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Differential Impact of the Foreign Exchange Crisis on Taiwan, Japan, and South Korea: A Politico-Institutional Explanation*

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Why did the East Asian economies make remarkable achievements before the 1990s, but suffer greatly since the foreign exchange crisis of 1997? Current theories of both liberal economics and the developmental state cannot provide a satisfactory answer, nor can they offer effective policy suggestions to solve the current crisis. This article suggests that a politico-institutional approach provides a better explanation to the above question and offers more effective prescriptions than current theories. The authors argue that politico-institutional relationships among the state, the ruling party, local factions, and conglomerates in these countries contributed significantly to the massive mobilization of resources but also generated long-term inefficiencies in resource utilization, which ultimately led to the economic breakdown during the foreign exchange crisis. Thus, solutions to the East Asian recession come not from cosmetic and inflationary Keynesian policies, which, in fact, might be counterproductive, but rather from the readjustment of the politico-institutional relationships among the four institutional actors.

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What Happened to the East Asian Miracles?

Before the mid-1990s, the East Asian "four little tigers" (Taiwan, Singapore, Hong Kong, and South Korea) and Japan were credited with having created economic miracles. The four little tigers served as the models of Third World development, especially for their Southeast Asian neighbors. Moreover, the "Japan, Incorporated" model was emulated by other industrialized countries. With their rapid growth, trade expansion, and improved living standards, these countries boldly proclaimed the twenty-first century to be the Asian century. In 1993, the largest international financing organization, the World Bank, endorsed the East Asian success stories with a special research report entitled *The East Asian Miracle: Economic Growth and Public Policy*.

But the foreign exchange crisis of July 2, 1997 has seemed to have destroyed these Asian Cinderella stories overnight. In fact, even before the foreign exchange crisis surfaced, signs of trouble had emerged in the economy of the regional hegemonic power, Japan; the bubble economy had burst in 1992, leading to an average growth rate of only one percent from 1992 to 1996. However, the fatal blow to the economies in Japan and the four little tigers began on July 2, 1997 when a currency devaluation avalanche swept through East Asian countries, accompanied by stock market collapses. From July 1997 to June 1998, Thailand's stock market dropped 63 percent; Singapore's stock market fell by 74 percent; the Indonesian stock market was reduced by 88 percent of its value; and South Korea's stock market took a 71 percent dive.[1] From July 1997 to May 1998, Indonesia's *tun* depreciated by 84 percent; the South Korean *won* depreciated by 59 percent; the Japanese *yen* and Taiwanese dollar devalued 16 percent and 18 percent, respectively; and Singapore's dollar suffered a 14 percent

[1]*Lianhe bao* (United Daily News) (Taipei), June 29, 1998, 11.

reduction in value.[2] Other economic indicators in figure 1 reveal a general and consistent decline in these Asian economies.

Although all East Asian economies suffered from the foreign exchange crisis, there existed substantial variation in scope. Taking Japan, Taiwan, Singapore, and South Korea for example, two variations are obvious (see figure 1). First, in terms of growth rates, Taiwan and Singapore seem to be weathering the storm better than Japan and South Korea. Japan's low inflation rate should not be interpreted as an indicator of health, as it merely reflects the persistence of its serious recession that began in 1992. Japan's low short-term interest rate should also be interpreted in the same manner. Moreover, the depreciation rate of the Japanese *yen* would be 23 percent higher if the reference point used is US$1:¥93.97 in 1995, instead of figure 1's reference point of US$1:¥115.9 in 1996. Second, the South Korean economy seems to be performing the worst of all these countries by all five indicators.

This paper aims to address the following questions: Why did East Asia's miraculous economies grow so rapidly yet collapse even more quickly? Does the fault lie only with George Soros, the greedy global foreign exchange speculator? Why did variations exist among the East Asian countries in terms of their capabilities in coping with the foreign exchange crisis? Why did South Korea suffer the most among the four, despite the fact that South Korea's conglomerates have successfully made their brand names (such as Lucky-Gold Star electronics, Hyundai automobiles, and Daewoo machinery) known to international markets? Why has the Taiwan economy weathered the crisis better than the other economies? Was it simply because the small and medium-sized enterprises (SMEs) are the major contributors to Taiwan's economy?[3] Can large doses of Keynesian policies, as experimented or contemplated by some of these countries, rescue them from the crisis?

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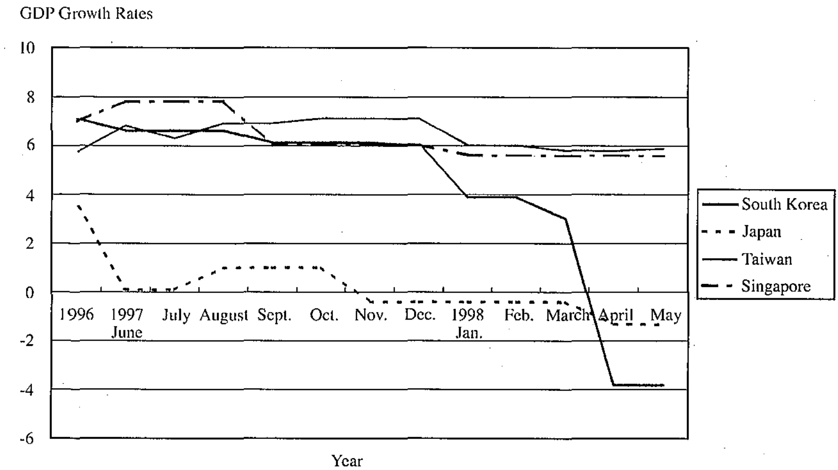
[2]Organization for Economic Cooperation and Development (OECD), *Main Economic Indicators*, July 1998, 80-85; International Monetary Fund (IMF), *International Financial Statistics*, June 1998, 78-87.

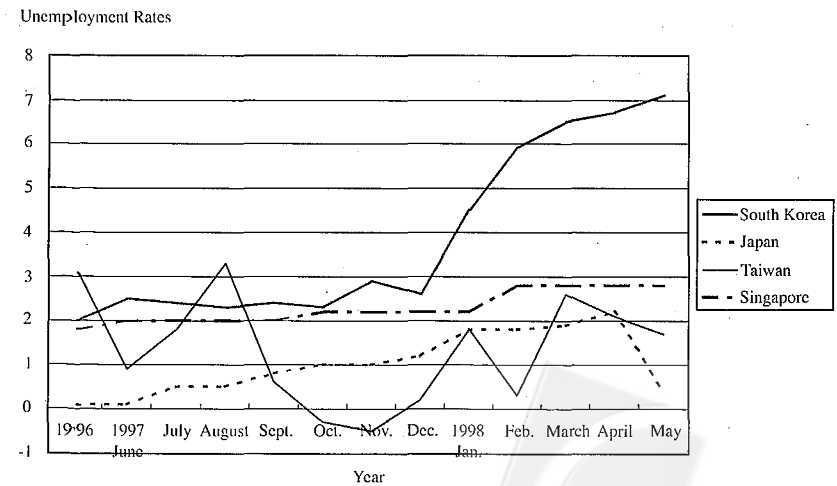
[3]*Far Eastern Economic Review*, August 6, 1998, 12-14.

Figure 1
East Asian Economic Performance After the Foreign Exchange Crisis

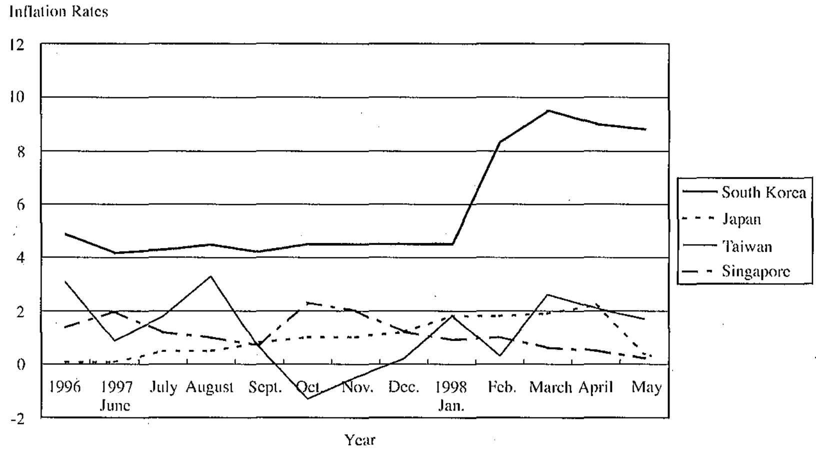
GDP Growth Rates



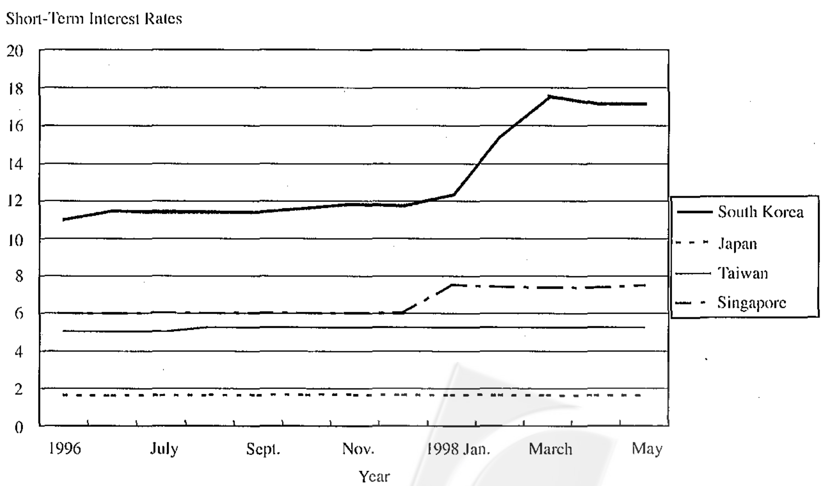
Unemployment Rates



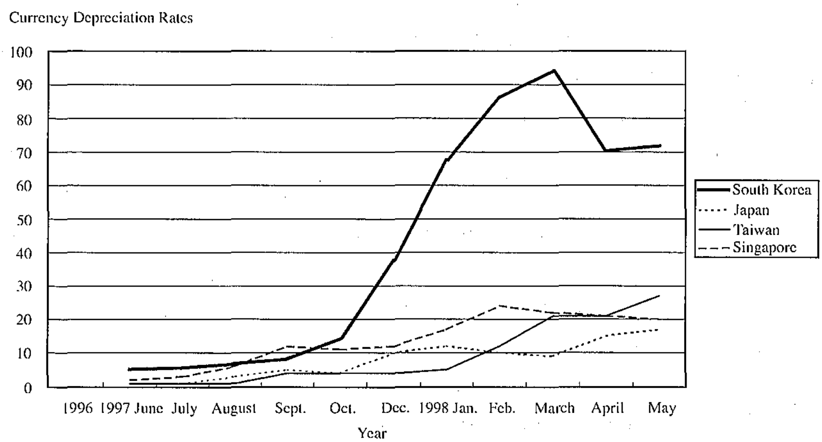
Inflation Rates



Short-Term Interest Rates



Currency Depreciation Rates



The major argument of this paper is that these Asian countries have developed certain political institutions which, while contributing in the past to the massive resource mobilization in economic development, have at the same time generated long-term inefficiencies in resource utilization.[4] To solve the current economic crisis, it is not enough, and may be even counterproductive, to adopt Keynesian stimulation policies or to manipulate macroeconomic indicators. The real solution lies in the readjustment of current political institutions in order to create an effective monitoring system for the improvement of efficiency in resource utilization.

The second section of this paper will briefly criticize past research that, while having explained the success of East Asian economic development, has failed to offer a satisfactory answer to their current entrapment. Then, we will introduce the politico-institutional approach that has guided our empirical research and policy suggestions. The third to fifth sections describe the political institutions of Japan, South Korea, and Taiwan, as well as their different consequences for economic development. Since Tai-

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[4]Efficiency in resource utilization refers not only to cost reduction, but, more importantly, to the best use and allocation of resources in the economy.

wan's political institutions were different from those of South Korea and Japan before the 1980s, but have become similar afterwards, the Taiwanese case receives a more detailed treatment than the other two. The last section, based on the politico-institutional analysis, proposes various institutional policies to cope with the current economic crisis.

Theoretical Arguments

A Critique of the Current Explanation

Explanations for the success of the East Asian economies have been more than abundant. Liberal economists have attributed the Asian success stories to the adoption of an export-led industrialization strategy, which includes export promotion, currency devaluation, responsible monetary and fiscal policies, reduced government intervention in the market, and encouragement of foreign investment. In recent years, the "theory of the developmental state" has gained popularity among not only scholars but also national and international policymakers. In a nutshell, the theory suggests that the existence of a developmental state (characterized by political autonomy, administrative capacity, and strong leadership) is the cause of rapid economic development in these Asian countries.

The developmental state theory has been challenged on both theoretical and empirical grounds. On the theoretical side, the critics challenge the definition and operationalization of its key theoretical terms, such as "relative autonomy," "autonomous state," and "administrative capacity."[5] They doubt whether the causal relationships between autonomy, capacity, and leadership on the one hand, and economic development on the other, are as simple as the statists have argued. The critics also question whether the developmental state theory has a solid foundation in organization theory. On the empirical side, the so-called Asian developmental states seem to have empirical attributes quite contrary to what the statists have described, such

[5]The developmental state theory suggests that a state needs (relative) autonomy from the interference of selfish politicians in order to implement coherent development policies.

as corrupt and inefficient governments. At the same time, some underdeveloped countries seemed to fit the description of a developmental state, e.g., the Philippine state during Ferdinand Marcos' rule.[6]

Furthermore, most of the liberal economists and the developmental state theorists have not provided either warnings or explanations of the dramatic downturn of the East Asian economies in the mid-1990s. In the 1990s, the East Asian economies continued and even quickened their steps toward economic liberalization through their support of the World Trade Organization (WTO) and East Asian regional integration. The developmental state theory became largely obsolete when Taiwan and South Korea abandoned authoritarian rule in the late 1980s, and when the Liberal Democratic Party (LDP) in Japan temporarily turned over its long-term rule to a loose coalition of opposition parties in 1993. Hence, when the 1997 foreign exchange crisis broke out, there were few theories available to even explain the disaster, let alone suggest solutions. In the following section, we propose a politico-institutional approach to provide such answers.

A Politico-Institutional Approach

In the past twenty years or so, the term "new institutionalism" has been employed by hundreds of scholars in thousands of research projects. It is not possible to provide even a cursory review of these literatures, which encompass the fields of political science, sociology, economics, psychology, and legal studies.[7] It suffices, however, to enumerate a number of assumptions of the politico-institutional approach employed in this paper in order to conduct an analysis of the Asian cases.

First, following the usage by Crawford and Ostrom, institutions are defined as:

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[6]For detailed criticisms of the developmental state view, see Cheng-Tian Kuo, "Democratization and Economic Development in East Asia" (National Science Council Report, NSC 86-2414-H-004-017, 1997); Steve Chan, Cal Clark, and Danny Lam, eds., *Beyond the Developmental State: East Asia's Political Economies Reconsidered* (London: Macmillan Press, 1998).

[7]For theoretical and practical problems of the institutional analysis, see Elinor Ostrom, "Institutional Rational Choice: An Assessment of the IAD Framework" (Paper presented at the annual meeting of the American Political Science Association, San Francisco, 1996).

> Enduring regularities of human action in situations structured by rules, norms, and shared strategies, as well as by the physical world. The rules, norms, and shared strategies are constituted and reconstituted by human interaction in frequently occurring or repetitive situations. Where one draws the boundaries of an institution depends on the theoretical question of interest, the time scale posited, and the pragmatics of a research project.[8]

Second, our politico-institutional approach combines the basic assumptions and arguments developed in sociology, economics, and political science.[9] That is, individuals occupying the roles in an institution have

[8]Sue E.S. Crawford and Elinor Ostrom, "A Grammar of Institutions," *American Political Science Review* 89, no. 3 (September 1995): 582.

[9]The major institutionalist works in economics include: Armen A. Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organization," *American Economic Review* 62 (1972): 777-95; R.H. Coase, "The Nature of the Firm," *Economica* 4, no. 16 (1937): 386-405; Richard R. Nelson and Sidney G. Winter, *An Evolutionary Theory of Economic Change* (Cambridge, Mass.: Harvard University Press, 1982); Douglas C. North, *Structure and Change in Economic History* (New York: W.W. Norton, 1981); idem, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990); and Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: The Free Press, 1975); idem, *The Economic Institutions of Capitalism* (New York: The Free Press, 1985). In sociology, I draw from Howard Aldrich and Jeffrey Pfeffer, "Environments of Organizations," *Annual Review of Sociology* 2 (1976): 79-105; James G. March and Johan P. Olsen, *Ambiguity and Choice in Organizations*, second edition (Oslo: Universitetsforlaget, 1979); Amitai Etzioni, A *Comparative Analysis of Complex Organizations* (New York: The Free Press, 1975); John W. Meyer and Brian Rowan, "Institutionalized Organizations: Formal Structure as Myth and Ceremony," *American Journal of Sociology* 83 (1977): 340-63; Charles Perrow, *Complex Organizations: A Critical Essay*, third edition (New York: Random House, 1986); W. Richard Scott, *Organizations: Rational, Natural, and Open Systems*, second edition (Englewood Cliffs, N.J.: Prentice-Hall, 1987); Herbert A. Simon, *Administrative Behavior: A Study of Decision-making Processes in Administrative Organization*, third edition (New York: Macmillan, 1976); Arthur L. Stinchcombe, *Information and Organizations* (Berkeley, Calif.: University of California Press, 1990). In political science, institutionalist studies include: (1) bureaucratic studies by Max Weber, *Economy and Society*, ed. Guenther Roth and Claus Wittich (Berkeley: University of California Press, 1978); Phillip Selznick, "Institutionalism 'Old' and 'New'," *Administrative Science Quarterly* 41 (1996): 270-77; Terry M. Moe, "The New Economics of Organization," *American Journal of Political Science* 28 (1984): 739-77; Michel Crozier, *The Bureaucratic Phenomenon* (Chicago: University of Chicago Press, 1964); and Graham T. Allison, *Essence of Decision: Explaining the Cuban Missile Crisis* (Boston: Little, Brown, 1971); (2) regime studies by Robert O. Keohane and Joseph S. Nye, *Power and Interdependence: World Politics in Transition* (Boston: Little, Brown, 1977); Stephen D. Krasner, ed., *International Regimes* (Ithaca, N.Y.: Cornell University Press, 1983); Volker Rittberger and Peter Mayer, eds., *Regime Theory and International Relations* (Oxford: Clarendon Press, 1995); J. Martin Rochester, "The Rise and Fall of International Organization as a Field of Study," *International Organization* 40, no. 4 (Autumn 1986): 777-813; Christer Jonsson, "Interorganizational Theory and International Organization," *International Studies Quarterly* 30, no. 1 (March 1986): 39-57; and (3) constitutional studies by Juan Linz, *The Breakdown of Democratic Regimes: Crisis, Breakdown, and Reequilibration* (Baltimore, Md.: Johns Hopkins University Press, 1978).

only bounded rationality. They follow routines in their interaction with other actors in the institution. Certain inertia is built into institutions. Periodically, however, they also conduct cost-benefit calculation about their roles when the environment changes or when current routines no longer serve their interests.[10] Thus, while institutions constrain the strategic behavior of actors, strategic interactions may in turn affect institutional structures, especially when institutional structures are weakening due to challenges in the larger environment.[11]

Third, institutions evolve and adapt. As individuals interact with one another in an institution, institutions also interact with one another and, as a result, may change each institution's internal structure.

Fourth, different institutional structures have different implications for economic efficiency. Borrowing Paul Krugman's argument, an institution that is efficient in resource mobilization may not be an efficient institution in resource utilization.[12] Even before the 1997 foreign exchange crisis broke out, Krugman had contested that the economic achievement of the four little tigers was no more than a "paper tiger." He argues that the rapid economic growth was caused, in large part, by an astonishing capability in mobilizing slack resources. There was, however, no sign at all of increased efficiency.[13] East Asian countries input a large amount of labor and capital to stimulate economic growth. The governments control financial institutions and provide easy capital in order to reduce international competition costs. In the mobilization process, however, these countries have neglected the capability of research and development (R&D). As a result, their economies are sensitive to the fluctuation of international capital flow and market conditions.[14]

[10]Relevant theories include the political network theory by David Knoke, *Political Networks: The Structural Perspective* (New York: Cambridge University Press, 1990).

[11]This theoretical assumption is consistent with Munck's suggestion of a "political-institutional" approach. See Gerardo Munck, "Democratic Transitions in Comparative Perspective," *Comparative Politics* 26, no. 3 (1994): 371.

[12]Paul Krugman, "The Myth of Asia's Miracle," *Foreign Affairs* 73, no. 6 (November/December 1994): 62-78.

[13]Ibid., 70-71.

[14]David Felix, "International Capital Mobility and Third World Development: Compatible Marriage or Troubled Relationship?" *Policy Sciences* 27, no. 4 (1994): 365-94.

Although Krugman might have underestimated the real improvement of technology and economic structure in East Asian countries, he does provide a reliable prediction for what has happened in the East Asian economies since the foreign exchange crisis. What Krugman has not provided, however, is an explanation for why these Asian countries were able to successfully mobilize resources, why they chose such mobilization strategies at the expense of efficiency, why they suffered differently during the same foreign exchange crisis, and why many of the economic policies have failed to stimulate these economies. We suggest research should focus on their different political institutions, which facilitate resource mobilization but, at the same time, generate long-term inefficient resource utilization.

Thus, we propose an interdisciplinary approach—the politico-institutional approach—to analyze four critical, development-related institutions in East Asia. They are: the state, the ruling party, local factions, and conglomerates. Each of the four institutions has exerted a significant impact on the development of East Asian political economies. Furthermore, they have cooperated and become intertwined with one another during the development process. Therefore, concentrating on state factors alone (as do the old statists)[15] or taking state factors as primary factors (as do the "embedded statists" or the "state institutionalists")[16] will provide not only a partial but probably also incorrect explanation of the political economic phenomena in these Asian countries.

Based on the above politico-institutional assumptions, we suggest that the ruling party, the state, local factions, and conglomerates in these Asian countries have developed a complex system of symbiotic relationships. This system of relationships had the advantage of massively mobilizing slack resources in the economy and contributing to rapid economic

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[15]Peter B. Evans, Dietrich Rueschemeyer, and Theda Skocpol, eds., *Bringing the State Back In* (Cambridge: Cambridge University Press, 1985); Alice H. Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (New York: Oxford University Press, 1989); Thomas B. Gold, *State and Society in the Taiwan Miracle* (Armonk, N.Y.: M.E. Sharpe, 1986); Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton, N.J.: Princeton University Press, 1990).

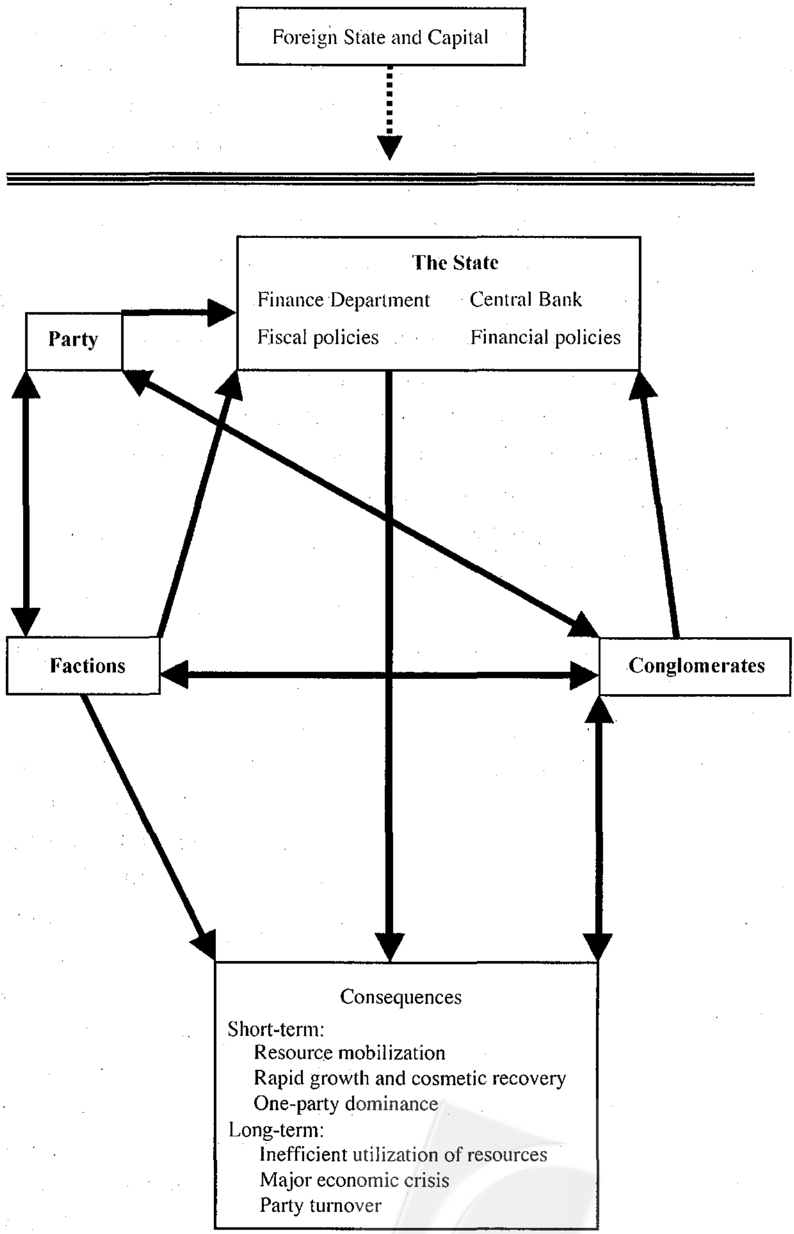
[16]Peter Evans, *Embedded Autonomy: States and Industrial Transformation* (Princeton, N.J.: Princeton University Press, 1995); Stephan Haggard and Robert Kaufman, *The Political Economy of Democratic Transitions* (Princeton: Princeton University Press, 1995).

growth. However, this system discourages the normal functioning of a monitoring system to reduce or prevent the inefficient utilization of slack resources. Figure 2 will help explain these arguments. On the resource mobilization side, we see that the ruling party would instruct the state, through the finance department and central bank, to provide conglomerates with financial and fiscal assistance in order to promote trade expansion. Conglomerates would offer political donations to the ruling party, which passes on the money to their factional followers, who then mobilize their relatives and friends to support the ruling party. The conglomerates also constitute a significant voting bloc because of the large number of their employees. As long as trade continues to expand and the economy continues to grow, this "virtuous cycle" reproduces itself and is able to ward off potential domestic challengers. For this virtuous cycle to reproduce itself, it is important to keep foreign intervention to a minimum, as foreign intervention would disrupt the orderly relationships among the chosen few.

This virtuous cycle, however, also generates a "vicious cycle" that undermines the economic development in the long term. The vicious cycle begins when a temporary recession occurs. Instead of taking more serious coping measures such as innovation and diversification, which would involve substantial risk and uncertainty, conglomerates ask the government to provide assistance in the expansion of existing facilities with only minor improvements in technology, quality, and cost reduction. Such expansion of investment has the short-term effect of stimulating the economy through cosmetic economic readjustment. State officials, the ruling party and its factional followers, and the general voting population certainly welcome such policies. Thus, all parties would be willing to suffer from inflationary policies in order to sustain an ever-growing balloon, even when cracks begin to appear.

In this vicious cycle, it is difficult to find political support for the effective functioning of a monitoring system which would serve to reduce or prevent the inefficient utilization of resources. Conglomerates aim at growth targets and market shares, which help them secure more loans and attract more stock investors. The state has no choice but to rely on these conglomerates in order to maintain economic stability and growth. Withdrawing support for these conglomerates during a recession would dev-

Figure 2
Politico-Institutional Relationships in East Asia



astate the economy. The ruling party and its factional followers would not seriously demand the state to play a monitoring role over these conglomerates, since the party's financial support is derived mainly from the conglomerates. Thus, like a drug addict, the conglomerates require ever more supportive economic policies from the state. The state, in turn, tolerates more bad loans and increasing inefficiency in the conglomerates. The ruling party and its followers need ever more financial donations in order to consolidate their power base against the ever-growing discontent of the general voting population, who ends up suffering from higher inflation and widening income distribution.

This East Asian system of economic development is self-destructive in the long term. Major external shocks, such as the 1997 foreign exchange crisis, only speed up the pace and severity of destruction. The destruction of Japan's virtuous cycle occurred even before the foreign exchange crisis broke out. A major crisis, like this recent foreign exchange crisis, does, however, also provide an opportunity to break from this vicious cycle. Figure 2 not only summarizes how the institutional actors form such a vicious cycle, it also points out how this vicious cycle can be broken. We will discuss these possible solutions in the last section of this paper, but first turn to describing the political institutions and their efficiency consequences in Japan, South Korea, and Taiwan.

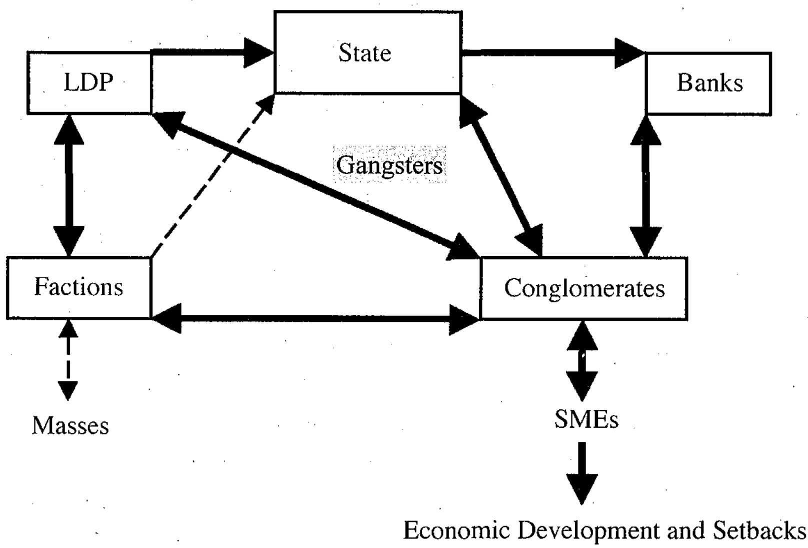
Japan

Figure 3 depicts Japan's political institutions of economic development. The evolution of and interaction among the state, the LDP, local factions, and conglomerates are described below.

In Japan, the state was an effective policy coordination center for successful economic development before the 1990s.[17] On the political side,

[17]On Japanese political economy, see: Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975* (Berkeley: University of California Press, 1982); T.J. Pempel and Keiichi Tsunekawa, "Corporatism Without Labor?" in *Trends Toward Corporatist Intermediation*, ed. Philippe C. Schmitter and Gerhard Lehmbruch (Beverly Hills,

Figure 3
Japan's Institutional Structure



the LDP, for the most part of the postwar era, has controlled the government and maintained a close relationship between the party and the state. Major policy initiatives originated in the state, but passed through the LDP's Policy Affairs Research Council before going to the obedient Diet. Factional leaders or senior members of factions occupied the LDP Policy Affairs Research Council and major party positions. These factional leaders formed patron-client relationships with junior Diet members by providing cam-

Calif.: Sage, 1979), 231-70; Leonard H. Lynn and Timothy J. McKeown, *Organizing Business: Trade Associations in America and Japan* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1988); Ronald Dore, *Flexible Rigidities: Industrial Policy and Structural Adjustment in the Japanese Economy 1970-80* (Stanford, Calif.: Stanford University Press, 1986); Richard J. Samuels, *The Business of the Japanese State: Energy Markets in Comparative and Historical Perspective* (Ithaca, N.Y.: Cornell University Press, 1987); Kent E. Calder, *Strategic Capitalism: Private Business and Public Purpose in Japanese Industrial Finance* (Princeton, N.J.: Princeton University Press, 1993); Frances McCall Rosenbluth, *Financial Politics in Contemporary Japan* (Ithaca, N.Y.: Cornell University Press, 1989). All of these works attempt to explain the success of Japan's economic development. It is difficult, however, to draw lessons from these works to explain the failure of Japan's economic development after 1990.

paign finance and pork-barrel projects. Factional members organized their own *koenkai* (support groups) in the constituency to mobilize votes at time of election. Because of the single nontransferable voting (SNTV) system, factions became the building blocs to ensure the LDP's dominance in the Diet. At the local level, the state bureaucracy seemed to increasingly rely on factional connections to acquire development finance from the central government.[18] But where did the large sum of money come from to support such huge patron-client networks? The conglomerates (*zaibatsu*) are the answer.

The conglomerates generously provided the campaign finance to factional leaders, who in turn distributed the money to their loyal followers.[19] What did conglomerates get in return? They needed low-cost loans, low taxes, and trade expansion assistance in order to compete in the international market. The state, under the influence of LDP factional leaders, provided these services to the conglomerates. The Ministry of Finance and the Bank of Japan adopted measures to provide tax breaks as well as cheap and long-term loans, while the Ministry of International Trade and Industry offered trade expansion assistance. Cheap loans were particularly important for the Japanese conglomerates, which aimed at long-term market shares in international competition. The loans permitted the conglomerates to make long-term investment schedule without worrying too much about cyclical recessions and stock price fluctuations.

Japanese conglomerates contributed greatly to the remarkable growth of the economy, but they did not do so alone. Studies have shown that these conglomerates succeeded because they formed together with the vast number of SMEs various institutional relationships including subcontracting, technical assistance, financial help, and the famous "just-in-time" system.[20]

[18]On Japan's factional and local politics, see Haruhiro Fukui and Shigeko N. Fukai, "Pork Barrel Politics, Networks, and Local Economic Development in Contemporary Japan," *Asian Survey* 36, no. 3 (March 1996): 268-86; and J. Mark Ramseyer and Frances McCall Rosenbluth, *Japan's Political Marketplace* (Cambridge, Mass.: Harvard University Press, 1993).

[19]Hidetaka Yoshimatsu, "Business-Government Relations in Japan: The Influence of Business on Policy-Making Through Two Routes," *Asian Perspective* 21, no. 2 (1997): 122-23.

[20]Daniel I. Okimoto, *Between MITI and the Market: Japanese Industrial Policy for High Technology* (Stanford, Calif.: Stanford University Press, 1989).

These institutional relationships allowed the conglomerates to share the costs and benefits of collective actions with SMEs in order to compete in the international market.

Thus, the Japanese institutional structure helped bring about rapid economic development. This "virtuous cycle" began in 1960 when Prime Minister Ikeda Hayato proposed the Income-Doubling Plan in order to consolidate the rule of the newly merged LDP.[21] The cycle reproduced itself during the two oil crises of the 1970s and to the present. However, as Paul Krugman has argued, the Japanese system was efficient in the sense that it could massively mobilize slack economic resources. But the efficiency in the utilization of mobilized resources was ignored.[22] The institutional structure was so well connected that the monitoring system lost its function. Thus a vicious cycle was created when the virtuous cycle could no longer sustain the huge accumulation of waste and inefficiency in the economy.

The shock to the institutional structure came in the 1980s, when Japan faced the global recession that followed the second oil crisis. In contrast to the United States where the Reagan administration adopted austerity measures to encourage market efficiency, the Japanese government adopted the wrong readjustment policies. The state followed the old recipes of making loans more accessible with lower interest rates in order to encourage investment. What was different about the recession in the 1980s from those in early periods was that Japan needed a large-scale structural change rather than an expansion of existing facilities. Japan had prospered based on a very limited number of industrial goods (e.g., automobiles, automobile parts, home appliances, and small electronic products), with relatively small profits derived from the improvement of existing technologies. As the East Asian newly industrialized countries (NICs) and second-tier NICs began to catch up on these standardized products, Japan needed to increase its innovative activities and diversify its competitiveness into other sectors, such as

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[21]In 1955, the Liberal Democratic Party was formed by Seiyukai (the Liberal Party) and Minseito (the Democratic Party) in order to confront the growing political influence of the socialists. But the election of the new president of the LDP also created the precedent of money politics.

[22]See note 12 above.

biochemistry, aerospace technology, banking, and insurance services.[23]

However, both the Japanese government and the banks failed to face the real problems. These two institutions were built around the old industrial product structure and did not develop interest or expertise in other sectors of the economy. Therefore, most of the cheap loans went to existing industries. When Japanese conglomerates received these loans, they did not invest in expanding existing facilities as the world market was highly recessionary and thus risky. The *zaibatsu* did not invest in other businesses either, because traditionally they did not like to do so. Instead, they invested the money in real estate and the stock market where exorbitant profits were guaranteed. The SMEs, following the steps of their patrons, joined the pool. The bubble economy began to grow. None of the monitoring systems worked: the state, the Bank of Japan, commercial banks, or the LDP factional leaders were only concerned with the amount and not the source of campaign finance. The gangsters entered the game because profits from real estate and the stock market were very lucrative.

In sum, Japan's institutional structure explains both the rapid economic development before the 1990s and the long-term stagnation of the economy after 1992 when the economic bubble finally burst. Unless significant institutional changes are made (to be discussed in the final section), the current economic stagnation will continue for the years to come despite the cosmetic reforms introduced by the government since April 1, 1997.[24]

South Korea

Although some variations exist, the basic politico-institutional struc-

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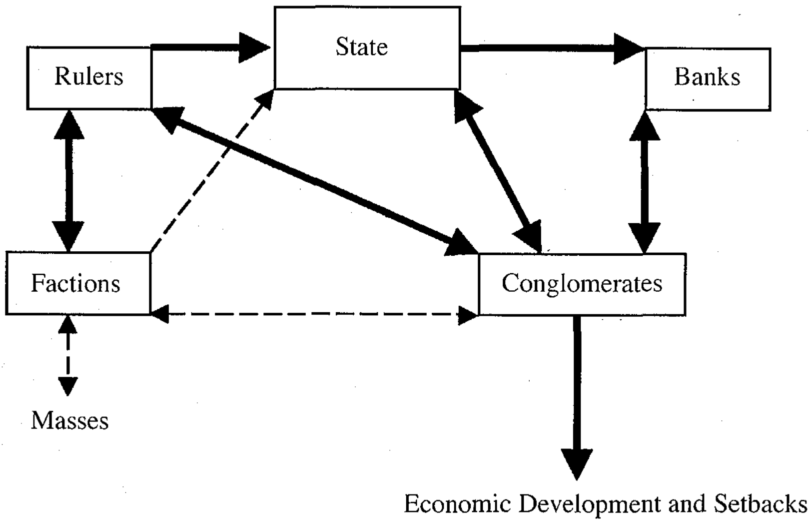
[23]About 74 percent of Japan's exports are automobiles (and parts), electronic parts, computers and parts, and home appliances. Among the twenty-five largest banks in the world, seven are Japanese banks, including the largest one, Bank of Tokyo-Mitsubishi. However, their net profits are far smaller than their American and European counterparts. See *Japan Almanac 1998* (Tokyo: Asahi Shimbun, 1998), 117, 127.

[24]On April 1, 1997, the Japanese government proclaimed certain revolutionary measures in order to save the economy. However, these policies, including restructuring of nonbank financial institutions and lifting controls over foreign capitals, have met with little success. See *Far Eastern Economic Review*, April 16, 1998, 12-14.

Figure 4
South Korea's Institutional Structure



ture in South Korea is very similar to that of Japan. This section elaborates on the similarities and differences between the Korean and Japanese cases. Figure 4 summarizes the politico-institutional relationships in South Korea.

In South Korea, we see an essentially similar institutional structure with only minor variations. During the authoritarian rule of Park Chung Hee (1963-79) and the more liberal rule of Chun Do Hwan (1980-88), the state formed a solid development alliance with conglomerates (*chaebol*) in trade expansion. The state utilized various financial and fiscal incentives to encourage conglomerates to make large-scale investments in industries with export potentials. With generous tax breaks (legal or illegal) and below-market-rate loans (particularly private and public foreign loans), conglomerates continued to grow in size along with the growth of the South Korean economy.[25]

[25]On the Korean developmental state, see Amsden, *Asia's Next Giant*; David C. Cole and Yung Chul Park, *Financial Development in Korea 1945-1978* (Cambridge, Mass.: Harvard University Press, 1983); Stephan Haggard, Byung-kook Kim, and Chung-in Moon, "The

A vicious cycle, however, was created in the process. This was evidenced by the growth of debt-to-equity ratios of conglomerates and by the increase of foreign debts. The debt-to-equity ratios of the top fifty conglomerates in South Korea increased from 452 percent in 1983 to 506 percent in 1985.[26] The national debt increased from US$2.17 billion in 1990 to US$23.7 billion in 1996.

President Chun initially intended to distance himself from conglomerates by reducing fiscal and financial privileges to conglomerates and by providing easy loans to SMEs and South Korean SMEs did expand as a result. But the state found out immediately that if conglomerates suffered from stringent fiscal and financial regulations, the South Korean economy would decline rapidly. Chun withdrew his distancing policies and adopted his predecessor's pro-conglomerate stance. Kim Yung Sam, the first civilian president and a former opposition leader, had a similar experience with conglomerates as has Kim Dae Jung since 1997. Both had accused the previous governments of being too lenient on conglomerates and thus should be responsible for the resultant social injustice. Both adopted anti-conglomerate policies upon inauguration. They both soon reversed their policies, however, in the face of the threat of capital strikes from conglomerates. Furthermore, conglomerates adapted themselves well to the change of government leadership. They provided large amount of campaign financing and delivered huge number of votes from company employees to the incumbents. Thus, the symbiotic relationship between rulers and conglomerates persisted despite leadership changes.

Transition to Export-Led Growth in South Korea," *Journal of Asian Studies* 50, no. 4 (November 1991): 850-73; Leroy P. Jones and Il Sakong, *Government, Business, and Entrepreneurship in Economic Development: The Korean Case* (Cambridge, Mass.: Harvard University Press, 1980); Tamio Hattori and Yukihito Sato, "A Comparative Study of Development Mechanism in Korea and Taiwan: Introductory Analysis," *The Developing Economies* 35, no. 4 (1997): 341-57.

[26]Other studies also reported that the average self-owned capital of South Korean conglomerates was between 17 and 22 percent. See David I. Steinberg, "The Transformation of the South Korean Economy," in *Korea Briefing, 1993*, ed. Donald N. Clark (Boulder, Colo.: Westview Press, 1993), 42; Michael T. Skull and George J. Viksnins, *Financing East Asia's Success: Comparative Financial Development in Eight Asian Countries* (London: Macmillan, 1987), 103.

Although weaker than the Japanese case, South Korean rulers had also relied on their factional basis to mobilize political support. These factional bases were largely divided by geopolitics. Presidents Park and Chun had strong support in the eastern and northern parts of the country, while the two Kims built up their support in the western and southern parts of the country.[27]

The South Korean institutional structure was thus similar to Japan's, as were its developmental consequences. The structure was highly efficient in mobilizing economic resources, but poor in resource utilization efficiency. Over the years (and especially during recessionary periods) the state and the banks continued to rely on easy loans (a large portion of which came from abroad) to finance the expansion of conglomerates. The monitoring system, when it functioned, concentrated on output volume targets instead of operational efficiency. The rulers, the state bureaucracy, the banks, and the conglomerates were not interested or did not develop an expertise in operational efficiency. Thus, as in Japan during the 1980s, South Korean conglomerates invested their low-cost loans in real estate and the stock market. The bubble finally burst with the East Asian foreign exchange crisis which broke out in 1997. Along with the crash of the foreign exchange and stock markets, five conglomerates (Sangyong, Hanbou, Samlou, Sammei, and Dainoon) have declared bankruptcy.[28]

Even before his election to the presidency in late 1997, Kim Dae Jung accepted the rescue package of the International Monetary Fund (IMF) in order to boost the economy. The authors argue that, without seriously implementing other institutional reform measures, this recipe will simply repeat the same mistakes that the current institutional structure has produced for decades. The fresh money will either have no impact on the recession or give only temporary relief until an even bigger crisis breaks out in the near future. In the final section of this paper, we will propose some policy suggestions to break this vicious cycle in the Korean case.

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[27]Yong-hak Kim, "Resurgence of Regionalism in South Korea" (Manuscript, 1994).
[28]*Far Eastern Economic Review*, April 30, 1998, 12.

Taiwan

The Taiwanese case is more complicated than the Japanese and South Korean cases and therefore deserves a more detailed treatment. For the most part of its postwar development, Taiwanese conglomerates did not play a significant role in the "economic miracle." Therefore, the institutional relationships and their economic consequences in Taiwan were different from those of Japan and South Korea. Since the 1980s, however, Taiwanese conglomerates emerged and expanded rapidly and have transformed Taiwan's politico-institutional relationships and their consequences more along the path of the other two countries. Figures 5a and 5b summarize the differences and convergences.

This figure shows the state and the Kuomintang (KMT) had a symbiotic relationship before the 1980s. Although the KMT had a higher degree of decision-making power than the state, the state was able to keep its relatively equal status due to its huge size and administrative expertise. The KMT, being controlled by mainlanders, had to rely on local factions to consolidate its control over the masses. The KMT granted monopolistic or oligopolistic privileges to local factions in exchange for political support, particularly through local elections. Despite this exchange relationship, the KMT held a relatively dominant position over local factions. Local factions could only exert influence in local affairs. Some local factional leaders were recruited to the party center or to the central government. But these leaders had to dramatically reduce factional ties with their followers and were not allowed to form cross-county alliances. If such behavior was detected, transgressors would be forced into early retirement from the political scene.[29] The party and state security systems provided effective monitoring mechanisms to prevent these local factions from cheating. Local factional leaders utilized government privileges to build up their factional bases. During local elections, factional members mobilized their friends

[29]For the classic research on Taiwan's local factions, see Chen Ming-tong, *Paixi zhengzhi yu Taiwan zhengzhi bianqian* (Factional politics and the transformation of Taiwan's politics) (Taipei: Yuedan, 1995).

Figure 5a
Taiwan's Institutional Structure Before the 1980s

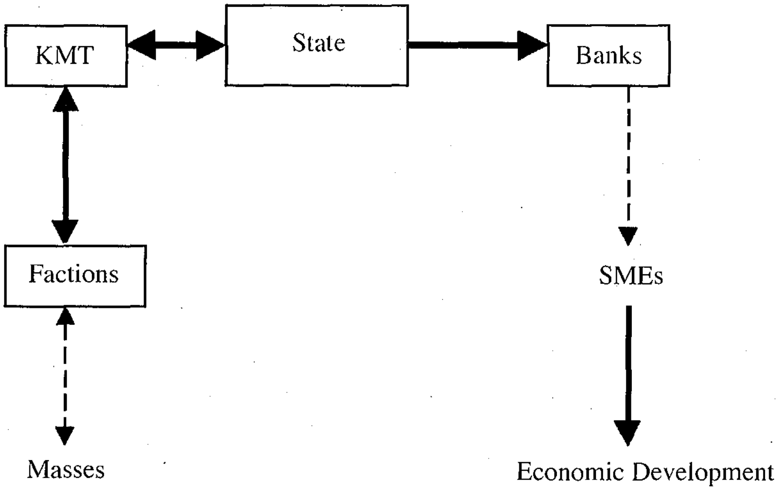
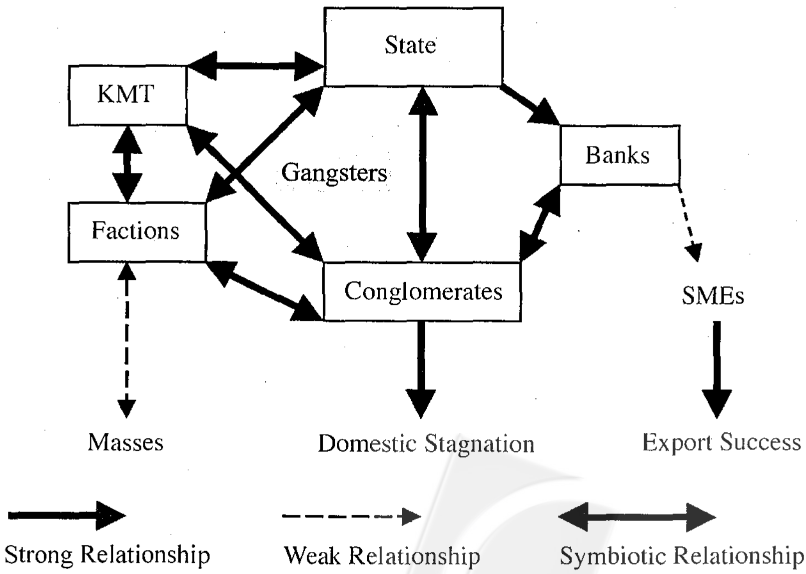


Figure 5b
Taiwan's Institutional Structure After the 1980s



and relatives to support their leaders (usually KMT members, or KMT-approved candidates).

The authoritarian state controlled most of the banks before the 1980s, either through state ownership or by stringent banking regulations. The banks provided vital investment and running capital to the SMEs. Since most of the loans required substantial collateral, the SMEs also sourced a large portion of their capital needs from the high-interest-rate curb market, whose order was maintained by the gangsters. Because of collateral requirements and the high interest rate in the curb market, these SMEs had to maintain high efficiency in order to survive in the competitive market. The SMEs, however, were not atomized producers. They built up various institutional relationships among themselves to maximize their profits and minimize the risks. These formal and informal institutions include professional associations, social clubs, the satellite system, subcontracting, and production chains linked to foreign companies.[30] Despite the high entry and exit rates of these SMEs, those who survived contributed greatly to Taiwan's economic miracle. Hence, during the period of authoritarian rule, the state was able to provide a stable, controlled political environment but did let the SMEs compete fiercely in the free market without much political interference.

The contribution of SMEs to Taiwan's economic growth is apparent when compared to the cases of Japan and South Korea. In 1987, Taiwan's top ten companies (including four state-owned companies) contributed only 14.3 percent of gross domestic product (GDP), Japan's top ten contributed 32.1 percent of GDP, while South Korea's top ten took up 63.5 percent of GDP.[31]

Since the 1980s, the internal structural relationships of the state, the KMT, and local factions began to change due to new challenges in the

[30]Cheng-Tian Kuo, "Private Governance in Taiwan," in Chan, Clark, and Lam, *Beyond the Developmental State*, 84-95; Chen Jie-Xuan, *Xieli wanglu yu shenghuo jiegou: Taiwan zhongxiao qiye de shehui jingji fenxi* (Cooperative network and life structure: A socioeconomic analysis of Taiwan's small and medium-sized enterprises) (Taipei: Linking Publishing Company, 1994).

[31]Gary Gereffi, "Big Business and the State: East Asia and Latin America Compared," *Asian Perspective* 14, no. 1 (1990): 9-13.

political and economic environments. Their mutual external relationships transformed as well. Furthermore, new conglomerates emerged, dramatically impacting Taiwan's political and economic contours. The evolution of each of these institutions is analyzed below.

The State

Before 1987, the state was relatively coherent, strong, and efficient, as described by the developmental state theory. With the lifting of martial law in July 1987, the old constitutional foundation of authoritarian rule had to be modified. Through four revisions of the constitution, President Lee Teng-hui steadily molded the constitutional structure to his liking. The president consolidated his position as the real decision-making center, having the premier serve as his chief of staff. The legislature acquired some political power from other branches of the government, but its power against the administration actually declined due to the large increase in the number of legislators and new constraints in those check-and-balance clauses. The new constitution introduced complicated conditions that would make impeachment of the president almost impossible.

Although President Lee prevailed over the constitutional revision processes, the state was actually weakened by the leftover ambiguity in the constitution and by Lee's political maneuvers. The major constitutional problem is the ambiguity over whether the president or the premier is the constitutional head of the administration. Article 53 of the constitution, which stipulates that the Executive Yuan is the nation's highest administrative body, has survived through the revisions. The president and the premier share many important decision-making powers, such as the ability to appoint important government positions and conduct cabinet member meetings. The vital showdown will come when the president has a different party affiliation than the majority party of the legislature, as has happened during the cohabitation periods in France. At present, however, the decision-making and implementation of many national policies have been revised, delayed, or canceled due to the differences in opinions between the president and the Executive Yuan.

President Lee's political maneuvers to consolidate his power have further weakened the state. Having no strong political background, except for the personal trust of President Chiang Ching-kuo, President Lee had to rely on a small circle of king's men to help him build up political coalitions against established interests. He has had five premiers in his eleven years of tenure as president. Premiers Yu Kuo-hwa, Lee Hwan, and Hau Pei-tsun respectively represented three formidable established interests: the palace faction led by Madam Chiang (President Chiang Kai-shek's wife), the KMT system, and the military. Each time President Lee made a temporary alliance with one group of people to fight against the strongest opponent and then formed another one to remove the current ally. By 1993, President Lee had consolidated his control by replacing military strongman Hau with Lee's protégé Lien Chan. Premier Lien was forced to resign his premiership in 1997, because he was elected vice-president the previous year. Although the Supreme Court did not find his dual administrative positions unconstitutional,[32] Lien was under great political pressure from both within and outside the party to give up his premiership. Vincent C. Siew, a former minister of economic affairs and protégé of President Lee, succeeded Lien. Since then, however, differences in opinions over national policies between President Lee and Premier Siew have broken out from time to time. The Ministry of Education had almost completed the procedure for the recognition of diplomas issued in mainland China, for instance, when the president called at the last minute for a halt to the process and forced the highly popular minister of education to resign. Secondly, in the controversy over the appointment of the chief of the Investigation Bureau, supporters of President Lee and the premier respectively mobilized their institutional resources to discredit the other side, exposing personal and political scandals related to the entire security system.[33] Other ministers in the cabinet and potential ministers became more absorbed in the political struggle than in handling government business. Making things worse is the fact that President Lee's term will end in the year 2000, and there is no apparent successor with the same charisma as President Lee. The field is wide open.

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[32]Zhou Liang-dai, *Dafaguan huiyi xianfa jieshi yu xianzheng zhidu zhi chengzhang* (The constitutional review of the Supreme Court and the growth of the constitutional system) (Taipei: Shiying, 1998), 94.

[33]*Lianhe bao*, July 11, 1998, 2.

In sum, the vital ambiguity in the revised constitution and the constant political maneuvers by the president to consolidate his power have generated great uncertainty in the state. Opportunism on the part of bureaucrats becomes rampant under this highly uncertain environment. Efficiency of the administration is much less a concern than job security or promotion for bureaucrats.

The KMT

During the period of authoritarian rule, the KMT acquired two functions in addition to those of a regular political party.[34] The first function was that of operating a security system controlling the government and society. The second characteristic was the party's ownership of mega-business enterprises. Both of these functions have faced environmental challenges and required adaptation under democratization. The adaptation strategies adopted by the KMT turned out to have had mixed results on the functioning of the new democracy.

The KMT as a security system: In 1950, with the support of his father Chiang Kai-shek, Chiang Ching-kuo transplanted the Leninist party system onto Taiwan. Among other things, the KMT was employed to consolidate Chiang Ching-kuo's power within the party and to prevent social forces from challenging him from outside, in preparation for the ultimate succession to the presidency. From 1949 to 1975, Chiang Ching-kuo successfully eliminated or suppressed the major factions within the party, and gradually recruited the king's men responsible directly to him. When Chiang Kai-shek died in 1975, Chiang Ching-kuo, then the premier, was already in full control of Taiwan's political power. It surprised no one when Chiang Ching-kuo easily won the presidential election in 1978, with no other candidate running. But with the sudden death of Chiang Ching-kuo in early 1988, the king's men scrambled to take over the supreme commandership. However, the upper echelon of the KMT, which was dominated by mainlanders, could not unite to cope with the divide-and-rule strategy employed

[34]For a detailed study of the role of the KMT in Taiwan's democratization, see Steven Hood, *The Kuomintang and the Democratization of Taiwan* (Boulder, Colo.: Westview, 1996).

by President Lee Teng-hui and disappeared from the political scene one by one. As the chairman of the KMT, President Lee had not fully trusted this machinery except during elections. Followers of major political opponents remained in the party and waited for a comeback whenever the president made a major mistake. Over the years, President Lee has staffed his men to upper-level positions. But the process has not been completed, and even his followers are looking for the next patron as President Lee's term expires soon.

As the political uncertainty within the KMT increased, party members began to build patron-client relationships with people in other institutions, including local factions and conglomerates. This activity resulted in the long-term weakening of the KMT. Reports have shown a general decline of party discipline in the increasing confrontation between the administration and the legislature, as well as between the central and local governments.[35] The mass support for the KMT similarly registered a steady decline in legislative elections, mostly due to the KMT's close association with "gold and goons."[36] As a result, the KMT continues to lose influence as a policy coordination center.

The KMT as a business enterprise: To support the huge party machinery, the KMT had to develop a stable source of finance. Although the KMT claimed itself to be a people's party with two million members, many party members did not pay membership dues. Being the party in power, the KMT utilized government resources and privileges to build a huge business empire worth about US$9 billion and which, according to some conservative estimates, generates more than US$140 millions a year in dividends.[37]

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[35]Wu Wen-cheng reported the decline of party discipline in the legislature. The open and ugly confrontation between provincial governor James Soong and President Lee since the 1997 decision by the National Assembly to shrink the size of the provincial government is exemplary of the KMT paralysis. In this confrontation the entire provincial party organization has been at a tug war with the party center. See Wu Wen-cheng, *Taiwan de minzhu zhuanxing: Con weiquanxing de dangguo tixi dao jingzhengxing de zhengdang tixi* (Democratic transition in Taiwan: From an authoritarian party-state system to a competitive party system) (Taipei: Shiying, 1996), 353-54.

[36]The KMT's vote shares in legislative elections steadily declined from 73 percent in 1983 to 46.43 percent in 1998.

[37]Some studies reported that in 1997 the KMT's enterprises were worth US$4.76 billion in assets, and their dividends were US$4.88 billion. See Chu Yun-han, "Taiwan's Unique

For instance, the KMT's construction company routinely gets awarded the government's major construction projects, and its stock company maintains a critical lead through inside information about the government's major policy initiatives. When the KMT enterprises are short on cash flow, they can easily receive financial support from state-controlled banks. The opposition parties have criticized the government for linking the state's coffers to those of the KMT.

Since the 1980s, these KMT enterprises have encountered increasing market competition due to the country's economic liberalization and democratization. The state budget has been under close scrutiny by the opposition parties. Moreover, local factions and conglomerates entered the lucrative construction and stock businesses. To maintain their competitiveness, these KMT enterprises began to develop their financial autonomy from the party center. Internally, they asked for a large portion of profits to remain with the enterprises instead of going to the KMT's coffers. They became more reluctant to sell or buy stocks to meet the party center's political purposes, e.g., to raise campaign money for party candidates. The leaders also pressured the party center to cut down the size of the party bureaucracy. Externally, they began to build alliances with conglomerates in order to maintain their oligopolistic status in the domestic market.[38]

Local Factions

Under authoritarian rule, local factions provided a legitimacy function for the mainlander-dominated KMT government. At local election time, these factions were able to deliver enough votes through their personal networks to support KMT candidates, thus maintaining a cosmetic democracy for American consumption. The KMT government rewarded these factions by local monopoly and oligopoly rights, such as local transportation, schools, credit unions, and sales of government-controlled commodities. These protected profits were sufficient for maintaining factional

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Challenges." *Journal of Democracy* 7, no. 3 (1996): 76; *Caixun* (Financial News), August 1998, 157.

[38]Karl Fields, *Enterprise and the State in Korea and Taiwan* (Ithaca, N.Y.: Cornell University Press, 1995).

solidarity. So the exchange relationship between the KMT and local factions seemed to proceed smoothly. But this was not actually the case.

Being dependent on local factions was never an integral part of the Leninist philosophy. A Leninist party was supposed to build a direct relationship with the people, not indirectly through local factions. Therefore, after the KMT government consolidated its control by the late 1960s, Chiang Ching-kuo orchestrated a "purging the local factions" project.[39] The KMT placed party cadres chosen by the party center on the candidate roster of local elections, instead of accepting the nomination of factional members. Unfortunately, the project failed. Party organizations at the local level were unable to compete with the factions in vote mobilization. The KMT backed down in subsequent elections and allowed local factions to nominate their own candidates. In the late 1970s, the KMT tried a second time to undermine local factions by introducing the American primary system, but failed once again. The primary system has since been revised to let local factions recommend candidates.[40]

Although unable to undermine local factions, the KMT was able to contain the influence of local factions within local boundary. Factions were forbidden to form vertical or horizontal alliances. Those factional leaders who were promoted to the central government had to cut off their ties with factional followers. That is, they were not allowed to utilize their positions to distribute additional favors to their followers. Otherwise, a demotion was imminent. Horizontally, these factional leaders were not allowed to build cross-county or cross-city alliances with other factions. If they did, the KMT would provide financial and political support to opponent factions. Thus, the KMT and local factions maintained an uneasy cooperative relationship during the period of authoritarian rule.

Some scholars have suggested that political democratization and economic liberalization would ultimately retire factional politics.[41] Political democratization would normalize interest group politics while economic

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[39]Chen, *Paixi zhengzhi yu Taiwan zhengzhi bianqian.*

[40]Wu, *Taiwan de minzhu zhuanxing*, 368-74.

[41]Steven Hood, "Political Change in Taiwan: The Rise of KMT Factions," *Asian Survey* 36, no. 5 (May 1996): 482.

liberalization would reduce the relative influence of local monopoly rents. However, the lifting of martial law and the subsequent power struggle within the KMT leadership opened a new era for the expansion of local factions. President Lee actively enlisted the support of local factions to break up the non-mainstream faction of the KMT.[42] In return, local factional leaders were brought into the decision-making centers of the central government and the party. These factional leaders soon adapted to the new democratic system and found secured channels of interest maximization.

Vertically, factional leaders found new avenues of making profits in order to support their patron-client networks. They could now gain access to government procurement and construction projects, pass pork-barrel bills, and obtain easy loans from state-controlled banks.[43] They acquired a much larger capital pool than local monopoly rents in order to maintain factional solidarity. On the horizontal side, factional leaders learned to form cross-county alliances to increase their bargaining power against the KMT leadership. The talk about purging factions was gradually replaced by the slogan of institutionalizing the factions, à la the Japanese model.[44] The nomination of candidates would take factional considerations as the priority, even at the risk of losing an election due to nominating too many candidates.

Although gaining influence and profit opportunities from their presence in the central government and party center, local factions have found limits to these benefits. In the past, they survived on the local monopoly rights granted by the government and had little experience in modern enterprises. Furthermore, few had enough capital to compete in national markets. Thus, many local factions began to form alliances with the rising conglomerates, as the latter had expertise in management skills and were rich in capital.

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[42]The non-mainstream faction is a category, not a cohesive faction, of those KMT members who oppose President Lee.

[43]Cheng and Haggard have found that after democratization, Taiwan government expenditures on welfare, environment, and public works have expanded. See Tun-jen Cheng and Stephan Haggard, "Democracy and Deficits in Taiwan: The Politics of Fiscal Policy 1986-1996," APSA Working Paper in Taiwan Studies, no. 19 (1996).

[44]Kuan Chung, *Riben zhengdang yu zhengzhi moshi* (Japanese political parties and political styles) (Taipei: 1992).

Conglomerates

Taiwan's conglomerates emerged in the 1980s. Most of their predecessors were large family-based companies in protected markets including insurance, steel, food processing, automobile, real estate, petrochemicals, cement, and home appliances. Due to the gradual liberalization of financial regulations and domestic markets in the early 1980s, these large companies began to invest in other sectors of the economy and thus became conglomerates.

Business scientists would suggest that it is a natural tendency and rational strategy for large companies to diversify their investments into other sectors of the economy. However, most of the diversified investment seemed to concentrate in two rent-seeking sectors, real estate and the stock market. In recent years, profits earned from investments in real estate and the stock market (called "non-enterprise profits" in their accounting books) have exceeded the profits earned from original enterprise production.

The institutional perspective can easily explain the growth of conglomerates and their skewed investment strategy. Surviving in a protected market, the predecessors of these conglomerates had established stable political ties with the central and local governments. Although the authoritarian rulers had a distaste for large capitalists and thus set certain limits on their expansion, an institutional relationship was established in these protected sectors. The weakening of the authoritarian rule and especially the lifting of martial law set these large companies free. Democratization of power has also meant the democratization of corruption. These conglomerates found multiple channels of influence to assist their expansion. A snowballing or bandwagoning effect soon led to spillover from the original protected sectors to other protected sectors. The most lucrative real estate and stock markets were particularly the sectors that required political connections in order to survive the competition.

In contrast to the distaste of the authoritarian rulers for large capitalists, President Lee almost went to the other extreme in embracing them. With their political connections reaching up to the zenith of state power, these conglomerates have found few obstacles to their reaping of usury rents from various protected sectors. What did these conglomerates have to pay for these lucrative profits?

In addition to the bribing of individual officials, conglomerates were important players in democratic elections. Conglomerates were equipped with a large cash flow they could use to support the skyrocketing campaign expenses of the KMT and individual candidates. Their large number of employees made conglomerates a significant voting bloc. Some of these conglomerates further diversified investments into the mass media sector, which could be used for political purposes at time of election.[45]

Conglomerates also established various relationships with local factions. If local factions were strong and wealthy, conglomerates would establish cooperative arrangements with them in order to explore shared interests in national protected markets. If local factions were not wealthy, conglomerates would provide capital to consolidate factional cohesion. Conglomerates were equipped with a large cash flow and significant management know-how, while local factions could provide the necessary administrative assistance through their connections with local administrators and politicians. Sometimes, however, conglomerates would simply buy out a declining local faction or establish a new one in a locality in order to enter the business of politics. Such examples include beach-chair manufacturer Tseng Chen-nung who established his own faction in Chiayi County ten years ago and has since become a senior legislator, and Changyi Group's Yang Tien-sheng who bought out a weak faction in Taichung County and became a member in local and national representative bodies.[46]

Direct participation in politics by conglomerate members began in the 1970s and peaked in the early 1990s. After all, with the political uncertainty that is part and parcel of the democratic transition process, direct participation in politics seemed to provide a secured channel of political influence. However, some conglomerates suffered from such direct participation in politics due to the neglect of their own business or due to mistakes they made while participating in vital political struggles.[47]

This section has described the adaptation of the state, the KMT, local

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[45]*Lianhe bao*, January 4, 1998, 11.

[46]Ibid., June 23, 1998.

[47]Kuo, "Democratization and Economic Development in East Asia."

factions, and conglomerates to the changing economic and political environments of the 1980s and 1990s. Although conflicts existed among them, these four institutions constituted an iron rectangle in Taiwan's political economy in the following senses. First, they became the major actors in Taiwan's political economy (with the exception of the export sector). Second, there was more cooperation than conflict between the four institutions: in terms of capital flow, information flow, and personnel exchanges, substantial interpenetration among the institutions occurred. Third, they constituted quite a distinct group from the rest of the population in terms of their interaction frequency, value orientation, or even marriage relationships.[48] Thus, these institutional relations seemed to have created a "virtuous cycle of dominance" which should allow the iron rectangle to rule Taiwan in the near future.[49]

This is not to say that all individual politicians, state bureaucrats, local factions, and KMT cadres benefitted equally from the new democracy. Some politicians would lose a political struggle and disappear from the political scene. Some bureaucrats would be found guilty of corruption and be removed from their posts. Some local factions failed to adapt to the new environment and thus disbanded. And some KMT cadres were laid off due to the reduction in political work. However, as individuals come and go, the cooperative institutional relationships among the iron rectangle have not changed significantly.

Efficiency Consequences

At the theoretical level, the iron rectangle has a tendency to produce problems of inefficiency. The major problem is the lack of an effective monitoring system to prevent inefficient utilization of resources. Conglomerates have little incentive to improve their productivity, since they work in those domestic sectors protected by the state. The state lacks the

[48]For instance, all the cabinet members of Premier Siew have connections with the president or vice-president. And they are related to many of the conglomerates. *Xin xinwen* (The Journalist) (Taipei), no. 547 (1997): 40-43.

[49]Pempel uses the term to refer to one-party dominant regimes. See T.J. Pempel, *Uncommon Democracies: The One-Party Dominant Regimes* (Ithaca, N.Y.: Cornell University Press, 1990).

incentives or abilities to monitor inefficient utilization of resources, since bureaucrats have been more concerned with political struggles and conglomerates are able to influence the legislature, which supervises the bureaucracy. Democratic elections may provide an institutional check on politicians, but politicians can mobilize local factions to consolidate their incumbency. The mass media is supposedly the fourth branch of the government. However, the state, the KMT, and conglomerates are able to influence the mass media and generate the mood of "hate the congress but love my representative" among voters. As long as the general public remains disorganized or apathetic to politics, the organized forces of the iron rectangle can continue to maintain the spoils system even under democracy.

When the foreign exchange crisis broke out in 1997, Taiwan was able to weather the storm better than most East Asian countries. One of the major reasons is the persistent competitiveness of the SMEs in Taiwan's economy. But we should not overlook the relative independence of the Central Bank which, although gradually losing some authority, has held a tight control over the banks. What we are suggesting, however, is the trend of Koreanization and Japanization of the Taiwanese political economy. Many signs of a deeper economic crisis are on the horizon, with the state seeming to tilt toward the South Korean and Japanese solutions to these problems (i.e., inflationary domestic stimulus packages) instead of aiming toward economic readjustment.

Policy Suggestions

The politico-institutional approach helps us to identify the causes behind the successes and failures of the East Asian economies. This approach also locates some possible areas for reform. An independent and effective monitoring system needs to be established within the state, banks, the ruling party, or conglomerates. Gray areas that encourage opportunism should be reduced. Therefore, the state should strengthen and return autonomy to the existing economic planning boards to monitor the quality of administration and to explore alternative means to increase competition.

The central bank should be given the status as the highest monetary authority, granted independence from the Ministry of Finance, and be made free from political interference. Through the government's financial policies, banks should build up their relationships with SMEs instead of focusing their attention on conglomerates. Conglomerates should no longer enjoy state protection in domestic markets, especially in real estate and stock markets. The ruling party has to revamp itself by reducing patron-client ties and by instituting a more democratic system of recruitment. Or, an opposition party which has such a system can take over the government. Finally, to combat the troublesome factions, independent social organizations, such as community organizations and issue groups, should be established for the mobilization of exploited groups in society.

In Japan, we doubt that the government's proposal to pump money into the troubled banking system or other expansionary Keynesian policies would be effective in rescuing the economy. Given the Japanese institutional structure, these policies may be even counterproductive, resulting in delayed reforms, more corruption, and higher inflation and unemployment. Four institutional reforms seem to be more urgent than pumping money into the black hole of the banking crisis. First, the Bank of Japan, not the Diet, should be given the lead and political independence necessary to reform the banking system. Second, non-tariff barriers should be substantially reduced to welcome foreign companies to do business in Japan. Third, the Japanese voters should try again to vote another opposition party into the government. And fourth, conglomerates should work with the government and SMEs to engage in innovation and diversification into other leading industries.

In South Korea, the major institutional problems are the predominance of the conglomerates and the exclusion of foreign companies. Hence, the government should boldly encourage the proliferation of SMEs. The Bank of Korea should also enjoy more authority and political independence to initiate banking reforms. Furthermore, the South Korean economy needs also to create a hospitable environment for foreign companies instead of relying solely on foreign technology purchasing.

Finally, Taiwan has had a long tradition of SME dynamism, which has contributed to Taiwan's economic growth and ability to weather the foreign exchange crisis. Furthermore, its central bank and the banking system served as an effective mechanism to monitor the efficiency of the SMEs. However, the rise of conglomerates, the long-term rule of the KMT, and the KMT's symbiotic relationship with local factions have generated an expanding black hole in the otherwise healthy institutional structure in Taiwan. Therefore, future institutional reforms should address these erosive institutional relationships that have developed since the 1980s. Taiwan should speed up its efforts to join the WTO, membership in which would introduce foreign companies into the market as a check on the emerging conglomerates. The government should continue its support for the SMEs and recover political independence for the central bank. Moreover, Taiwan's voters should also consider alternatives to the KMT as the ruling party. After all, the survival of local factions has been closely linked to the fate of the KMT as the pork-barrel distributor. Local factions have yet to establish such a strong bond with other opposition parties. Hence, a defeat of the KMT in the legislature or in the presidential race may do a great service not only to the KMT itself but also to Taiwan's economic development.