358	1.00	424	1,384	1,808	1.00	417	2,419	2,836	1.00	455	3,585	4,040	1.00	501	4,882	5,383	1.00

Sources: Central Bank of China, *List of Financial Institutions* (Taipei, 1996), and Central Bank of China, *Financial Statistics Monthly* (various issues).

Note: Co. = number of companies; Bra. = number of branches.

[a]"Public" means publicly controlled financial institutions, which include, in addition to undisputed ones, International Commercial Bank of China, Taiwan Business Bank, Directorate General of Post Remittances and Savings Bank, credit departments of farmer and fishery associations, Taiwan Development and Trust Co., China Bills Finance Co., International Bills Finance Co., Taiwan Fire and Marine Insurance Co., Chung Kuo Insurance Co., and Taiwan Life Insurance Co. "KMT" means KMT-controlled institutions, which include Sinopad Commercial Bank, United World Chinese Commercial Bank, Chinatrust Commercial Bank, Kaohsiung Business Bank (after 1995), China Development Corp., China United Trust and Investment Co. (before 1994), Chung Hsing Bills Finance Co., Fuh-Hwa Securities Finance Co., Central Insurance Co., and Shin Fu Life Insurance Co.

Table 7.3 **Total Assets of Financial Institutions in Taiwan (million NT dollars)**

	1990				1995			
Type	Public	KMT	Private	Total	Public	KMT	Private	Total
Central bank	2,646,854			2,646,854	3,100,536			3,100,536
	(1.000)			(1.000)	(1.000)			(1.000)
	[0.272]			[0.210]	[0.197]			[0.132]
Domestic banks	6,323,824	220,991	472,398	7,017,213	10,921,453	934,287	2,709,153	14,564,893
	(0.901)	(0.032)	(0.067)	(1.000)	(0.750)	(0.039)	(0.211)	(1.000)
	[0.649]	[0.643]	[0.190]	[0.558]	[0.693]	[0.848]	[0.411]	[0.621]
Local branches of foreign banks			313,645	313,645			603,101	603,101
			(1.000)	(1.000)			(1.000)	(1.000)
			[0.126]	[0.025]			[0.092]	[0.026]
Credit cooperatives			879,120	879,120			1,764,234	1,764,234
			(1.000)	(1.000)			(1.000)	(1.000)
			[0.353]	[0.070]			[0.268]	[0.075]
Credit departments of farmer associations	632,079			632,079	1,359,532			1,359,532
	(1.000)			(1.000)	(1.000)			(1.000)
	[0.065]			[0.050]	[0.086]			[0.058]
Credit departments of fishery associations	11,075			11,075	28,056			28,056
	(1.000)			(1.000)	(1.000)			(1.000)
	[0.001]			[0.001]	[0.002]			[0.001]
Investment and trust companies	24,514	62,172	383,651	470,337	57,361	52,702	282,353	392,416
	(0.052)	(0.132)	(0.816)	(1.000)	(0.146)	(0.134)	(0.720)	(1.000)
	[0.003]	[0.181]	[0.154]	[0.037]	[0.004]	[0.048]	[0.043]	[0.017]
Bill finance companies	19,024	16,010		35,034	37,812	23,167	28,827	89,806
	(0.543)	(0.457)		(1.000)	(0.421)	(0.258)	(0.321)	(1.000)
	[0.002]	[0.047]		[0.003]	[0.002]	[0.021]	[0.004]	[0.004]

(*continued*)

Table 7.3 (continued)

	1990				1995			
Type	Public	KMT	Private	Total	Public	KMT	Private	Total
Securities finance companies		42,349		42,349		83,686	25,369	109,055
		(1.000)		(1.000)		(0.767)	(0.233)	(1.000)
		[0.123]		[0.003]		[0.076]	[0.004]	[0.005]
Property and casualty insurance companies	9,607	2,433	39,585	51,625	20,560	5,239	94,204	120,003
	(0.186)	(0.047)	(0.767)	(1.000)	(0.171)	(0.044)	(0.785)	(1.000)
	[0.001]	[0.007]	[0.016]	[0.004]	[0.001]	[0.005]	[0.014]	[0.005]
Life insurance companies	65,912		403,043	468,955	212,897	2,169	1,076,499	1,291,565
	(0.141)		(0.859)	(1.000)	(0.165)	(0.002)	(0.833)	(1.000)
	[0.007]		[0.162]	[0.037]	[0.014]	[0.002]	[0.164]	[0.055]
Central reinsurance company	3,373			3,373	6,542			6,542
	(1.000)			(1.000)	(1.000)			(1.000)
	[0.000]			[0.000]	[0.000]			[0.000]
Property and casualty insurance cooperatives	343			343	297			297
	(1.000)			(1.000)	(1.000)			(1.000)
	[0.000]			[0.000]	[0.000]			[0.000]
Central deposit insurance company	2,343			2,343	8,009			8,009
	(1.000)			(1.000)	(1.000)			(1.000)
	[0.000]			[0.000]	[0.000]			[0.000]
Total	9,738,948	343,955	2,491,442	12,574,345	15,753,055	1,101,250	6,583,740	23,438,045
	(0.775)	(0.027)	(0.198)	(1.000)	(0.672)	(0.047)	(0.281)	(1.000)
	[1.000]	[1.000]	[1.000]	[1.000]	[1.000]	[1.000]	[1.000]	[1.000]

Sources: Central Bank of China, *Statistics of Important Business of Financial Institutions* (Taipei, 1990, 1995), Central Bank of China, *Financial Statistics Monthly* (March 1997).

Note: Medium business banks and postal savings systems are included in domestic banks; the other categories are the same as in table 7.2. Numbers in parentheses are horizontal percentages. Numbers in brackets are vertical percentages.

Table 7.4 Kuomintang-Controlled Financial Businesses, 1997

Holding Companies	Formal Financial System
Central Investment Holding Co.	*Financial institutions*
Founded 1971, investing 70 companies	Commercial banks
1995 Assets: NT$40.8 billion; profits $4.4 billion	Sinopad Commercial Bank
	Chinatrust Commercial Bank
Hua Hsia Investment Holding Co.	United World Chinese Commercial Bank
Founded 1975 (unofficially, 1991 officially)	Medium business banks
1995 Assets: $7 billion; profits: $680 million	Kaohsiung Business Bank
Kuang Hwa Investment Holding Co.	Investment and trust
Founded 1979, investing 51 companies	China Development Corp.
1995 Equity: $15.1 billion; profits: $1.7 billion	Life insurance companies
Asia Pacific Holding Co.	Shin Fu Life Insurance Co.
Founded 1991, overseas investment	Property and casualty insurance companies
Chii Sheng Industrial Co.	Central Insurance Co.
Founded 1988, oversees 17 companies	*Money market*
1994 Profits: $105 million	Chung Hsing Bills Finance Co.
Jen Hwa Investment Holding Co.	*Capital Market*
Oversees Grand Cathay Securities	Taiwan Stock Exchange Corp.
King-Dom Investment Holding Co.	Fuh-Hwa Securities Finance
Oversees insurance investments	Securities dealers and traders
	China Trust Investment Co.
	Grand Cathay Securities Co.
	International Investment Trust Co.
	Informal Financial System
	Leasing companies
	Central Leasing Co.
	Investment companies
	Central Link Investment Consulting Co.
	China Investment and Development Co.
	Global Investment Holding Co.
	Grand Cathay Venture Capital Co.
	International Venture Capital Investment Corp.
	Tai Shin Venture Capital Co.
	Universal Venture Capital Investment Corp.

Source: Laurie Underwood, "How Big is Big?" *Topics* 27, no. 4 (May 1997): 29–32.

two types, preventive interventions and positive interventions. Preventive interventions are those measures meant to keep the system transparent and to prevent bankruptcy. These measures include reserve requirements, equity ratios, deposit rates, deposit insurance, auditing and disclosure of information, and measures against insider trading. Positive interventions consist of limitations on new financial institutions and products, regulated prices of financial services, and strategic financial policies. In Taiwan, positive measures in the past included strict entry restrictions on private banks, limits on new branches, government ownership of financial institutions, interest rate controls, restrictions on foreign banks, authorization of bank products, and preferential policies for exports, for small and medium-size businesses, and for strategic industries (based on high linkage effects, promising market potential, high tech, high value added, low energy consumption, and low pollution). The strategic financial policies have let the Development Fund of the Executive Yuan create some investment funds and development corporations.

For preventive banking regulation, according to Baltensperger and Dermine (1987), there are three motives: bank safety and overall financial stability, monetary control, and prevention of monopoly activity and concentration. It is widely recognized in Taiwan that the most success has been achieved in terms of monetary control and price stability. There has been total failure in terms of making the system more transparent and preventing monopoly, concentration, and insider manipulation. Results have been somewhat in between in terms of financial safety and stability (see Shea 1994, Yang 1994, 1997; Patrick 1994). The positive interventions have often been criticized as being inefficient and hampering past growth. Specifically, for example, most small and medium-size firms could not obtain funds from the formal financial system or take advantage of the strategic preferential policies, except for export credits. They have had to pursue underground capital bearing a much higher interest rate (see Shea 1994, 233; and fig. 7.2). In general, much of the financial inefficiency and underdevelopment were blamed on the high degree of government intervention in interest rate determination, as well as in financial intermediation, market structure, and banking operations (Shea 1994, 222).

7.3 The Liberalization of Financial Policy

Financial reform in Taiwan is a long and accelerating process. Since the financial system was heavily regulated and broadly criticized as a backward sector damaging the whole economy, the financial deregulation has been under way for a long time. The financial reform embraces liberalization, privatization, and internationalization. Financial liberalization includes interest rate decontrol, market entry deregulation, and so forth. Privatization of government banks has been discussed and the authorities decided to reduce the government's equity in the three biggest commercial banks (First, Hua-Nan, and Chang-Hua) to below 50 percent by offering part of the stock in the market. This policy is controversial because the government will still wholly control the banks by holding some 40 percent of stock. Nevertheless, nothing was done until the end of 1997. While internationalization may not be segregated from liberalization, the government is mainly concerned with policies related to the development of Taiwan into an Asia-Pacific financial center.

The financial liberalization has been going ahead since the mid-1970s and was speeded up in the late 1980s. The major deregulations can be summarized as follows.

1. *Branches:* The regulations governing branching by existing banks were relaxed in 1984, allowing each qualified bank to set up three full-service branches and three limited-service agencies per year, as compared with two of each previously.

2. *Interest rates:* Decontrol has proceeded in several steps since 1975. The fixed and uniform rates (in formal financial markets) were gradually relaxed and were completely floated after 1989 when the new Bank Law was promulgated. However, since most of the major banks are still government controlled, competition is less than complete.

3. *Bank activities:* The 1989 Bank Law granted MOF the power to authorize new financial products. For example, bill transactions formerly conducted only by bill finance companies were opened to some private banks in 1992.

4. *Private banks:* The 1989 Bank Law liberalized regulations concerning the establishment of new private banks. Fifteen new private banks, each with a minimum equity of NT$10 billion required by the law, were granted charters in 1991. By May 1997, nineteen new private banks were established and operating, creating better service attitudes, even in public banks, and more competition in the whole banking industry.

5. *Foreign exchange:* The central bank introduced a floating system in 1978 but still continuously intervened up until the mid-1980s, which resulted in an undervaluation of the NT dollar, huge trade surpluses, short-term speculative capital inflows, and a boosted money supply. In 1987, the authorities phased out most of the controls and liberalized long-term exchange rates, and by 1990 liberalized short-term exchange rates.

6. *Foreign banks:* Before liberalizing private banks owned and operated by Taiwanese, foreign banks were allowed to set up local branches in Taiwan. But only one branch would be approved for each foreign bank before 1986 in Taipei. This was gradually relaxed, and by 1994 there were no more restrictions on the number of branches if the transmitted capital from their head offices is over NT$150 million for the first branch and over NT$1.2 million for each additional branch. Banks were also authorized to open branches in Kaohsiung and Taichung in 1985 and 1990, respectively.

By far the most ambitious reform of Taiwan's financial institutions has been the plan for developing Taiwan into an Asia-Pacific Regional Operations Center (CEPD 1995). The core of the plan is the designation of six specific operation centers—a manufacturing center, sea transportation center, air transportation center, financial center, telecommunications center, and media center. According to CEPD, developing Taiwan as a financial center means "establishing it as a base from which domestic and foreign financial institutions may provide transnational financial services for the East Asian region" (1995, 22–30). In the short term, the plan emphasizes the development of offshore financial markets, a derivative market, a gold market, bond and securities markets, the stock market, and the insurance market. For example, offshore financial markets include the establishment of a regional fund-raising center, foreign exchange market, offshore banking market, and foreign currency call-loan market.

"Concrete measures," as stated in CEPD, are to relax restrictions on inward and outward capital transfers, on foreign banks, on the operations of financing companies, and on "cross-(Taiwan)Strait" regulation, to enact reasonable taxation of financial transactions, to speed up the privatization of state-owned banks, which includes enacting the Law Governing the Administration of State-Owned Financial Institutions and reviewing the classification and separation of banking activities. Other complementary policies are the training of financial personnel and the establishment of infrastructure such as building an international financial complex and improving the quality of telecommunications facilities.

In fact, the idea of a regional financial center began in 1982 when the Executive Yuan approved the Project of Uplifting Taiwan's Position in East Asia. In accordance with the project, the Offshore Banking Center was set up in 1984, but only the International Commercial Bank of China (Taiwan) established an offshore banking unit. The internationalization process was very slow before 1987 when exchange controls were relaxed. The important measures adopted by the end of 1990 consisted of capital flow deregulation; access to the domestic financial market, for example, liberalizing branching and activities of foreign banks, creating an offshore banking center, and setting up financial institutions abroad for which the restrictions limiting overseas branches by domestic banks were lifted in 1988 by MOF; and establishment of the Taipei Foreign Currency Call Loan Market. However, if the system of government ownership is not changed, the prospects for the regional financial center plan can hardly be optimistic.

7.4 Comparisons of the Financial Development of Japan, Korea, and Taiwan

One way to understand the Taiwanese financial system, its reform and problems, is to compare them with those of Japan and Korea. The three countries share common economic and institutional circumstances and patterns of development, but they also have certain significant differences.[2]

As for major similarities, commercial banks have been the core of all three financial systems, and capital markets were developed later and are

2. This section draws heavily from Patrick and Park (1994).

relatively unimportant. The systems have been characterized by separation between the formal and informal sectors and between commercial and investment banking, and within banking by segmentation by borrower and function (e.g., see table 7.1). All three countries pursued export-oriented development strategies while concurrently protecting most of their domestic production from imports to support their preeminent objective of rapid growth. To achieve macroeconomic goals, the financial authorities have used their control of the financial system to channel funds to investment in priority sectors through, for example, central bank rediscount of export trade bills at low interest rates. The three economies all lack reliable accounting and auditing systems and also lack publicly available information on company performance, prospects, and hence creditworthiness. Banks have therefore found it cheaper and safer to require collateral, usually specific real assets, against loans rather than rely on the business performance of borrowers. Accordingly, banks are criticized for "pawnshop" banking. Supervision by the financial authorities has not been transparent. Consequently, these countries have been denounced as "insider societies"—societies taking the existence and utilization of insider information for granted, making few efforts to prevent insider trade, and enforcing few penalties for misuse (Patrick 1994, 338, 353).

Before deregulation began seriously in Japan in the 1970s and in Korea and Taiwan in the 1980s, the financial authorities held interest rates at below-market levels, restricted entry of new financial institutions and creation of new financial instruments, segmented financial markets, and insulated domestic finance from world financial markets. The most important domestic regulations were government-established or sanctioned ceilings for interest rates on deposits, loans, and new bond issues—so-called financial repression. Korea has been the most repressed of the three, Taiwan next, and Japan the least (see table 7.5). Because of the degree and the implementation of the financial repression, the financial system and the indirect intervention by the government have developed differently. Thus the consequences of financial repression were different in the three countries.

In Japan, lending institutions evaded interest rate ceilings by requiring compensating balances or loan-related fee income, so that effective interest rates for the borrower were raised closer to the market level, and the possibilities of inefficient credit allocation and rent-seeking activities by the real sector were reduced accordingly. However, rents accrued to the banks in the form of higher profits, higher wages, less efficient management, and perhaps less risk taking in loan portfolios than would otherwise have been the case (Patrick 1994, 337). In Korea and Taiwan, recipients of rationed credit are major financial supporters of the political apparatus in power. In Korea, with the biggest interest rate gap among the three countries between bank and curb market loans, rationed credit was re-

Table 7.5 Indicators of Relative Financial Liberalization of Japan, Korea, and Taiwan

Indicator	Japan 1965	Japan 1990	Korea 1965	Korea 1990	Taiwan 1965	Taiwan 1990
FIR[a]	3.62	6.62	0.89	4.55	1.61	4.95
Overall level						
Domestic	Low	High	Low	Medium	Low	High
International	Low	High	Low	Low	Low	Medium
Government involvement						
Ownership of banks	Low	Low	High	Low	High	Medium
Credit allocation	Medium	Low	High	High	High	Medium
Interest rate controls	High	Low	High	High	High	Low
Possibility of new bank entry	None	None	None	Low	None	High

Source: Patrick (1994, 342).
[a]FIR stands for financial intermediation ratio (ratio of financial assets to GNP).

ceived by big private business groups. The government not only forced the banks to make huge numbers of policy loans to selected firms in designated industries, but foreign funds were also borrowed by the government and relent to those big business groups at interest rates substantially below market rates (Patrick 1994, 330, 335, 349, 351). In Taiwan, state enterprises, which operate in major basic industries as well as public utilities, communications, and transportation, were granted a large share of rationed credit. The rest went to KMT enterprises, for obvious political reasons, well-managed big private enterprises, because of the conservative nature of state-owned commercial banks where severe penalties were readily imposed on bank officials for defaulted loans, and export credits, due to the government's industrial policy.

Korea had a fundamental problem in the real sector because those big private business groups granted substantial profit margins and government subsidies were generally producing "bleeding exports." Japan's financial institutions retained huge profits that inevitably invited all kind of scandals and fraudulent activities contrary to the interest of shareholders. In Taiwan, the profit margins on low-interest loans were partly engulfed by the inefficiency of public enterprises and KMT enterprises and partly embezzled by KMT enterprises and big private enterprises. Obviously the ruling party enjoyed both economic and political gains at the cost of inefficiencies and inequities in the use of financial capital.

Deregulation and liberalization of financial markets and institutions in all three countries has been a conscious, gradual, piecemeal process. Policymakers decided to liberalize financial markets in response to changing circumstances—domestic market forces, changing political constituencies and their concerns, and globalization. Previous forms of repression have become less effective because the economies are now more mature, the curb markets undermined the regulated market, and current account surpluses created domestic liquidity and affected market interest rates. Moreover, foreign pressures have compelled the economies to open their domestic markets to international competition. The authorities have issued timetables to abolish credit and interest rate ceilings, relax entry and financial instrument barriers, and open the economies to international financial flows. These policies have been more or less implemented. Over time, the degree of liberalization has been substantial, at least in Japan and Taiwan, as shown in table 7.5.

Judging from what has happened during the Asian financial crisis of 1997, Patrick (1994) has almost perfectly summarized and distinguished these three countries' financial development. However, two fundamental structural issues in Taiwan have been neglected. One is the spurious nature of privatization and the other is the existence of KMT enterprises. Patrick has made it clear that privatization is not equal to liberalization. He points out that even a decade after the banks were privatized in Korea, the government still appointed new presidents for five of the commercial banks and continued to intrude into banks' lending policies and management (Patrick 1994, 349). However, special problems concerning privatization in Taiwan have been totally neglected in all financial studies (see, e.g., Patrick 1994; Park 1994; Shea 1994; Yang 1994, 1997).

Patrick is very sensitive in the interaction of the financial system and the sociopolitical system. Since finance is a very powerful instrument, when the power to allocate credit lies in the hands of the political and government bureaucratic authorities, the use of finance to support the political apparatus in power, to finance elections, and to reward supporters has been condemned (Patrick 1994, 337, 338, 366). Nevertheless, Patrick does not mention the involvement of the KMT in the financial market, although Yang (1994, 299) briefly describes KMT enterprises in the same volume (Patrick and Park 1994). These and other issues will be addressed in the next section.

7.5 Evaluation of Financial Reform in Taiwan

As mentioned before and as Ito and Krueger (1996, 2) have stated, Taiwan's financial deregulation has been due at least in part to the ineffectiveness of earlier types of regulation that came under stress from worldwide financial integration. In other words, international pressures have played a significant role in the financial liberalization in Taiwan. Hence, before criticizing the financial reform policy, it is worthwhile to point out the importance of internationalization. In fact, the export-oriented strategy itself serves as a built-in ratchet to check all domestic policies that threaten global competitiveness.

It is generally agreed that Taiwan's comparative advantages in setting up a regional financial center include (1) good location; (2) competent marine transportation; (3) massive international trade; (4) huge trade surpluses and cumulative foreign reserves, which are especially beneficial for a regional funding center; and (5) the Hong Kong situation after 1997. Its disadvantages are (1) inefficiency of government administration; (2) poor infrastructure including local communication and transportation; (3) lack of internationally experienced personnel; (4) existing government-owned financial institutions; (5) lack of comparable internationalized financial regulations in such areas as foreign exchange control, international finance, deposits of foreigners and foreign deposits of Taiwanese, and the tax system; and (6) the political difficulty of Taiwan's government joining the international community. Obviously, financial internationalization will solve many of these problems. Moreover, international pressure has always been the best means to liberalize domestic restrictions in Taiwan. A number of historical events support this viewpoint.

U.S. aid to Taiwan after the Korean War had an important influence in creating Taiwan's booming private enterprise system. "Without the intervention of AID (Agency for International Development), private enterprise would not have become, by 1965, the mainspring in Taiwan's economy" (Jacoby 1966, 138). A leading example of AID's promotion of the private sector was the establishment of the China Development Corporation in 1959, which was considered "the most important aid-sponsored industrial finance intermediary . . . with original capital provided by a Development Loan Fund loan" (191).[3]

In the 1980s, due to preferential financial policies toward exports, including an undervaluation of the NT dollar, Taiwan had abundant trade surpluses, which accumulated huge foreign reserves. Although this created substantial inflationary pressure, the belief that "only exports matter" could not be changed. Prolonged criticism by many local economists and some government officials proved of little use. It was in response to pressure from the U.S. government that Taiwan started to liberalize its foreign exchange rate controls (Yang 1997). Also in the 1980s, U.S. pressure played a determinate role in opening markets in banking, insurance, telecommunications, and other service sectors for domestic investors. In fact, in many cases liberalization policies affected foreigners much earlier than they did domestic business. For example, local branches of foreign banks (all privately owned) were welcomed much earlier than private domestic banks, which only became legal in 1989.[4]

Even today, U.S. pressure to open up the telecommunications business

3. Interestingly enough, China Development Corporation is now a KMT-controlled venture capital company and serves as the headquarters of the KMT enterprises.

4. The free import of tobacco and wine (made by foreign private firms) coupled with the local Monopoly Bureau of Tobacco and Wine has resulted in the bizarre fact that anyone in the world can produce wine and tobacco to sell in Taiwan except Taiwanese.

in exchange for supporting Taiwan's bid to join the World Trade Organization is playing the primary role in opening the industry to the private sector. Schive and Jan (1997) study the process of financial deregulation in Taiwan during 1990–97 and find this was also true for the financial market. In other words, the shortest way to arrive at the liberalization of domestic markets in Taiwan is follow a path from Taipei via Washington back to Taipei.

A general problem in the Taiwanese financial system is that the informal financial system is still not subject to prudential supervision, while the formal system is subject to insufficient preventive regulations and a lack of strict enforcement of those regulations that do exist. Three more specific structural problems threaten the Taiwanese financial system: first, multiple systems of oversight for the formal financial system; second, KMT-controlled financial institutions; and third, fraudulent privatization. The first two problems have not been dealt with by the financial reform, and the third is expected to be created by the reform.

In the past decade, several ill-functioning financial institutions have suffered runs and even bankruptcy, all of them either credit cooperative associations or credit departments of farmer associations. The problem stems from the multiple systems governing formal financial institutions, one for Postal Remittances and Savings, another for credit co-ops (there is some difference between credit cooperative associations and credit departments of farmer associations), and a third for banks. The multisystem creates an unfair competitive disadvantage for normal banks. As mentioned earlier, credit co-ops were privileged substitutes for commercial banks while private banks were completely prohibited before 1990. The direct authorities over the credit departments of farmer and fishery associations are the Ministry of the Interior and the Council of Agriculture, not the usual financial authorities. The problems are made worse by the fact that farmer and fishery associations have historically been the auxiliary election headquarters of the KMT.[5] The credit departments of farmer associations hold many bad and overdue loans.

The second structural problem, the prominence of KMT-controlled enterprises in the financial system, and the third problem, fraudulent privatization of state enterprises, must be discussed together because they are closely intertwined.

The KMT owns or controls many enterprises in both the formal and informal financial sectors, as shown in table 7.4. In addition, the Central Investment Holding Company used to control two important financial institutions through the KMT's political power without investing any

5. The credit departments of the farmer and fishery associations are generally classified as "private" financial institutions (e.g., Shea 1994, 284). However, since the government effectively controls the associations, these credit departments are controlled by the government.

money. The first is the International Commercial Bank of China (ICBC).[6] ICBC was created prior to 1912 in the Ching Dynasty in mainland China as the Bank of the Great Ching. It then became the Bank of China in 1912 after the revolution and was finally "privatized" in 1971 to avoid seizure of its overseas assets by the People's Republic of China when it replaced the Republic of China in the United Nations. From 1971 to 1994, more than 75 percent of ICBC stock shares were owned by the Development Fund of the Executive Yuan. However, the Development Fund entrusted some 30 percent of the ICBC shares to the Central Investment Holding Company (CIHC), registered the shares in its name, and claimed ICBC was a "private" firm (for then the percentage of state-owned shares was below 50 percent). During this period, ICBC was not monitored by the Legislative Yuan and the Control Yuan. ICBC registered its investment in the Chinese American Bank in the United States using the same trick and was found out and fined by the U.S. government in 1997 for false registration. The Development Fund reclaimed the shares held in the CIHC's name in 1994 and sold them. The second case is that of the China Bills Finance Company. The Development Fund held some 35 percent of the shares of China Bills Finance and registered all of them under the CIHC so that China Bills Finance was again claimed to be a private firm. The story is almost the same as that of ICBC. During this period, there were three bill finance companies in Taiwan (the only securities finance company shown in table 7.4 is Fuh-Hwa Securities Finance, which is also owned by the KMT): Chung Hsing Bills Finance, owned by the KMT (see table 7.4); International Bills Finance, owned by ICBC; and China Bills Finance. The KMT thus controlled all of them.

The privatization of the state-owned banks has long been a target. In fact, while ICBC was privatizing in 1971, privatization of the state-owned banks attracted much discussion. Taiwan launched its privatization program in 1989 and started to privatize some state-owned enterprises after 1994. However, these privatizations always ended in one of three results: Type I privatizations are those in which the state maintains control of the "privatized" enterprise (Chang and Olds 1996). Type II privatizations are those in which the "privatized" enterprise becomes a party-controlled enterprise. And Type III privatizations are simply a mix of Types I and II. These privatizations are shown in table 7.6. The privatization of the state-

6. In fact, a lot of mistakes are made in distinguishing whether financial institutions in Taiwan are public, private, or KMT enterprises. While ICBC and China Bills Finance are both government owned, they have been controlled by the KMT for a long time. The former was classified as privately owned and the latter as KMT owned (Yang 1994, 298). Farmer and fishery associations are totally controlled by the government, and Fuh-Hwa Securities is KMT controlled; however, all of these were identified as privately owned (e.g., Shea 1994, 284).

Table 7.6 "Privatized" Public Enterprises

Enterprise	Date of "Privatization"	Government Shareholding (%)	Party-ization?
Chung Kuo Insurance	March 1994	36.36	
BES Engineering	June 1994	0	Yes
China Petrochemical Development	June 1994	16.20	Partly
China Steel	March 1995	42.10	
Liquidised Petroleum Supply Administration	July 1995	0	Yes
Yang Ming Marine Transportation	February 1996	45.04	

Note: Government shareholding and party-ization are as of 1 May 1997.

owned banks will obviously follow the Type I method of privatization, as stated in Shea (1994, 260). There are other Type I state-controlled enterprises, one of them being ICBC (Yang 1994, 298).

When we say a "publicly" owned and operated firm, the word "publicly" is put in quotation marks by Stiglitz:

> In different countries there are different patterns and forms of ownership and control—as we would normally use those terms. While *nominally* all the property may belong to all of the people, the "people" do not directly exercise control, and even in democratic governments, the link between those who actually make decisions and those on whose "behalf" they exercise control may be very weak. In some countries control may be exercised directly from the planning "center" or the relevant industry ministry; in others a plant may be under the control of a large "firm," or the plant may be more directly under the control of its managers. In all of these cases there are myriad influences that affect the decisions, including the interests of the workers at the plant. When plants are establishment controlled, it is more common for the managers to be exercising their control nominally on behalf of the workers, with some limited attention being paid to the remote interest in the state as the provider or "owner" of the capital. (1995, 171)

"Public" companies not working in the public interest is a common theme. In Taiwan, the ruling party (KMT) and the state have been closely intertwined, and the economic system has been designated "KMT-state capitalism" (Chen et al. 1991). The ruling party is particularly powerful because it is a Leninistic party, which means the party overrules government administrators.

As a result of KMT-state capitalism, rumors of rent-seeking activities, insider trading, and, worse, policy insider trading have not ceased. Recently, it was rumored that up to twenty Democratic Progressive Party members of the National Assembly "borrowed" money from the KMT during the 1997 assembly with the understanding that they would collaborate with KMT proposals in place of repayment (*Journalist,* 18 May 1997, 77).

7.6 Concluding Remarks

The business service sector gains importance in a newly industrialized country such as Taiwan. The government seems to be coming to the realization that business service industries are important, because five out of six designated regional operation "centers" in its biggest development plan are in this sector. However, Chinese traditional culture holds this sector in contempt. Typical industrial policy still discriminates against it. To expose the conflicts and structural problems in this sector in Taiwan, I have used the financial system as an example.

The literature devoting itself to Taiwan's financial system typically confronts a paradox because it usually begins from "miracle" economic development experiences (high growth rate, equalized income distribution, low unemployment rate, and stable prices; e.g., Shea 1994, 222–23) and ends up concluding that the financial system is underdeveloped, rigid, and inefficient (e.g., Shea 1994, 266) or that "the maintenance of financial efficiency and financial stability simultaneously becomes a challenge for the government" (Yang 1997). While it may suggest to the third world that an underdeveloped financial system is compatible with an "economic miracle," it is an unsuccessful story from the viewpoint of the Taiwanese because the economic growth of Taiwan is mediocre compared to that of Japan, Hong Kong, and Singapore.

The reform in the financial system reveals that liberalization and internationalization are only half-measures. Privatization is partial and results in "nationalization of private-owned enterprises" and "party-ization." Solutions to the structural problems in the financial system are straightforward. Prospects for such solutions are dim under the current ruling party, however.

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Comment Motoshige Itoh

Ching-hsi Chang offers a good description of the basic characteristics of Taiwan's traditional financial system and the process of its reform under international competition in the financial industry. Like such East Asian countries as Japan and Korea, Taiwan has a financial system that is characterized by various kinds of severe government regulations, such as interest ceilings and entry barriers, and by strong public control of the management of financial institutions. In fact, the paper has a section that compares Taiwan's financial system with those in Japan and Korea.

One of the distinguishing features of Taiwan's financial system is the important portion of financial institutions owned and controlled by a political party. This feature is not found in Japan. It is interesting to know how important this political feature was for the slow pace of financial deregulation in Taiwan. Not only Taiwan but also other countries in Asia have their own reasons for the slow or quick speeds of their deregulation processes. For example, when one discusses the process of deregulation in Japan, one cannot neglect the role of bureaucrats (Ministry of Finance) and their relations with the financial industry. Although Chang does not go into detail about the political elements of the deregulation of Taiwan's financial system, more comment on this issue might make the process of deregulation clearer to readers.

It is interesting to know that the structure of the traditional Taiwanese financial system has many features in common with the systems in Japan and Korea. The three countries also have the common feature that manufacturing industries took off earlier than service sectors. In fact, the three countries achieved strong comparative advantages in their manufacturing sectors in spite of heavily regulated financial sectors. As Chang points out, Asian-style industrial policy, in which financial resources are concentrated in targeted industries and financial support is provided to export-oriented industry, is a vivid feature of Taiwan's financial system; it is very similar to practices in Japan and Korea. There is a vast literature on the effect of industrial policy, especially financial support policy, on the industrialization process; it might be useful to compare the case of Taiwan with other East Asian countries in this context. One might ask the following question: How important is the financial system—in particular, its government-

Motoshige Itoh is professor of economics at the University of Tokyo.

controlled features—to the process of industrialization in Taiwan, and how is the deregulation process related to the stage of economic development in Taiwan? Although the paper emphasizes pressure from the United States as the most important element promoting deregulation, internal factors, especially the stage of economic development, must have an important influence on the structure of the financial system.

After the EASE8 meeting in Taiwan, currency crises hit several Asian countries, and the financial systems in these countries faced serious difficulties. Taiwan was not among this group. It is interesting to see what differences in Taiwan allowed it to stay out of the financial and currency crisis. The paper shows one difference between Taiwan and the other countries. The process of financial system deregulation in Taiwan seems to be slower than in neighboring countries. This slow process of deregulation may have kept Taiwan out of volatile short-term international capital flows.

Comment Hirotaka Yamauchi

Ching-hsi Chang's paper deals with the regulatory reform of the financial market in Taiwan. The paper is very informative and interesting in that it depicts Taiwan's financial market comprehensively and compares it with those of Japan and Korea. Chang then evaluates Taiwan's financial policy, which raises many obstacles to liberalization, and concludes that the underdeveloped, rigid, and inefficient financial system creates a paradox when taken together with the economic development "miracle" in that country.

According to Chang, financial reform and regulatory policy change is now under way in Taiwan, but the complexity of the financial structure is the main obstacle to promoting real competition in this sector. Taiwan's financial sector consists of a formal system and an informal system. The distinction depends on whether or not a financial institution is subject to regulation by the Ministry of Finance. In the formal system, public ownership plays the main role, and the Kuomintang owns or controls most of the other, nonpublic financial institutions. In this situation, the many differences in competitive position among financial institutions are likely to spur complaints about the straight introduction of competition.

In a sense, it seems quite natural that this sector has a complex industrial configuration. Especially in an industry subject to tight government regulation, vested rights and interests are preserved, and mechanisms that

Hirotaka Yamauchi is professor of transport economics in the Faculty of Commerce, Hitotsubashi University.

curtail malperformance cannot work well. As a result, over time various types of financial institutions have survived, which could make the industry more complex. As Chang indicates, this situation resembles that in Japan—one reason why competition policies in Japan have been very slow in coming.

Recognizing many difficulties, Chang points out that the main forces driving the liberalization of financial markets are "foreign pressures," especially from the United States, and international competition. The "shortest way to arrive at the liberalization of domestic markets in Taiwan is follow a path from Taipei via Washington back to Taipei." And in order to create an international financial center, the government plans to implement a fair and transparent financial policy as well as to prepare the country's infrastructure for international financial trade. This situation is also very similar to that in Japan.

However, it seems to me that Chang's paper overlooks a very important point, which could be one of main sources of change in the industrial configuration. That is the dynamic process of domestic markets. As pointed out in the paper, until now regulatory reform and privatization in Taiwan's financial industry have not been so advanced; but competition, even in its infant stage, is likely to require further liberalization or deregulation, and such momentum has synergic effects on government policy. Individual entities want to act more freely to cope with emerging competitive pressures and therefore demand a more liberal environment. By analyzing explicitly and in detail the emerging competitive process in domestic financial markets, Chang's paper could be a more powerful, more useful study of Taiwan's financial sector.