

Democratization and Financial Reform in Taiwan: The Political Economy of Bad-Loan Creation

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DEMOCRATIZATION AND FINANCIAL REFORM IN TAIWAN: THE POLITICAL ECONOMY OF BAD-LOAN CREATION

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This study shows that many bad loans now burdening Taiwan's financial institutions are interrelated with the society's democratization which started in the late 1980s. Democratization made the local factions and business groups more independent from the Kuomintang government. They acquired more political influence than under the authoritarian regime. These changes induced them to manage their owned financial institutions more arbitrarily and to intervene more frequently in the state-affiliated financial institutions. Moreover they interfered in financial reform and compelled the government to allow many more new banks than it had originally planned. As a result the financial system became more competitive and the qualities of loans deteriorated. Some local factions and business groups exacerbated the situation by establishing banks in order to funnel funds to themselves, sometimes illegally. Thus many bad loans were created as the side effect of democratization.

I. INTRODUCTION

THIS article looks at the relationship between democratization and the financial system¹ in Taiwan during the 1990s, examining in particular the impact of democratization on the growth of nonperforming loans (NPLs). By and large the political and financial systems are independent of each other, and the workings of one do not necessarily exert an influence on the workings of the other. Since in Taiwan, however, the financial system had been incorporated into the authoritarian political regime, the two systems were also linked together in their transformation as Taiwan's politics and economy experienced large-scale structural change during the 1990s. One of the consequences of this inter-linkage was the increase in financial institutions' NPLs.

There are two significant reasons for explaining the inter-linkage between the two systems. Firstly, the seriousness of Taiwan's NPL problem which is the dependent variable of this article. The present ratio of NPLs held by Taiwan's financial institutions has reached a level where caution is demanded. This has brought on a

¹ A financial system has indirect financing carried out through financial institutions such as banks and direct financing such as stock markets. This study deals solely with the former.

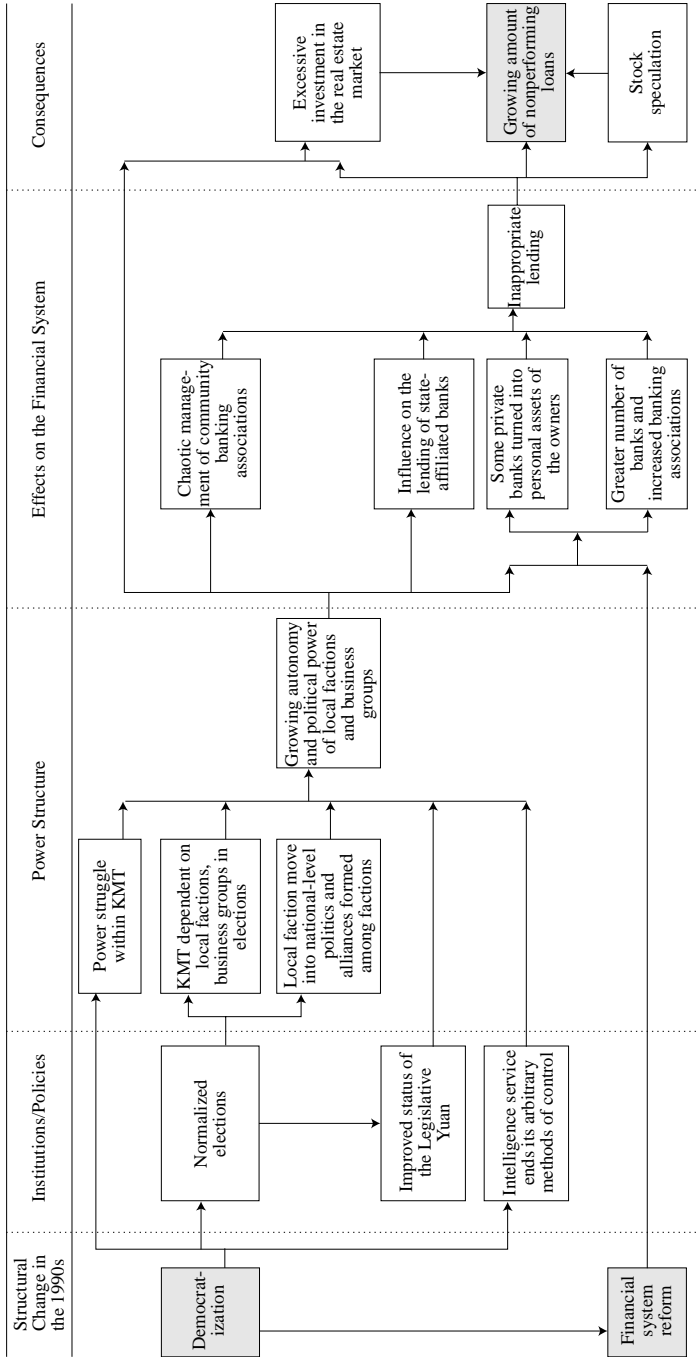
credit crunch which has negatively affected the entire economy. Given Taiwan's insecure national standing, its economic deterioration could jeopardize its national survival. Therefore, in order to devise appropriate measures to cope with the problem, it is essential that we understand the political and economic factors that have led up to the present situation.

The second significant reason is the interconnection between democratization and change in the financial system provides a good example of the multidimensional transformation of Taiwanese society during the 1990s which is the theme of this special issue. Our approach focuses on the autonomic dynamism of each system and on the interplay among systems. By the end of the 1980s, the old financial system as it stood had become increasingly ineffective, and there was a strong demand for reforms. This was a driving force of the financial system itself. But the reform would be entirely different and not thoroughgoing without the simultaneous commencement of democratization because the financial system was a subsystem of Taiwan's authoritarian regime. For the same reason, the financial system had been deeply affected by the change in the power structure brought on by democratization during the 1990s. Now as a result of the presidential election in March 2000, there was a change for the first time of the party in power, and Taiwan has now finished the process of democratic transition. At this stage, the power distribution in the political system is determining the speed and procedures for the disposal of NPLs; at the same time, however, the ongoing reform of the financial system is compelling more of the badly performing financial institutions to withdraw from business, and this is rearranging the power structure of the political world.

The analytical method used in this study is an interdisciplinary approach. The analysis will start from the dimension of the financial system itself, then proceed to the political dimensions. Section II will first look at the growth of NPLs, then will examine the causes for this growth, and from them pick out those causes which are relevant to the political dimension. Section III will examine the relationship of those causes with Taiwan's democratization. This examination will follow two tracks. One will analyze how changes in the political power structure brought on by democratization opened the way for political intervention into the financial system. The second track will show how the ongoing reform of the financial system in conjunction with the changes in the power structure led to the increase in NPLs. The examination of changes in the power structure will focus on the relationships between state and society, referring in particular to the relationship of the Kuomintang (KMT) government with local factions (*difang paixi*)² and business groups (*caituan*), an area where a significant amount of research was carried out in Taiwan during the 1990s. The results of this analysis are summarized in Figure 1. Finally, Section IV

² Local factions are political groups that control Taiwanese politics at the county level and below. Their role under the former authoritarian regime and their activities in the democratizing process are discussed below in this study.

Fig. 1. Democratization and the Growth of Nonperforming Loans



Source: By the author.

will summarize the above two sections and look at recent developments focusing on the interrelationship between the political and financial systems.

Before ending this section, I would like to comment on some previous studies. Democratization and its relationship with the economy including the financial system has been researched extensively in Taiwan in recent years. The material of interest to this study overlaps to a great extent with that contained in the volume edited by Chu and Bau (2000),³ and one chapter of that volume, by Kuo, Chen, and Huang (2000), is a direct precursor to the research of this study. The authors first show the upward trend in the ratio of NPLs in the indirect financing system and search out the political causes for this trend, pointing out the roles played by local factions and business groups. This article is in agreement with their findings.

However their argument does not sufficiently bring together the relationship between political intervention in the financial system and the rise in NPLs. And although the facts the authors present are all important, they are no more than ad hoc circumstantial evidence. By comparison, this article, as summarized in Figure 1, presents an overview of the entire chain of causality. Here the variables are interconnected through inferring the causes from the results retrospectively, i.e., analyzing relations between factors from the right to the left of the figure. This article also strengthens the evidences for its argument by referring to a number of scandals, like the case of embezzlement that came to light at the Tungkuang Credit Cooperative, which more directly and clearly demonstrate the intervention of political power in the financial system.

The authors also overemphasize the political factors, particularly the roles of the KMT, business groups, and local factions, to the point that their discussion of these factors tends toward reductionism. To avoid this reductionist problem, the present study sees the financial system and its reform process as having a certain degree of autonomy insulated from the influence of the political system.⁴ This approach allows the following analysis to be more balanced and more comprehensive.

II. THE GROWTH OF OVERDUE LOANS IN THE FINANCIAL SYSTEM

A. *Growing Volume of Overdue Loans*

During the 1990s Taiwan's financial system became increasingly unstable. In 1995 the Changhua Fourth Credit Cooperative failed which triggered a series of runs on community banking institutions,⁵ and the Chungli and Yenpu agricultural

³ T. J. Cheng has also done more than a little research on the subject. See, for example, Cheng (1997), Cheng and Schive (1997), Cheng (1999).

⁴ In an earlier study (Satō 2001), which is the basis for the present article, I recognized this problem, but not to a sufficient degree. This has been rectified in this study.

⁵ Community banking institutions encompass the local credit cooperatives and the credit departments of the farmers' and fishermen's associations.

cooperatives were rescued through mergers with other cooperatives. During the latter half of 1998 Taiwan was hit by the aftereffects of East Asia's economic crisis which produced a wave of business bankruptcies that extended to the financial sector. Two bill-finance companies⁶ failed, and the Kwang San Group and Ever Fortune Group respectively relinquished management rights in the Taichung Business Bank and Pan Asia Bank. These financial institutions were all affiliated with business groups and lent loans to other affiliated companies or guaranteed their commercial paper. When the affiliated companies fell into difficulties or bankruptcies because of the recession, the financial institutions could not escape being involved (Abe, Satō, and Nagano 1999, pp. 44–54).

The upward trend in the ratio of overdue loans⁷ (shown in Figure 2) provides a quantitative indication of the instability in the financial system. Three points can be noted from the figure. One is that the ratio of overdue loans held by Taiwanese financial institutions has already risen to a dangerous level. Taking into account that the definition of overdue loans as defined by the Taiwanese financial authorities is looser than the international standard, the problem is actually more serious. Following the standard used by other countries, one source estimated that the ratio of overdue loans would reach 9 per cent (*Gongshang shibao*, Sept. 13, 2000). A second point is that from 1995 the ratio of overdue loans consistently trended upward. Before that date the ratio remained substantially low, staying around the 1 per cent level for banks (Kuo, Chen, and Huang 2000, p. 82, Table 1). The third point is that the ratio of overdue loans at community banking institutions is extremely high and rising at a rapid rate.

B. *Main Factors for the Increase in Overdue Loans*

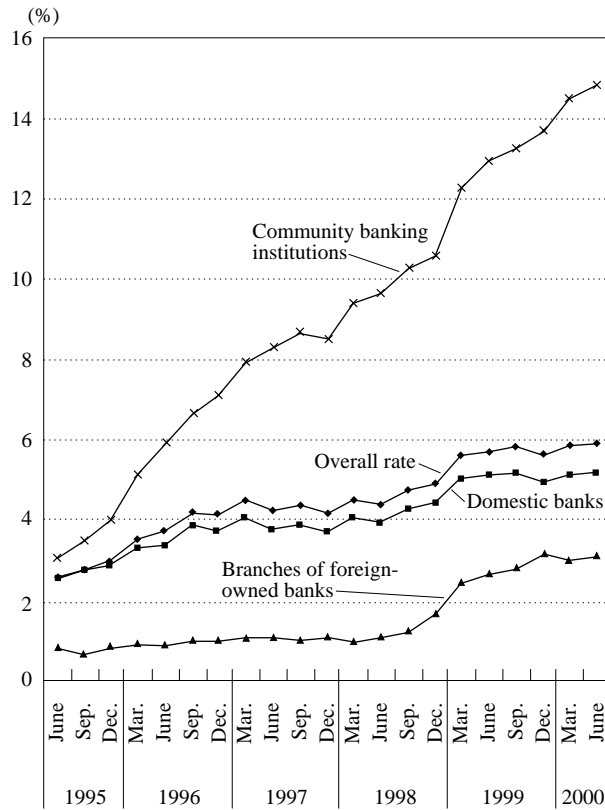
According to interviews at financial institutions, government organizations and with specialists in the field conducted during September and October of 2000 (see Appendix Table I), two main reasons came out as causes for the rise in overdue loans.⁸ The first was that changes in the industrial structure made a growing number of NPLs. Starting from the latter half of the 1980s, Taiwan's industrial structure underwent great change. Many companies in the so-called traditional

⁶ These companies are unique to the Taiwanese financial system. Their business is mainly guaranteeing commercial paper and underwriting.

⁷ Overdue loans are a category of NPLs, and Taiwanese financial authorities define them as loans having nonpayment of interest for six months and nonpayment of principal for three months. This study uses overdue loans because it is easier to get data about them than unrecoverable loans.

⁸ Also some interviewee recognized the slow pace of the legal process in disposing of overdue loans as another reason. An interesting argument that one interviewee pointed out was that the outflow of funds in the 1990s had caused the stagnation of the real estate market. But whether this argument is true or not depends on what these funds should have been used for had they not flowed overseas. The question is outside of the scope of this study and is mentioned here only as one view expressed in the interviews.

Fig. 2. Change in the Rate of Overdue Loans



Source: By the author from data obtained from the homepage of the Taiwan Ministry of Finance (<http://www.boma.gov.tw>).

Note: June 2000 is the projected rate of change.

industries⁹ experienced a slump in their business which hampered the repayment of their loans. Many of them tried to overcome their depressed situation by diversifying and investing overseas, but their efforts often resulted in failures which created additional NPLs. The slump in the traditional industries also produced unemployed workers who then could not repay their loans which further increased the amount of bad loans.

The second main reason was inappropriate lending on the part of financial insti-

⁹ “Traditional industries” is a term used to designate those industries other than such newly developing industrial sectors as semiconductor and computer related industries. It encompasses a wide range of industries, but the important ones for this study are the construction and real estate industries.

tutions. Loans to the real estate industry were especially problematic. Excess lending during the first half of the 1990s, as will be discussed later, led to a serious oversupply of housing which created a large volume of NPLs. Another important source of NPLs was loans for speculating in stocks. Before the 1990s very little financing from financial institutions had been invested in the stock market, so when the market crashed in 1990, there was little effect on these institutions. But during the 1990s financial institutions provided an increasing amount of money for speculation in the stock market. Moreover, most of the securities for this financing were stocks. Consequently the fluctuation in stock prices since the latter half of the 1990s has severely affected the performance of financial institutions. The cause of this problem has been reforms in the financial system which at the start of the 1990s opened the way for the establishment of new banks resulting in a dramatic increase in the number of financial institutions. This increased the severity of competition, and financial institutions, particularly new entrants to the industry, sought to cultivate loan markets by loosening their standards for lending.¹⁰

Moreover, some loans were extended even though from the start it was known that their repayment was uncertain. As will be pointed out later, it became easy for local factions and business groups to demand loans from financial institutions they operated themselves, or to bring pressure on state-affiliated financial institutions using their political clout.

It is difficult to show quantitatively how much of the growth in overdue loans has been the result of change in the industrial structure or inappropriate lending. Although the first factor seems to have had a larger impact, we cannot neglect the second factor for the following two reasons. Theoretically, catastrophes such as large-scale bank runs and distrust among the financial institutions in the call market could take place were the instability of a financial system to go beyond a certain critical point. Therefore, even though inappropriate lending in Taiwan has not been relatively large, it has greatly increased the risk of the financial system's collapse. Empirically, most of the financial institutions that have gone bankrupt and those where new management took over from the original owners were involved in inappropriate lending, particularly because of intervention by local factions and business groups.

It is apparent that of the two main causes for the growing amount of overdue loans, political factors lie behind the inappropriate lending. Changes in the political power structure brought on by democratization have contributed to much of the rampant increase in improper intervention. Also reform of the financial system combined with changes in the power structure has encouraged the extension of inappro-

¹⁰ Another example is house loan programs. According to Cheng (2000, p. 273), the new banks began to grant loans of 90 per cent in collateral value; until then the conventional financial institutions had made loans of 70 per cent of the value. Moreover, interest rates at these new banks were lower than at established banks.

priate loans, and this itself has come about to some extent as part of changes in the political system.

C. *Causes for the High Ratio of Overdue Loans at Community Banking Institutions*

As can be seen in Figure 2, the ratio of overdue loans at community banking institutions is extraordinarily high. The high ratio is especially serious at the credit departments of farmers' and fishermen's associations. According to the Council of Agriculture, which is the competent authority over these associations, of the more than 310 such credit departments, 50 of them as of the first half of 2000 reported that over 30 per cent of their loans had fallen overdue, and 15 had liabilities in excess of assets (*Zhongguo shibao*, June 1, 2000).

According to interviews with a division chief of the Council of Agriculture, several factors unique to credit departments of farmers' and fishermen's associations have caused their high ratios of overdue loans. One is the low liquidity of agricultural land used as collateral which has made disposal difficult. Secondly, farmers' and fishermen's associations are a type of cooperative, therefore their credit departments are deficient as financial institutions because they have no capitalization; they are not run by managerial specialists; and their area of business operations is limited. In spite of these deficiencies Taiwan has developed no organization at the national level to supplement them. In addition, recipients of loans from community banking institutions were hit by the outbreak of foot-and-mouth disease and by the earthquake in September 1999.

But these explanations are not sufficient. They do not explain why under the same conditions there are community banking institutions that are comparatively well managed and others that have gone bankrupt. Another important factor is that more than a few community banking institutions are run by local factions. That above-interviewed division chief agreed with this point. They lend money in line with the interests of these factions, and this has induced lax risk management which has often produced overdue loans.¹¹

Of course the connections between local factions and community banking institutions are nothing new. Therefore to understand why overdue loans have increased so rapidly in recent years, we need to examine the relationship with democratization.

III. NEGATIVE INHERITANCE FROM THE ANCIEN RÉGIME AND THE SIDE EFFECTS OF DEMOCRATIC TRANSITION

A. *The Financial System as an Element in the Old Authoritarian Regime*

1. *The role of the financial system*

In order to examine the political dimension behind the growth in NPLs, we need

¹¹ See Chen Chieh-Hsuan (1995, p. 126) for the words of a secretary general of a farmers' association.

to understand how the financial system was designed under the previous authoritarian political regime, because the destabilization of the financial system that has come with democratization has its origins in the distinctive features of that system during the authoritarian period.

After moving to Taiwan, the KMT government had two substantial threats to its existence. One was the People's Republic of China that the Chinese Communist Party had established on the mainland, and the other was the power of the *benshengren*, the local Taiwanese residents who had been living on the island for generations. The following analysis is related to the latter threat. Many *benshengren* harbored resentment against the KMT government because of the February 28 Incident and reacted against their exclusion from the national government. Some dared to challenge the KMT regime, calling for the independence of Taiwan.

One of the important means that the KMT government employed to deal with this threat was the financial system. The system was designed in part to curb any rise in the power of the *benshengren* while it was also used in part to conciliate them. The first task was accomplished with the establishment of a banking system largely monopolized by state-owned banks; the latter was achieved by letting the local factions operate the community banking institutions. In this way the financial system became a subsystem of Taiwan's authoritarian regime.

2. *State-owned banking system*

Until into the 1980s an outstanding feature of Taiwan's financial system was that the banking system was composed of state-owned banks¹² (Liu 1975, the last chapter; Itō 1988; Wade 1990, Chapter 6; Twu 1992; Cheng 1993; Fields 1995, Chapter 5). The only private banks were the Shanghai Commercial & Savings Bank which had moved from the mainland, two overseas Chinese banks, and the branch offices of foreign-owned banks. The participation of indigenous Taiwanese capital in the financial sector was permitted only in institutions at the periphery of the sector like investment trust companies,¹³ insurance companies, medium-sized business banks,¹⁴ and community banking institutions.

A banking system dominated by state-owned banks was set up for the express purpose of maintaining the power of the government. The KMT government recognized that for its own survival it would have to deal with two problems in running

¹² In this study, banks and financial institutions in which the government holds over 50 per cent of the stocks are referred to as state-owned. In Taiwan when the government's holdings in a bank falls below 50 per cent, it is regarded as privatized. But even in such cases the government remains the single largest stock holder and is able to exercise strong influence. In this study such "privatized" banks together with the state-owned banks and financial institutions are called state-affiliated banks/financial institutions.

¹³ Financial institutions for receiving trusts and applying the funds to long-term investments.

¹⁴ Set up with the 1975 reform of the Banking Law, these banks were formed out of the reorganization of mutual savings-and-loans companies which were traditional private financial institutions.

the economy (Cheng 1993). One was assuring stability which particularly meant controlling inflation. This concern derived from the KMT's perception that one of the major reasons for its loss of the mainland was its failure to control inflation. The other problem, as mentioned above, was the need to prevent the latent threat of *benshengren* power from developing too much in the economic sphere and turning that economic power toward the political sphere.

Having a banking system in which most of the banks were state-owned overcame both of these problems. The requisite stability was achieved because all banks followed the Central Bank's anti-inflationary financial policy. Being state-owned, there was no concern that the banks would deviate from the government's policy line.

The second problem was overcome because by excluding indigenous capitalists from the operation of banks, the KMT government prevented them from extending their influence into the banking sector and from transforming themselves into mammoth business groups commanding both industrial and financial sectors. The KMT government clearly showed its strong determination to obstruct the entry of indigenous capital into the banking industry when it countered attempts to revise the Banking Law in the mid-1980s (Fields 1995, pp. 170–82; Wang 1996, pp. 114–19).

During the first part of the 1980s, Tsai Chung-chou, the head of the Cathay Plastics Group and a lawmaker, organized the “*Shisan xiongdī*” (the thirteen brothers) with twelve other lawmakers and drew up plans for revising the Banking Law to permit investment trust companies to be transformed into banks. This was clearly a challenge directed against the state-owned banking system. The revision bill was amended and watered down to the point of ineffectiveness, and the challenge to the system failed. But the matter did not end there. Tsai, the prime mover of the revision effort, was made to suffer greatly for his actions. In 1985 the Tenth Credit Cooperative Association of Taipei, a subsidiary of Tsai's Cathay Plastics Group, was ordered by the authorities to suspend business operations which brought about the collapse of the entire group. The reason given for the order to cease operations was that Tsai had unlawfully withdrawn huge amounts of funds from the credit cooperative. But it seems that had Tsai not presented a challenge to Chiang Ching-kuo's leadership and the state-owned banking system, the government would not have chosen to shut down his credit association, which could have induced a financial crisis in the whole financial system (Cheng 1993, pp. 84–85; Fields 1995, pp. 178–89).

3. *Local factions and community banking institutions*

The KMT government did not solely work to hold down *benshengren* society. To maintain stable control, it was also desirable to gain its support. In reality the KMT government needed to obtain the votes of the *benshengren* in the local elections that took place even under the authoritarian regime. The KMT government had few

roots in local Taiwanese society, so it fostered local factions as its agents to win over the *benshengren* (Wakabayashi 1992; Wu 1992; Tsai and Chang 1994; Chen Ming-tong 1995). During elections local factions collected votes amongst the *benshengren* for the KMT government by fielding their own candidates with KMT endorsement or by supporting the KMT's candidates. Through these efforts the KMT was able to secure a certain amount of support from the *benshengren*.

In return for their support and assistance, the KMT government granted the local factions certain economic privileges. According to Chu, four of the privileges they enjoyed were the exclusive right to operate local monopoly business such as community banking institutions and transport facilities, financing from state-owned financial institutions, conducting business with the local governments particularly in the area of public construction, and the abuse of local government authority especially arbitrary city planning (Chu 1989, p. 151). In this way, part of Taiwan's financial system was used in local faction privileges as a tool for maintaining the KMT government.

But the relationship between the KMT government and the local factions did not only have this symbiotic aspect; there was also an aspect of tension in the relationship. While the government needed to rely on the local factions to maintain support in local areas, it had to avoid letting factions develop too much influence and becoming a challenge to the government. For this reason it limited factions and the power they wielded to their locales and did not let factions band together at the national level. The government also fostered and supported more than two factions in a locale, using them against one another to keep them under control and curb their growth. Over the decades this central control gradually loosened, but it basically remained in place under the authoritarian regime.

4. *Stability of the financial system during the authoritarian period*

The financial system under the former authoritarian regime was exceedingly stable. As noted in Section II, the ratio of overdue loans was kept at a very low level. Only a few community banking institutions failed, which were merged with other institutions, and there were no bank failures at all.¹⁵

There were a number of reasons for this stability. One was the restriction on new entrants into the system which along with the regulation of money and interest rates restrained competition, so there was no need for financial institutions to venture into high-risk financing. Another reason was that the government placed importance on stability in the financial system and maintained very strict control over the state-owned banks. These banks were supervised and overseen by upwards to six-

¹⁵ For information about the major problems that occurred in the financial system during the decades until the 1980s, see Lou et al. (1996, pp. 163–67). Regarding problems with banks, the only one was a dispute in 1984 over management at the Bank of Overseas Chinese, which was one of the few private banks.

teen government offices, and their autonomy in the areas of personnel, accounting, inspecting, budgeting, and administration was severely circumscribed. The employees of these banks were government workers, so there was no effort to do more than mediocre work because any efforts on their part to innovate, even if successful, would not be rewarded, while any failures were sure to be punished (Shea et. al. 1985, p. 48).

A third reason for the great stability was the small number of community banking institutions controlled by local factions that fell into serious trouble. This was a result of the KMT's effective control over the factions during the authoritarian period which curbed serious wrongdoing and deviation in the management of the community banking institutions. A fourth reason was the stability in the real estate market that supported Taiwan's financial system. And this stability was reinforced by the prudent lending of financial institutions in the real estate market which curbed overinvestment and rampant speculation. A final reason was that the stability of the financial system itself permitted the effective functioning of a safety net where troubled financial institutions could be merged with other institutions.

These factors that contributed to the stability of the financial system during the period of the KMT's authoritarian rule were lost in the process of democratization and financial reform. More ironically, the close ties between the government and the banks, and the operation of community banking institutions by local factions started to function as destabilizing factors.

B. *Democratization Increases the Burdens on the Financial System*

1. *Financial administration ill-prepared for reform*

If a financial administration maintains its autonomy and works effectively, it is enough to restrain inappropriate lending. That troubles arose in Taiwan's financial system during the 1990s indicates that the administration contained some defects.

One of these was that political power intervened not only in the financial institutions but also in the financial administration, and harmed its autonomy. Another shortcoming was that the financial administration was ill-prepared for and unable to keep up with the great changes that took place in the financial system and the political environment during the 1990s. This subsection examines the second problem more closely and an example of the first problem will be described later.

During the period of authoritarian government and the state-owned banking system, there was only a low-level need for financial administration, particularly for the supervision of financial institutions. Therefore financial administration was not seen as very important as indicated by the designation of the office in charge of it. It was ranked as a department (*si*), which put it below a bureau (*ju*), within the Ministry of Finance. (In July 1991 its ranking was raised to "*ju*.") As a consequence, its personnel and administrative resources were limited, and its organizational operations remained underdeveloped. The financial inspection staff in 1991

numbered 141 people (Tiao 1991) and increased to 272 people by 1999 (RDEC 1999, p. 162), which indicates the shortage of staff at the beginning of the reform. Some interviewee recognized that the present staff was still insufficient in number. Operationally, there was a lack of uniformity and consistency in the accounting practices and methods of financial institutions, therefore the office was unable to use computers for analyzing their balance sheets and to give them early warnings (Tiao 1991).

These deficiencies caused the financial administrative system to fail to properly supervise Taiwan's financial institutions in the midst of the great changes that took place during the 1990s. Insufficient supervision offered an opening for political intervention into the financial system.

2. *Changes in the power structure and political interference in the financial system*

(a) Changes in the power structure brought on by democratization

Democratization in Taiwan made remarkable progress after 1986. It also wrought significant changes in the political power structure. In particular local factions and business groups greatly increased their autonomy and political influence vis-à-vis the KMT government.

A number of factors brought about the increased autonomy and power of the local factions. One was the substantial increase in the importance of elections which also became much more competitive. Despite this new situation, the KMT had to continue relying on the local factions for waging its election campaigns (Wang 1996, pp. 152–56; Chen Ming-tong 1995, pp. 222–28). Another factor was the SNTV (single, nontransferable vote in a multiple-seat district) system used in elections for the Legislative Yuan (Legislature). Under this system success in elections came to rely much more on a candidate's own individual power and influence than on endorsement by the KMT (Chu 2000, p. 14). A third factor was that national elections opened the way for local factions to move into national-level politics, and there they were able to form alliances with other local factions (Chen Ming-tong 1995, pp. 228–33). Fourthly, as democratization progressed, the Legislative Yuan regained its original authority and functions, and it again began to play an important role in deciding political policies. This meant that unlike under the authoritarian regime where the Legislative Yuan almost always automatically ratified decisions by the Executive Yuan (the cabinet), under the emerging democratic system, the government was no longer assured of getting the legislature's approval.¹⁶ A fifth factor was that Lee Teng-hui, who became the new leader of the KMT following the death of Chiang Ching-kuo, was in conflict with the conservative wing of the party, and he turned to the local factions and their members in the Legislative Yuan for support

¹⁶ Although the KMT government had a majority during the 1990s, it had great difficulty managing the Legislative Yuan (Chu 2000, pp. 12–17).

(Wang 1996, pp. 84–85). One last factor helping local factions increase their autonomy and power was reforms in the intelligence service which reduced its ability to control the factions.

The above factors also worked the same way for business groups that had originated from local factions. Groups with different backgrounds did not necessarily care to use elections or the Legislative Yuan as sources for their power. But under the emerging democratic system, the KMT and the different forces within the government found it necessary to gain the support of the major business groups, and this gave these groups political clout.

Under democratization the local factions not only have greater autonomy and more political influence, also seem to have further strengthened their desire to amass money. Democratization has increased the frequency of elections, and the newly founded Democratic Progressive Party (DPP) has become a powerful competitor against the KMT. These have caused a substantial increase in the volume of money that local factions are using in elections.

(b) Political interference in the financial system

The changes that took place in the political power structure have had two direct effects on the financial system. One has been the increased autonomy of the local factions and business groups which has allowed them to be more selfish and arbitrary in the way they manage their financial institutions. During the authoritarian period, they would have feared being punished politically by the KMT government, and for this reason they exercised a certain amount of self-control in their activities including the management of their financial institutions. But that fear has disappeared. In addition, with the KMT government having come to rely on the local factions for its existence, there were times when it stepped in to rescue financial institutions that fell into difficulties, and this has weakened the self-discipline of the local factions all the more.

The second effect is the greater influence that politicians have come to have over state-affiliated financial institutions. The state-owned banks are under the supervision of the national and provincial assemblies.¹⁷ Assembly members use this authority to apply pressure on state-owned banks. Some of these banks have been privatized, and they no longer need to have the supervision of the assemblies. But as the largest single shareholder, the government still retains substantial influence over decisions affecting personnel, therefore even these so-called privatized banks have not been able to free themselves from the intervention of assembly members.

3. *Democratization and establishment of new banks*

Reform of the financial system in Taiwan has been progressing gradually since

¹⁷ The provincial assembly was abolished in 1998 and since then the Legislative Yuan has overseen the financial institutions owned by the provincial government.

the 1980s. A particularly important aspect of this has been permission to establish new banks (1989 revision of the Banking Law, 1990 enactment of standards for establishing banks, 1991 authorization to set up fifteen new banks) which has had the effect of reforming the state-owned banking system. This reform combined with the changes in the political power structure have contributed to the growth in NPLs.

The immediate reason for opening up the banking sector to new private banks was the exposure of functional limitations in the state-owned banking system brought to light by problems of excess liquidity in the late 1980s. As pointed out earlier, the state-owned banking system was extremely stable, but also too conservative to adjust itself to the rapid growth of Taiwan's industrial sector. The regulation of interest rates augmented its rigidity. As a result, an informal financing system had long ago come into existence which supplemented the formal system (Shea et. al. 1985). But it was during the latter half of the 1980s when the serious problem with excess liquidity surfaced that the ineffectiveness in the state-owned banking system became clearly acute. The banks were very limited in their ability to increase lending to make use of the rapid growth in deposits, and in extreme cases they refused to accept large deposits. Surplus funds with no place to go found their way into underground investment companies. However these companies frequently failed because of their reliance on speculative investments, and this became a serious social problem. This situation prompted moves to reform the financial system by allowing the establishment of new banks (Yin 1991, pp. 42–43; Chu 1999, pp. 151–52).¹⁸

At the same time, however, this reform process was influenced by democratization (Cheng 1993, pp. 90–91; Wang 1996, pp. 123–26; Chu 1999, p. 149). Had banking reform not kept pace with democratization, it is possible that efforts would have been made to solve the problems through other policies, and the choice of setting up new banks would not have been taken. As pointed out in an earlier section, the state-owned banking system had been set up as part of the authoritarian regime of the KMT government. Some conservatives not only tried to obstruct democratization but also wanted to keep the state-owned banking system. Lee Teng-hui, who was attempting to democratize Taiwan's political system, promoted liberalization of the banking system and the establishment of new banks as one measure toward bringing down the ancien régime. Lee made Shirley W.Y. Kuo, who, like Lee, had been a professor in the Department of Economics at National Taiwan University, head of the Ministry of Finance, and they pressed ahead with reforms while holding down the efforts of Yu Kuo-hwa, head of the Executive Yuan, who fought to preserve the state-owned banking system (Chen 1989; Hsu 1989).

¹⁸ Another factor was external pressure which was urging the Taiwanese government to allow the entry of foreign financial institutions. Consequently it was compelled to liberalize the entry of new domestic financial institutions at the same time (Cheng 1993, p. 90; RDEC 1999, p. 117).

However, the banking system reforms also opened the way for local factions and business groups to enter the financial sector. During the years of strict controls on new entrants, they had seen the banks enjoying excess profits, so when it became clear that the government was going to open up the banking system to new entrants, local factions and business groups expressed their desire en masse to set up new banks. This had two detrimental effects on the financial system.

One was the sudden increase in the number of banks. Originally the financial authorities had planned to approve between three and five new banks (Tseng 1991a, p. 86; Chu 1999, p. 152). In fact, however, fifteen new banks received approval, and major business groups and local factions were participants in most of them (Tseng 1991b). Many observers believe that most of these new banks were approved because of pressure on the Lee Teng-hui government (Tseng 1991a). Caught up in political battles within the KMT, it seems that Lee needed their support and could not reject their demands. Furthermore, several investment trust companies, medium-sized business banks, and credit cooperatives were reorganized into banks, by the end of 1999, forty-seven banks had come into existence compared to sixteen before the banking system was opened. Such an increase in the number of banks greatly intensified competition. Banks had to become more aggressive in their lending, and the quality of their loans deteriorated.

The second negative effect was that some of the new banks had questionable reasons for being established and had relied on political clout to pressure officials into approving their establishment. From the start of the reforms there were fears that they would illegally lend money to the business groups which owned them. This happened at the Chung Sing Bank, one of the new banks. This scandal, which is discussed further below, came to light in 2000.

4. *Scandals expose the banking system's problems*

The above three subsections show how political factors have been a mechanism for creating NPLs. This mechanism is common knowledge within Taiwan's financial sector, administrative authority, and political world. But it has not been easy to find objective, demonstrable proof of this mechanism. So the problems remained out of sight until scandals revealed their existence and brought them to public attention.

(a) *Chungli City Farmers' Association of Taoyuan County*

This farmers' association experienced a run on its deposits in 1995, and in the following year it was absorbed by the Taiwan Provincial Farmers' Association. During the course of the year before the run occurred, the Ministry of Finance had sent three official notifications to the Taoyuan county government which had authority over the association telling it to relieve the secretary general who was in immediate charge of running the association. However the county government ignored these notices, apparently because the head magistrate of Taoyuan county at that time, Liu Pang-yu (who was later assassinated), was also the leader of the local

faction, and the secretary general of the farmers' association was a faction member (Tiao 1995).

This case exemplifies the problem of the Ministry of Finance of the central government finding its authority unable to match the political clout of the local faction, and the ministry loses the ability to regulate the community banking institution operated by that faction. In other words, along with its insufficient capabilities as mentioned above, the financial administration has also been limited by the political power growing in the democratization process.

(b) Tungkuang Credit Cooperative

In 1999 an inspection by the Central Department Insurance Corporation uncovered suspicions that the chairman of the Tungkuang Credit Cooperative, Kuo Ting-tsai, and other members of the staff had been counterfeiting securities and embezzling from the deposits in the credit cooperative. Kuo was an important person in the Chang faction, one of the two big factions in Pingtung county, and was a member of the Legislative Yuan. He was also close to Ong Da-ming, who was leader of the Hualon group and very influential in the political and financial world. Kuo was regarded as Ong's spokesman in the Legislative Yuan (Kang 1999, p. 54). In November 2000 the district court sentenced Kuo to imprisonment for twelve years at hard labor for embezzling 2.3 billion New Taiwan dollars from the credit cooperative (Taiwan Pingtung District Court 2000).

This case is a complex of the various elements in Taiwan's financial system during the 1990s. It shows that some community banking institutions were being run as the private possessions of the local factions. The head accountant of the Tungkuang Credit Cooperative, Hsu Shu-chin, had played a central role in carrying out the crime, and she was also Kuo's secretary in the Legislative Yuan (Taiwan Pingtung District Court 2000, p. 35). The case also shows the collusion with business groups. Along with embezzling from the cooperative, Kuo and his group used counterfeit securities as paid-in capital to set up the Fahua Securities Investment Trust Company in 1996. At the time an individual named Lin Hsiu-fen was one of the people deeply involved (Taiwan Pingtung District Court 2000, pp. 60–61, 64). Lin had been a former secretary to Ong Da-ming (Jen 1999, p. 49). (She along with Ong had previously been convicted of illegal stock transactions.)

A third point in this case was the use of the money that Kuo and his group embezzled. According to newspaper reports, part of it was used to provide for subordinates (*"tsngaka"* in Taiwanese, *"zhuangjiao"* in Mandarin) who had the task of collecting votes during elections (*Jingji ribao*, Sept. 1, 1999). In effect Kuo used his economic privileges to build up political influence. A fourth point was that state-affiliated banks, notable the Farmers Bank of China, invested funds in the Fahua Securities Investment Trust Company that Kuo's son managed (*Jingji ribao*, July 8, 1999). Kuo was considered to have pressured the banks to invest taking advantage of his position on the finance committee of the Legislative Yuan. In other words, it

showed a mechanism which used political authority, especially a Legislative Yuan member's influence on state-affiliated banks, to yield economic rent. When this is put together with the third point, one can see a mechanism where economic rent and political influence mutually assure one another.

(c) The Chung Shing Bank

A succession of scandals revealing political interference in the financial system broke out during the year 2000. The Chung Shing Bank scandal in particular exposed the problems existing in the newly established banks.

The chairman of the Chung Shing Bank, Wang Yu-yun, was the leader of the Wang faction, one of the three big local factions in Kaoshiung city. He had also been a member of the Legislative Yuan and the head of the Hua Eng group. Suspicions were that in 1998 Wang had used false names to provide financing to Huang Tsung-hung, governor of the Taiwan Pineapple group, that went beyond the legal limit. There were also suspicions that Top Construction & Development, a company run by Wang's son, had received kickbacks from Huang (*Zhongguo shibao*, June 11, 2000).

Letting new banks enter the banking system had raised fears that the local factions and business groups who were the primary entities setting up the new banks would essentially make these banks their own possessions in order to facilitate the procuring of their own funds. The Chung Shing Bank scandal proved that these fears had been correct.

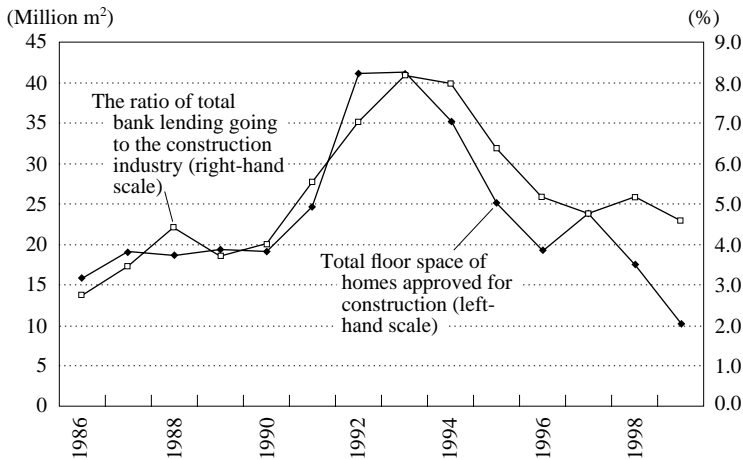
5. *A mechanism creating excess investment in the real estate market*

Many of the NPLs are connected with the real estate industry, therefore this problem needs to be examined more closely. The reason real estate has such a conspicuously large amount of NPLs is because of overinvestment in the 1990s. The bubble in the real estate market burst in 1990, and the adjustment phase set in. As mentioned above, this crash had little influence on financial institutions. However, regulations on floor space ratios were to be introduced from 1992, so most developers rushed to submit their construction projects for approval before the new regulations took effect. This assured that there was going to be an excess of supply in the real estate market, and the glut has continued to the present. At the start of 1999 there were estimated to be 850,000 unsold homes on the market (RDEC 1999, p. 177).

Within the context of this study, two factors can be pointed out for the overinvestment in the real estate market. One was that regulations on floor space ratios were introduced at the same time that the new banks were established. The many new banks needed to develop lending markets, therefore they were quite easy in offering financing to the real estate and construction industries at that time. As Figure 3 shows, the rate of lending to construction companies as a portion of total bank lending coincides perfectly with the approvals for home construction.

The other factor is the possibility that the rent creation mechanism of the local

Fig. 3. Home Construction and Bank Lending to the Construction Industry



Sources: By the author using data from the Construction and Planning Administration, Ministry of Interior homepage (<http://www.cpami.gov.tw/>) and Economic Research Department, the Central Bank of China, *The Financial Statistics Monthly, Taiwan District, the Republic of China*.

factions and some of the business groups accelerated the excess investment in the real estate market. Reports and research in recent years have shown clearly that these factions and groups have built rent creation mechanisms centered on land development (Tienhsia Pienchi 1992; Chen Dung-Sheng 1995; Wang 1996, Chapter 5; Jou and Chen 1998). Through their control of local governments, local factions and business groups have acquired the authority to intervene in urban planning. Using this authority they have changed the classification of agricultural land to residential and commercial land, incorporated sloped land (*shanpodi*) into urban planning areas, manipulated the choice of locations for urban land adjustment (*shidi chonghua*); through such intervention they have been able to reap enormous financial returns. And of course the needed funding in the whole process has been supplied via their financial privilege, meaning the financing from community banking institutions and state-affiliated financial institutions.

Democratization, on the one hand, enhanced the autonomy of local factions and business groups; at the same time, the increased frequency of elections pushed up expenditures; the former factor provided opportunities and the latter created motivations for the factions and business groups to abuse the above rent creation mechanism. But the party could not last forever. It exacerbated excess supply, and the real estate market fell into serious stagnation.

IV. CONCLUSION: THE INTERACTION OF DEMOCRATIZATION AND FINANCIAL SYSTEM REFORM

This article along with others in this special issue have sought to understand Taiwan's transformation in the 1990s as multidimensional. The core points of this approach are that each of the many spheres of a society has to a certain degree its own autonomy and that therefore any two spheres have a bilateral relationship, where a change in one sphere affects and induces change in the other and vice versa. Regarding democratization and the financial system in Taiwan, the former clearly has its own dynamism. In the case of the latter, it had been a subsystem of the authoritarian governing system, therefore its reform became interlinked with democratization of the political system. However, by the end of the 1980s, reform of some sort could no longer be avoidable with or without democratization because it became clearly evident that the financial system itself had serious defects and could not accommodate itself to rapid economic development. For this reason it is not appropriate to see reform of Taiwan's financial system only as one part of the democratization process.

Regarding the interaction of different social spheres, up to this point this study has focused solely on one matter, the impacts of democratization on the financial system, particularly the negative ones. Changes in the political power structure that came with democratization increased political intervention in the financial system. It also led to the distortion of financial system reform (which started simultaneously with democratization) such as the excess number of banks and the entry of unqualified financial institutions. In these two ways, democratization has contributed to the substantial increase in NPLs.

The rest of this article will examine both directions of the interaction between the political system and the financial system focusing on recent events concerning the NPL problem. First, the change of government that took place with the elections of March 2000 has altered the actions of the political system on the financial system. In that election, the DPP's Chen Shui-bian defeated Lien Chan of the KMT and James Soong, who seceded from the KMT, which brought about a successful change of government. This change has had both positive and negative effects on the financial system, particularly for solving the NPL problem and for the soundness and stability of the financial system.

On the negative side, despite having succeeded in bringing about a change of government, the Chen regime's authority has been too weak to implement measures needed for reforming the financial system. One weakness is in the area of government finance. Although the government has already strengthened deposit insurance and established the Financial Reconstruction Fund to stabilize the financial system, these schemes probably are not sufficient and further infusion of public

funds will be necessary. This raises the pressure for tax increases, but at the same time there are strong demands for tax reductions. Caught up in these contending issues, there is no certainty that the Chen government will be able to get sufficient public money injected into the financial system.

Another weakness of the new government is the minority standing of the DPP in the Legislative Yuan. For more than a year and a half after Chen Shui-bian assumed the presidency in May 2000, his government had to face a Legislative Yuan where the DPP held less than one-third of the seats, which had been determined by the 1998 election. Following the election that took place in December 2001, the DPP became the largest party, but it still does not control a majority in the Legislative Yuan, even together with the Taiwan Solidarity Union which has shown its cooperation. This minority standing has made it difficult for the government to get the support it needs in the Legislative Yuan when trying to hammer out reform policies. This has been the case particularly over policies to deal with the community banking institutions which directly affect the vested interests of the local factions.

On the positive side of the change of government, there has been some success in efforts to remove from the financial system the interference of local factions and other influential groups having symbiotic relations with the KMT. The series of scandals, including the one at the Chung Shing Bank, have come to light because the authorities have been able to expose the illegal and corrupt activities involving financial institutions. The government has been reshuffling personnel on the boards of state-affiliated financial institutions, and has been making efforts to prevent outside interference in these institutions (Yang 2000). In August 2001 it took its first substantive steps to clean up the NPL problem. It undertook the forcible seizure of thirty-six farmers' and fishermen's associations which had extraordinarily high ratios of NPLs. But the initial plan to set up a National Agricultural Bank and have it absorb the seized financial departments did not go through, and instead they have been absorbed by existing banks. This outcome indicates the government's continuing weakness.

Turning next to examining the effects that actions of the financial system have had on the political system, the essential point is that Taiwan's financial system is operating more autonomously than before and is compelling local factions and business groups to provide restitution, which includes withdrawal from the financial system, to compensate for their rent-seeking. At the macro level of the financial system, the entry of local factions and business groups relying on their political influence has made the system severely competitive, and as a result they have not been able to realize the excess profits they had anticipated. At the micro level, because of NPLs accumulated through rent-seeking, some financial institutions run by local factions and business groups have experienced runs on their deposits. They have also found that their political influence has not been able to completely close off supervision and seizure by the government's financial authorities. As a result,

financial institutions too avaricious in their rent-seeking have sooner or later found their business has come to a dead end; or even worse, as with the Tungkuang Credit Cooperative and the Chung Shing Bank, they have been prosecuted for their crimes. And once local factions and business groups have lost financial institutions as sources of rent, they inevitably lose their political influence.¹⁹

Looking into the future, the ideal scenario is for the government to continue its efforts to curb the power and influence in the political system of local factions and business groups and build sound institutions to promote the stability of the financial system, which will make badly performing financial institutions exit from that system. This should ultimately reduce the political clout of the local factions and business groups economically dependent on those financial institutions. Unfortunately, the power and influence of the local factions and business groups within the political system remains strong and may prevent the above-mentioned scenario from moving ahead smoothly. Therefore, the danger has not yet been entirely removed that the financial system could break down under the weight of NPLs.

¹⁹ Although the district court had already found him guilty of embezzling from the Tungkuang Credit Cooperative, Kuo Ting-tsai tried to get reelected to the Legislative Yuan in the election of December 2001. He appeared to be a strong contender during the early stage of the campaign, but in the end he received only about 16,000 votes; more than 35,000 were needed to win.

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APPENDIX TABLE I
 INTERVIEWS CONDUCTED IN SEPTEMBER AND OCTOBER 2000

Government organizations	The Central Bank of China (Sept. 25); Bureau of Monetary Affairs, Ministry of Finance (Sept. 26); Financial Analysis Department, Council for Economic Planning and Development, Executive Yuan (Sept. 27); Economic Research Department, Council for Economic Planning and Development, Executive Yuan (Oct. 3); Agricultural Finance Division, Farmers' Service Department, Council of Agriculture, Executive Yuan (Oct. 5); Central Deposit Insurance Corp. (Oct. 6)
Financial institutions	Two branches of Japanese banks (Sept. 22), Two previous chairmen of banks (Oct. 3, 4), State-affiliated financial institution (Oct. 5)
Political parties and statesmen	National Policy Foundation (the KMT's think tank) (Sept. 22), A lawmaker of the DPP (Sept. 26), A lawmaker of the New Party (Sept. 29)
Researchers specializing in financial system	Chung-Hua Institution for Economic Research (Sept. 21, Oct. 4); A professor of the Department of Banking, National Chengchi University (Sept. 27); Taiwan Research Institute (Sept. 29); A professor of the Department of Economics, National Taiwan University (Oct. 6)
Researchers specializing in Taiwan's politics and society	A professor of the Department of Sociology, National Taiwan University (Sept. 21); A professor of the Department of Sociology, Tunghai University (Oct. 2)

Note: Date of interview in parentheses.