

# The Political Economy of Local Banking in Taiwan\*

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*Taiwan's financial institutions, like their counterparts in other East Asian countries in recent years, have been bogged down by bad loans, deteriorating asset quality, and mismanagement. Government efforts to reform the financial system are at best piecemeal. This paper analyzes the political, social, and economic context of Taiwan's local financial institutions, a body whose problems are symptomatic of the general banking sector in Taiwan. The paper finds that Taiwan's local financial institutions are deeply embedded in the Kuomintang (KMT)-centered political economy, and are thus not easily subject to large-scale reforms. The ascension to power by the Democratic Progressive Party (DPP) since the 2000 presidential elections should pave the way for more serious reforms. Difficulties still abound, however.*

**KEYWORDS:** patronage; clientele; farmers' associations; fishermen's associations; credit cooperatives

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"The more politics, the shadier the banking."

—A major shareholder of the Hsinchu SME Bank.

Though having escaped from the 1997-98 East Asian financial crisis relatively unscathed, Taiwan now seems ensnared by an unfolding banking crisis. Despite stopgap measures taken by the government, nonperforming loans have risen continuously. A deflationary equity market only further saps the health of financial institutions with such assets as stocks and real estate becoming less valuable. Down the road, there will be more dips. Taiwan's impending accession to the World Trade Organization (WTO) will certainly increase competition in the real economy, yet the financial sector seems unprepared for the upcoming economic challenges. Though bankers, economists, some well-informed journalists, and politicians have all expressed a sense of urgency that Taiwan's outdated banking system be renovated through liberalization and internationalization, the reforming efforts seem to be tentative, if not halfhearted. The replacement of the Kuomintang (KMT 國民黨, the Nationalist Party) by the Democratic Progressive Party (DPP 民主進步黨) in the 2000 presidential elections has brought about some reform measures, but their long-term effectiveness, still remains to be seen.

In this paper, we will argue that the ideas and institutions underpinning the KMT party-state are the backbone of Taiwan's banking system. The ideas refer to patronage and controls: the government ensures that no financial institution is allowed to go bankrupt and these institutions in turn serve party-state interests. Institutionally, a patron-client power structure—with the KMT being the patron and local factions and business conglomerates being the clients—undergirds the financial sector. This paper will focus on local financial institutions to illustrate the financial problems in Taiwan, as these institutions are symptomatic of the general malaise of the larger banking sector. This paper begins with a brief introduction to Taiwan's banking system, followed by an examination of the political economy of Taiwan's local financial institutions. A conclusion will follow.

## **A Brief History of Taiwan's Banking**

### *Banking Institutions*

Banking institutions in Taiwan are nothing short of a labyrinth. According to the classification of Taiwan's Central Bank, Taiwan has fifty-four commercial banks, three hundred and sixty-two local financial institutions, sixteen bills and finance companies, four securities finance companies, and thirty-nine foreign banks. The commercial banks can be further divided into one Postal Remittances and Savings Bank (郵政儲金匯業局), sixteen "old-timers" (which are vestige of Taiwan's development-era banking institutions), thirty-two new banks which came into existence in the early 1990s as a result of financial liberalization, and five small and medium-sized enterprise (SME) banks (中小企業銀行). The postal savings system, owned by the Ministry of Transportation and Communications (交通部), functions mainly as a deposit-taker, but is not allowed to make loans. Of the three hundred and sixty-two local financial institutions, forty-eight are credit cooperatives (信用合作社), two hundred and eighty-seven are Farmers' Association credit departments (農會信用部), and twenty-seven are Fishermen's Association credit departments (漁會信用部). The credit cooperatives and credit departments of farmers' associations and fishermen's associations differ from banks, not in function, but in ownership: the former are based on membership, the latter on shareholding. These financial houses are by no means banks, but their functions partially overlap with banks. The labyrinth does not end here. The licensing laws, the supervisory structure, and the degree of government shareholding in these financial institutions are all different for different classes of financial institutions. For example, the Ministry of Finance (財政部 MOF) directly finances and operates the Central Trust of China (中央信託局 serving as a government purchase monopolist agent) which is licensed under the Central Trust Ordinance. The state-owned banks also fall under the jurisdiction of the MOF. For the newly established banks licensed under the liberalizing Banking Law, however, the MOF would have only indirect influence on banking operations.

With the above outline, we now turn to Taiwan's banking history that to a considerable degree predetermined current banking quagmire in

Taiwan.

### History

The decision by the KMT government to retain local financial institutions after Taiwan reverted back to China in 1945 was more of a historical necessity than choice. The Japanese colonial power set up the first credit cooperatives in Taiwan in 1914 in an attempt to control the economic activities in the colony. Under the original design, the credit cooperatives—especially those in the rural areas—were supposed to be the financial centers of their respective localities. The credit cooperatives in the urban areas were secondary, since some Japanese colonial banks were already performing major financial functions in the urban areas. The Chinese authorities established the first farmers' associations in Taiwan in 1890, five years prior to the signing of the Treaty of Shimonoseki in which China ceded Taiwan to Japan after it lost the Sino-Japanese War, 1894-95. Japan's grand strategy toward Taiwan was to extract Taiwan's agricultural resources in order to complement the industrial power of Japan. This strategy presupposed a firm control over Taiwan's rural areas; farmers' associations, together with credit cooperatives in the rural areas, thus served as a convenient vehicle for the carrying out of administrative controls. Administrative controls over the rural areas were only increased after the 1930s as Japan further mobilized the resources of its colonies in preparation of war with the Pacific powers of China, the United States, and Great Britain. In contrast, urban credit cooperatives had never been the target of intensive mobilization by the Japanese colonial regime. Over the years, many Taiwan local elites (e.g., members of prominent families, professionals, and well-educated intellectuals) began to be involved with urban credit cooperatives, forming—to use a terminology of modern social science—a geography or network of monetary transactions.<sup>1</sup> Once taking back Taiwan in

<sup>1</sup> There are many books and articles, mostly in Chinese, explicating the origins, roles, and functions of these credit cooperatives, farmers' associations, and fishermen's associations. See, for example, Chyuan-jeng Shiau, "The Functions and Development of the Farmers' Association in the Republic of China," *Shehui kexue luncong* (Journal of Social Science), no. 34 (June 1986): 465-87; Pao-an Lin, "Local Finance and Society in Taiwan" (Doctoral dissertation, Tunghai University, 1994; in Chinese); and Chieh-hsuan Chen, *Huobi wanglu yu shenghuo jiegou* (Monetary network and livelihood structure) (Taipei: Lianjing chubans

1945, the KMT government was unable to uproot these local financial institutions. There were other reasons for the KMT government to retain the colonial financial legacy. The Second Sino-Japanese War from 1937 to 1945 had devastated the Chinese economy. The KMT government simply did not have the means or the will to replace Taiwan's financial infrastructure. Another reason was that after 1949—when the KMT government was defeated by the Chinese Communist Party (CCP) and fled to Taiwan, the party could not afford to further alienate Taiwan's local elite (who had just experienced the February 28, 1947 Incident<sup>2</sup>) by eradicating the local financial institutions.

As for the regular banks, the KMT government adopted a strategy of "priority of public banks over private banks" and "controlled access." The loss of mainland China to the CCP forced the KMT to go through much soul-searching. One of the lessons learned was that hyperinflation during the years 1945-49 damaged the economy so badly that rural peasants, urban labors, and intellectuals all became alienated from the KMT regime. Moreover, private capitalists who speculated and profited during the hyperinflation were deemed the culprits. With distrust of private capital so deeply ingrained in the minds of decision-makers, the strategy of managing the banking sector was naturally one that emphasized public over private banks. In addition, this strategy had a major side benefit: the ability to forestall the emergence of Taiwan indigenous capitalists that may someday become a power center posing challenge to the KMT regime.<sup>3</sup> Thus, in

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gongsi, 1995). For researches on Taiwan society written in English, one can see, for example, Stuart E. Thompson, "Taiwan: Rural Society," *The China Quarterly*, no. 99 (September 1984): 553-68; and Emily Martin Ahern and Hill Gates, eds., *The Anthropology of Taiwanese Society* (Stanford, Calif.: Stanford University Press, 1981). For the general concept of the geography (or network) of money, see Andrew Leyshon and Nigel Thrift, *Money/Space* (London: Routledge, 1997).

<sup>2</sup>This incident has had a lasting major impact on how local Taiwanese perceive the KMT government. Current politics in Taiwan, despite democratization, is still haunted by this incident. This is probably the single most important event that imparts an element of ambivalence to Taiwan's attitudes toward both China and Japan. For an assessment of this incident, see Lai Tse-han, Ramon H. Myers, and Wei Wou, *A Tragic Beginning* (Stanford, Calif.: Stanford University Press, 1991).

<sup>3</sup>Tun-jen Cheng, "Guarding the Commanding Heights: The State as Banker in Taiwan," in *The Politics of Finance in Developing Countries*, ed. Stephan Haggard, Chung H. Lee, and Sylvia Maxfield (Ithaca, N.Y.: Cornell University Press, 1993), 55-92.

the 1950s Taiwan's banking sector was dominated by public banks, with one exception<sup>4</sup>—the Shanghai Commercial and Savings Bank (上海商業儲蓄銀行).

As Taiwan's economy began to take off in the 1960s and 1970s, the tightly controlled banking sector no longer had the capacity to serve the economy. The KMT government, shackled by past ideology, adopted a prudent strategy of "controlled access." The party-state began to license more public banks—over which the government would have direct control, some private banks owned by overseas Chinese capitalists who had shown their allegiance to the KMT government, and—from 1972 to 1976—ten foreign bank branches or representative offices (eight from the United States, one from Canada, and one from Britain) apparently for the sake of diplomatic considerations. The heavy presence of the government in the banking sector during the economic takeoff period was justified on the grounds that the government must "socialize" the risks associated with making loans to emerging industries in order to avoid financial instability.

Up until the mid-1980s the banking sector, under the tight aegis of the government, seemed to serve the economy well. Since the Plaza Accord of 1985, however, the Taiwan currency began to appreciate against the dollar and the banking system was filled with excessive liquidity. Unable to find a proper outlet for the excessive liquidity, banking institutions lent heavily to real-estate and stock markets, thus giving rise to a large bubble in Taiwan's hitherto smooth-running economy. Apparently, market forces had to be reintroduced into the banking sector so that resources could be allocated more efficiently through the banking system. Coinciding with this new economic situation was American pressure on Taiwan to open up its financial market and banking sector. Taiwan's merchandise trade surplus with the United States reached a peak—in excess of US\$16 billion—in 1987. This was certainly unbearable to an increasingly trade-belligerent Con-

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<sup>4</sup>Since inception, the International Commercial Bank of China (ICBC 中國國際商業銀行) was owned by the ruling KMT. Given the nature of the party-state in Taiwan before democratization in the late 1980s, fair is to say that the ICBC was actually a public bank. The KMT government changed the ICBC shares to private hands overnight in the wake of U.S. severing its formal diplomatic relations with the ROC in 1978. So, nominally, the ICBC could also be regarded as a "private" bank.

gress which requested the executive branch to "level the playing field" with American trading partners who enjoyed a lopsided trade surplus in their trading with the United States. Since enjoying comparative advantages in the financial and banking sectors, the United States could easily exert pressure on Taiwan in this regard. Against this backdrop, the Taiwan government in 1989 finally permitted the establishment of domestic private-capital banks, exactly four decades after the KMT government relocated from the mainland to Taiwan. At approximately the same time, the government also opened the banking sector to additional foreign bank branches or representative offices.

The above is a quick overview of Taiwan's banking structure. Turning now to the consequences of the banking arrangement in Taiwan, we see the first consequence has been rigidity. The heavy presence of governmental control of the banking sector means that market force signals are much weakened in the banking operation. There are several reasons for the weakening of market signals. One is that staffers in public banks are more civil servants than bankers in the modern sense of these terms. Their careers are based on seniority rather than on performance. The make-or-break of a banking career hinges on one's ability *not to make mistakes*, rather than on one's ability to calculate risks and make profits based on these risks. Another reason is that the government frequently puts banking operations on a short leash. For example, even after Taiwan gradually liberalized its capital account in the 1990s, the Central Bank still requests banks to report any foreign exchange transactions in excess of US\$100,000. This request is strictly enforced, especially when the Taiwan currency is under depreciation pressure. As one ex-manager who was responsible for foreign exchange operations at a major bank matter-of-factly states, "The Central Bank is the FX market."<sup>5</sup> A third reason is information asymmetry biased against bankers as a result of the government's lax enforcement of regulations and laws concerning business practices. Clear then is why bankers, especially those in public banks, are risk-averse; they run the banks like pawnshops. The rigidity may not negatively affect any

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<sup>5</sup>Interview, July 10, 1997.

economic development in which the government plays a major role. Writing in 1985, Robert Wade makes a case for Taiwan's banking rigidity, saying that such rigidity:

- (1) gives the government more control over the balance of payments, the implementation of tariffs and quantitative restrictions as instruments of selective protection, and the cost of financial capital to domestic borrowers;
- (2) reduces financial instability by socializing the risks of private loss, i.e., to shift onto the government some of the risks of loss to which private lenders and producers with high debt/equity ratios are exposed;
- (3) guides sectoral mobility; and
- (4) provides political support if the government could adroitly use the financial systems to create social coalitions for its economic agenda.<sup>6</sup>

While Wade's persuasion may apply to the pre-1985 economy, economists in Taiwan generally agree that Taiwan's economy had undergone a major change since the mid-1980s and that the rigidity had probably outlived any usefulness.

The second consequence of government involvement in the banking sector is a duality in the financial system. On the one hand, there is the organized and regulated part of the financial system that includes financial institutions (which can be further divided into "money-creating" institutions and "non-money-creating" institutions) and financial markets (which can be further divided into the money market, capital market, and foreign

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<sup>6</sup>Robert Wade, "East Asian Financial Systems as a Challenge to Economics: Lessons from Taiwan," *California Management Review* 28, no. 4 (Summer 1985): 106-27. On a more general level, Oliver Williamson argues that sometimes hierarchy can be efficient. See Oliver Williamson, *Markets and Hierarchies* (New York: The Free Press, 1975). Of course, inspired by the two classics—Ronald I. McKinnon, *Money and Capital in Economic Development* (Washington, D.C.: Brookings Institution, 1973) and Edward S. Shaw, *Financial Deepening in Economic Development* (New York: Oxford University Press, 1973), the relationship between the financial system and economic development has been a subject of heated academic debates.



exchange market). On the other hand, there is an unorganized and unregulated curb market. The very reason for the financial duality is that the government through its heavy involvement in the banking sector has been able to artificially "repress" interest rates so that savings could be directed to economic sectors desired by the government. In order to achieve higher return than the banks can provide, some private capital flows to the curb market. On the demand side, the SMEs that cannot meet the banks' "pawnshop" requirements resort to this market in order to fulfill their needs for capital. The curb market accounts for nearly a quarter of all financial flows.<sup>7</sup> While being more effective than the organized and regulated part of the financial system, the curb market does have problems in terms of adverse selection, moral hazards, and costly contract enforcement. In addition, the government has no way to tax transactions in the curb market and the curb market can compromise the Central Bank's monetary policy.

The third consequence of government heavy-handedness in the banking sector is suboptimal allocation of financial resources. This suboptimality can be observed in two banking practices: the bias of loan decisions against SMEs and loan decisions sometimes based on political rather than banking considerations.

Because of the pawnshop mentality and practices in banking institutions, the SMEs are not considered good customers for loans because the SMEs are not in the same league as large private or state-owned enterprises in providing high-value collateral. By and large, however, SMEs perform better than the big boys in terms of creating job opportunities and contribution to foreign exchange earnings. Moreover, the SMEs' share of bank loans is consistently smaller than their share of gross domestic product (GDP) contribution and share of foreign exchange creation. SMEs rely more on the curb market for capital needs than do large enterprises.<sup>8</sup>

In the 1980s, Taiwan experienced net capital inflows in 1980-81 and

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<sup>7</sup>Central Bank of China, *Zhonghua minguo Taiwan diqu zijin liuliang tongji* (Flow of Funds in the Taiwan Area, ROC) (Taipei), various issues.

<sup>8</sup>"Reports on SMEs' Economic Activities," from Industrial and Commercial Census in the Taiwan Area Tape (Ministry of Economic Affairs, Small and Medium-Sized Business Administration, various years).

again in 1986-87. In 1980 the capital account balance was 5.4 percent of GDP, while in the three remaining years the proportion reached around 10 percent of GDP. The current account balance had all been in the black in the 1980s (with the exception of 1980). In the four years from 1984 to 1987, the current account balance as a percentage of GDP reached a double-digit plateau of 11.8, 14.8, 21.6, and 17.7, respectively.<sup>9</sup> The result has been a rapid expansion in the liquidity of the domestic banking system. In the meantime, the KMT government began to democratize Taiwan's political system, thus increasingly facing fierce electoral challenges from the opposition. One way for the KMT to overwhelm the opposition parties was to coalesce with big money interests to enhance the party's campaign war chest. Therefore, financial institutions under the aegis of the government would sometimes base their loan decisions on political considerations rather than on sound risk assessments. The politics involved in the loan decisions can take various forms, such as "moral persuasion" from the Ministry of Finance or lenient monitoring of problem loans to businesses with strong political connections.

With the background of Taiwan's banking institutions in mind, we now turn to the political economy of local financial institutions to illustrate Taiwan's banking problems in general.

### **The Political Economy of Local Financial Institutions**

Retreating to Taiwan in 1949, the KMT government seemed to be on its way to extinction. The United States had just issued a white paper jet-tisoning its longtime protégé. Taiwan's economy, much damaged during the Pacific War and now experiencing the rippling effect from the mainland's hyperinflation, was in shambles. The People's Liberation Army (PLA) was preparing a cross-Strait invasion, and the local Taiwanese were not—as usual—trustful of the mainlander-dominated regime. While long-

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<sup>9</sup>International Monetary Fund (IMF), *International Capital Markets* (Washington, D.C.: IMF, 1995), 111.

term survival was at best a long shot for the KMT government, survive it did. The breakout of the Korean War in 1950 certainly helped the KMT government's cause by strengthening Taiwan's international standing. On the domestic front, however, the KMT made itself viable by organizing a coalition with local factions. This coalition had since kept the KMT in power (until the presidential elections in 2000), despite the fact that the regime transformed from practicing "hard" to "soft" authoritarianism in the 1970s, or from "soft" authoritarianism to full democracy in 1987. In effectiveness, this coalition can be matched only by factionalism in Japan's Liberal Democratic Party. Since local financial institutions are pivotal to this coalition, a wholesale reform of these local financial institutions would run the risk of undermining the cornerstone of the coalition. We shall now elaborate on three aspects of this coalition: structure, social fabric of local financial institutions, and the effects of the coalition.

### *Structure*

A marriage of convenience with local factions helped the KMT in several ways. First, by opening local elections<sup>10</sup> the KMT could presumably make itself a showcase of democracy in sharp contrast with its arch-rival on the mainland. Next, local elections served as conduits for local political participation and at the same time the coalition with local factions made the election processes and results controllable. Winning local elections would give the KMT much-needed legitimacy in domestic politics.

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<sup>10</sup>National elections were not fully opened until Taiwan had well embarked upon the democratization process since 1987. The election for the National Assembly (國民大會 basically a constitution-amending body) was opened in 1991, legislative election in 1992, and direct presidential election in 1996. Before 1991 the National Assembly was staffed with tenured representatives whose natural constituencies were in mainland China. The Legislative Yuan was staffed with both tenured legislators (the majority) as well as newly elected legislators who went through periodical "supplementary" legislative elections since 1972. Elections of the Taiwan governor and Taipei and Kaohsiung city mayors—though considered as local elections—were opened in 1994 because these elections, like national elections, bore tremendous implications for the KMT's monopoly of power. The local elections that were opened immediately after 1949 were elections for the Taiwan Provincial Assembly, county magistrates and councils, metropolitan city councils (Taipei and Kaohsiung), mayors and councils of cities that fall within the jurisdiction of Taiwan Province, and township heads and councils. In terms of administrative level, the township is at the bottom, with counties and cities one notch above, and the trio of Taiwan Province and Taipei and Kaohsiung cities yet another rung above. On the top is the central government.

Lastly, due to its experience in the mainland, the KMT concluded that controlling society was of primary importance to regime maintenance. For example, Chiang Kai-shek once remarked, "Hereafter the party organization must delve deep into the society, infiltrate the mass public, and hence reform the society. This is the fundamental goal of the KMT reform."<sup>11</sup> The most feasible way to control Taiwan society, given the distrust of indigenous Taiwanese of the KMT regime, was through a partnership with local elites, given that large-scale violent repression was not cost-effective in the long run. For the local factions, joining the KMT as a minor partner was a default option, because the KMT had well demonstrated it had the will and means to crush any opposition.

The coalition between the KMT and local factions is one based on a patron-client relationship.<sup>12</sup> As the patron, the KMT required political support (mainly in the form of votes) from the local factions, the client. In return, the KMT would grant factions local monopoly businesses which included operations of credit cooperatives, farmers' associations, and fishermen's associations. Usually not many strings were attached to the granting of these monopoly businesses. The factions would in turn serve as patrons, responsible for providing particularized services to their clientele constituents.<sup>13</sup> The constituents would reciprocate by networking, campaigning, and mobilizing votes for the candidates supported by local factions and the KMT. Once the candidates were elected, they could further siphon off additional government resources to their constituencies, and the elected representatives, local factions, and the KMT could all claim credit for this distribution of favors.<sup>14</sup> Three devices underpinned this social contract.

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<sup>11</sup>Fu-ming Hsu, *Zhongguo Kuomintang de gaizao 1950-1952* (Reform of the KMT, 1950-52) (Taipei: Cheng Chung Book Company, 1986), 48.

<sup>12</sup>For a general theoretical treatment of this topic, see James C. Scott, "Patron-Client Politics and Political Change in Southeast Asia," *American Political Science Review* 66, no. 1 (March 1972): 92-113. For applications of this concept to the case of Taiwan, see Arthur J. Lerman, "National Elite and Local Politician in Taiwan," *ibid.* 71, no. 4 (December 1977): 1406-22; and Edwin A. Winckler, "National, Regional, and Local Politics," in Ahern and Gates, *The Anthropology of Taiwanese Society*, 13-37.

<sup>13</sup>For the variety of these services, see Szu-yin Ho, "Legislative Politics of the Republic of China, 1970-1984" (Doctoral dissertation, Department of Political Science, University of California/Santa Barbara, 1986), 145-49.

<sup>14</sup>This sort of behavior is not unusual even among advanced industrial democracies. See, for

The first is a "firewall" that exists between the electoral machine and the state bureaucracy. While the KMT was a major partner in its coalitions with local factions, the party had total control over the state bureaucracy. This allowed the KMT to use bureaucratic power to sanction any recalcitrant factions. For example, the KMT could selectively tighten up inspections of a local banking institution operated by an untoward faction. The second device is a delimitation of factional turf along the line of administrative units. This demarcation serves two purposes: for one, the factions could not coalesce to form a monopsony against the monopolistic KMT; for another, the local factions would not be free-riding on or offsetting each other when mobilizing votes for KMT candidates. If there is more than one faction in an administrative unit—say, a county, the KMT would "divide and rule," alternating its support between the factions, elections, or elective offices. The third device is a "socializing" of the distribution of money or merchandise involved with the patron-client relationship. For example, in addition to providing services to their affiliated farmers, the farmers' associations would help the farmers to arrange loans, purchase fertilizers, and sell their rice. The loans would be arranged through the credit departments of the farmers' associations, which would then deal with the Farmers Bank of China (中國農民銀行). Fertilizers would be purchased from the Taiwan Fertilizer Company (台灣肥料公司), a state monopoly firm, via the Taiwan Provincial Government's Food Bureau (台灣省政府糧食局). Rice grown by the farmers would be sold to government-licensed merchants who would then deal with the Food Bureau. The Food Bureau would then seek out the Central Trust for rice export issues.<sup>15</sup> Furthermore, the rice/fertilizer swap (carried out by the Food Bureau) and paddy field tax (田賦) in kind (rice, basically a tax on the farmers) provided enough food rationing for government employees. The government was therefore able to strengthen the loyalty of public servants.<sup>16</sup> This socializa-

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example, David R. Mayhew, *Congress: The Electoral Connection* (New Haven, Conn.: Yale University Press, 1974); and J. Mark Ramseyer and Frances McCall Rosenbluth, *Japan's Political Marketplace* (Cambridge, Mass.: Harvard University Press, 1993).

<sup>15</sup> A flow chart of this description could be seen in Chin-ching Liu, *Taiwan zhanhou jingji fen-xi* (An analysis on Taiwan's postwar economy) (Taipei: Renjian chubanshe, 1992), 147.

<sup>16</sup> The author thanks an anonymous reviewer for this valuable insight.

tion—or put another way, this lack of a free market—ensures the attachment of farmers to their associations. This certainly does not mean that the farmers' associations practice feudalism. On the contrary, successful land reform carried out during the 1950s had made the farmers independent.

### *The Social Fabric of Local Financial Institutions*

As mentioned in the first section, credit cooperatives in the urban areas since the Japanese colonial era had been the gravitational center of local elite. Over time these credit cooperatives grew into a critical mass, attracting more and more people and thus forming communities around them. There are three reasons for this social evolution. First, the repression of interest rates involved a hierarchical allocation of credits. In allocating the credits, top priority was assigned to state-owned enterprises or large private enterprises. The other consumers—the SMEs—were put on the backburner. One resort for the losers in the credit-rationing process was cooperatives (the alternative the curb market). Many sociological studies have pointed out that customers of the credit cooperatives would frequently develop habitual or emotional attachment to "their" cooperatives. Moreover, this is not lost on the cooperative management who, more often than not, emphasizes personalized services.<sup>17</sup> A second reason is that, according to banking regulations, the credit cooperatives have a lower required reserve for their deposits, and hence a lower cost of capital. Even so, the government was never serious in enforcing the lower reserve requirement. The credit cooperatives are therefore able to offer higher interest rates for the deposits and lower interest rates for the loans. Third, in the inception stage of the banking development, the banks set up branches mainly in the metropolitan areas, where industries and commerce were more prosperous than those in the suburban areas. This left a niche to credit cooperatives. Once the suburban areas caught up industrially and commercially, the credit cooperatives received a strong head start vis-à-vis the banks. For example, the four largest metropolises in Taiwan are Taipei, Kaohsiung, Taichung,

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<sup>17</sup>See, for example, Lin, "Local Finance and Society in Taiwan," 110-71; and Ming-tung Chen, *Paixi zhengzhi yu Taiwan zhengzhi bianqian* (Factional politics and political change in Taiwan) (Taipei: Yuedan chubanshe, 1995), 109-206.

and Tainan; the timing of their development is also in that sequence. The average share of the deposits of credit cooperatives to the total deposits in each of the four cities, from 1984 to 1991, were 5.5 percent (Taipei), 20.8 percent (Kaohsiung), 44.1 percent (Taichung), and 25.1 percent (Tainan).<sup>18</sup> Since Tainan is very close to Kaohsiung, these statistics generally fit the pattern that credit cooperatives are more active in emerging than in early-developed cities.

It should be noted that the political-economic context of credit cooperatives is based on a trinity: merging the citizen (those with a household registration in the administrative unit which licenses the credit cooperative), the customer, and the member of the credit cooperative. The citizen is a political agent for he/she votes in the elections; the customer is an economic agent who connects the local economy with the credit cooperative; and the member of the credit cooperative is a broker between the citizen and the customer, for only when a citizen joins the credit cooperative as a full member can he become a customer. This means that local factions who operate credit cooperatives can use this political-economic network as a channel for political mobilization.

While membership of credit cooperative is on a voluntary basis, membership of farmers' association is almost mandatory. Each farmers' association runs as a monopoly firm in an administrative unit, normally the township. The firm has both a board of directors (理事會) elected by members as well as an executive director (總幹事) chosen by the board that controls four departments of credit, distribution, sales, and insurance. Laws created the monopoly. The Farmers' Association Ordinance, promulgated in 1952, states that only one farmers' association can be set up in a township, the basic administrative unit. The Banking Law stipulates that the Farmers Bank of China can absorb savings in the rural areas and provide credits to agrobusiness.<sup>19</sup> This stipulation is interpreted as the legal basis for setting up a credit department in the farmers' association. The

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<sup>18</sup>Calculation is based on data provided in Lin, "Local Finance and Society in Taiwan," 115.

<sup>19</sup>In addition, an administrative ordinance by the Central Bank stipulates that the Taiwan Co-operative Bank (台灣合作金庫) and the Land Bank of Taiwan (台灣土地銀行) could take re-deposits from farmers' associations and credit cooperatives.



same law also grants almost unlimited power to the Ministry of Finance in deciding the branching of banking institutions, hence the credit department of the farmers' association is the only banking institution available in a rural area. Based on the laws or ordinances of this sort, the KMT government created many a local monopoly in farmers' associations.

To prevent the tail from wagging the dog, the KMT government put two leashes on the farmers' associations—one administrative and the other political. Administratively, major personnel and other decisions made by the farmers' associations are subject to the approval of agriculture and forestry-related agencies at the government one level above the administrative unit to which the farmers' association belongs. Politically, the KMT has packed the board of directors with party members in elections of the board. Of the 3,743 board directors elected in the first farmers' association board director election in 1954, 3,607 were KMT members—a whopping 96 percent. All the executive directors were KMT members.<sup>20</sup> Political control of this sort has been the rule in association board director elections.

The four functional departments in the farmers' association serve as the centers in their own right in a hub-and-spokes network in the rural areas. The credit department is responsible for various financial services, sometimes acting as a proxy for government-owned banks. The distribution department is assigned the task of doling out pesticides, fertilizers and agricultural machines, as well as inventorying and shipping produce and livestock. The sales department provides a wide variety of services, ranging from operating the 4-H clubs (四健會), transferring to the farmers agricultural technologies developed by government-sponsored research institutes, to providing home economics lectures to housewives and running nurseries. The insurance department takes care of the health insurance of the farmers and their produce and livestock. Of the four functional departments, the credit department is of primary importance, for the other three all need financing. As our descriptions demonstrate, the farmers' associations deal with many people on a day-to-day basis. The resulting social net-

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<sup>20</sup>Teh-fu Huang and Hwa-tzong Liu, "Farmers' Association and Local Politics," *Xuanju yanjiu* (Journal of Electoral Studies) (Election Study Center, National Chengchi University, Taipei) 2, no. 2 (November 1995): 65.



work is extremely efficient in mobilizing public opinion and votes in times of elections.<sup>21</sup> Safe is to say that the coalitions between the KMT and the local factions in the rural areas hinge upon the working of farmers' associations, which, in turn, revolve around their respective credit departments. The modus operandi of the farmers' associations is, by and large, applicable to fishermen's associations—and thus does not require elaboration.

Given the intimate interpersonal network of the credit cooperatives, farmers' associations, and fishermen's associations, unsurprising is that in managing these local banking institutions, sometimes the "old boys' club" would turn into an "old boys' flub." Of the twenty-nine runs suffered by the local banking institutions during the period 1995-96, 38 percent were due to rumors spread deliberately by rival factions who do not control the local banking institutions, 24 percent to large-scale embezzlements by executive directors as a result of lax internal supervision, 21 percent to the spillover effect of runs on other institutions, and 17 percent to poor management.<sup>22</sup> Technically, all the loopholes found in the management of local banking institutions could be fixed through changes in laws or regulations. However, the government has so far avoided an oversweeping reform of the system, instead simply employing stopgap measures to redress the problem. We argue that political concerns are behind this incremental approach to local banking institutions. To explicate these concerns we now turn to the effects of the coalitions between the KMT and local factions.

### *Effects*

Given the importance of local financial institutions to the coalitions between the KMT and local factions, one would expect that local factions would often try to stick their hands into the cookie jar. They did. Of the 108 local factions that were once alive or are still extant, 63 have been involved with the management of credit cooperatives (58.3 percent) and 53

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<sup>21</sup>For a vivid description of how opposition factions fight for the control of farmers associations, how contacts are made during the election campaign, and what techniques are used, see Hwa-tzong Liu, "The Changing Political Role of Farmers' Associations in Taiwan" (M.A. thesis, Department of Political Science, National Chengchi University, 1995; in Chinese).

<sup>22</sup>Jih-chu Lee, "Local Financial Institutions in Taiwan" (Manuscript, 1996), 18.

with the management of farmers' associations (49.1 percent).<sup>23</sup> One caveat is in order: that a local faction does not have control over local banking institutions does not mean that there were no incentives to enter into a coalition with the KMT. More often than not, various local factions have already been granted other local or regional monopolies, such as local transportation businesses.

The coalition was of great value to the KMT's holding onto power. Before the start of the democratization process in 1987, the ban on forming new parties had enabled the KMT to overwhelm the unorganized opposition in various elections. With the lifting of party ban, however, the KMT came to face an opposition of much higher caliber. We therefore will present aggregate data on the electoral fortunes of the major parties since 1986, using the legislative election in 1986 as the base line for comparison. Local factional activeness is generally in a reverse relationship with socioeconomic development. Thus, we classify the townships, cities, and districts (all at the same administrative level) according to their socioeconomic development along a five-category scale in descending order from metropolis, satellite area, emerging area, to declining area and remote area). This bivariate analysis shows that the KMT consistently fared better in less developed areas than it did in better developed areas and that vote shares by the two major opposition parties, the DPP and the New Party, were relatively constant across the five categories. The coalition works whether the polity is democratic or not.

Disaggregate data also demonstrate the importance of local factions to the KMT's electoral competition. In Taichung County Council (台中縣議會) elections in 1986, 1990, and 1994, 91.1 percent, 95.3 percent, and 97.2 percent, respectively, of KMT seats were occupied by members belonging to one of the three local factions active in the county. In the county's township chief elections held in the same years, a similar factional dominance was observed. The same pattern can be found in Kaohsiung County (高雄縣). In Kaohsiung County Council elections of the same

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<sup>23</sup> Calculation is based on raw data collected by Ming-tung Chen, in Chen, *Paixi zhengzhi yu Taiwan zhengzhi bianqian*, 277-95.

years as above, the proportions were 84.2 percent, 84.6 percent, and 91.7 percent; in township chief elections, the numbers were 91.3 percent, 82.6 percent, and 84.2 percent. In the elections for farmers' association board of directors in 1993, the KMT-seats-occupied-by-faction-members proportion was 100 percent for Taichung County and 97 percent for Kaohsiung County.<sup>24</sup>

## Conclusion

The above analysis shows that local financial institutions in Taiwan are a system full of moral hazards and agency problems. The local financial institutions base their loan decisions not on risk analysis but on network *guanxi* (關係 relations), knowing all too well that the government will bail them out should mishaps happen—a typical case of moral hazard. Before Taiwan embarked upon the democratization process in 1987, the KMT government as the principal could not make a true effort to supervise the local financial institutions as it needed the support of local factions to prop up regime legitimacy. Once democratization began, local factions gained bargaining leverage over their KMT principal as democratization vastly reduced the cost of the exit option for these local factions. Local factions could now play one political party off against the other. As the KMT lost its fifty-year-long grip on the presidency to its rival—the DPP—in 2000, some true reforms in this regard may finally be in sight. The DPP's electoral power is based on public appeals rather than on the support of traditional local factions, thus rendering the new administration more latitude to reform the local financial system. As of now, the reform has begun with the Ministry of Finance taking over the management of thirty-six local financial institutions that have experienced the worst liquidity problem.<sup>25</sup> The moral hazards are still here to stay, however, as the government announced the deposits would be guaranteed to one hundred percent. Politi-

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<sup>24</sup>Huang and Liu, "Farmers' Association and Local Politics," 71-75.

<sup>25</sup>*Gongshang shibao* (Commercial Times) (Taipei), July 22, 2001, 1-2.

cally, local factions do not necessarily lose their bargaining position vis-à-vis political parties once there is a change in government, for these factions can still elect their men into the legislature to articulate their interests. In addition, the property rights of these local financial institutions are still held firmly in place. The long-term effectiveness of the DPP government's reform initiatives is still uncertain.

The traits of local financial institutions could also be found in the banking system as a whole that includes banks of various sorts. Since 1998, several companies listed on the Taiwan Stock Exchange went under. Investigations show that all these companies had shady dealings with their major banks, thus causing tremendous problems for their banks once these companies became insolvent. There are moral hazards and agency problems in corporate governance of these companies as well. The KMT-centered political-economic-social order is again the root cause of Taiwan's looming banking crisis in recent years. As the banks' share of the financial market is much larger than that of local financial institutions, to clean up the banking system will be even more difficult. Japan and South Korea are two cases in point.

In this essay we have shown that the KMT in Taiwan has followed the dictum that rather than "growing out of the barrel of the gun," political power "grows out of the supply of credits." The KMT had succeeded in turning local financial institutions into political centers on which local elites depend for maintenance of their social distinction. Elections were a time for the KMT and its local allies to reaffirm their coalition. This political-economic nexus, which could be found in the banking sector in general, was what had deterred sweeping reforms of local financial institutions. Furthermore, the lack of determination to reform this KMT-centered political economy was probably what cost the KMT the presidential election in 2000 and, with it, a fifty-year control of government and other aspects of political life. Whether the succeeding DPP government can really clean up the banking system remains to be seen. This is an extremely difficult task, as the ideas and institutions undergirding Taiwan's banking system have been deeply rooted in politics, economy, and society for over half a century. A system of property rights has been well established. In this regard, North certainly has a point,

The informal constraints had gradually evolved as extensions of previous formal rules ... change is sometimes possible... but it ignores the deep-seated cultural inheritance that underlies many informal constraints. Although a wholesale change in the formal rules may take place, at the same time there will be many informal constraints that have great survival tenacity because they still resolve basic exchange problems among the participants, be they social, political, or economic. The result over time tends to be a restructuring of the overall constraints ... to produce a new equilibrium that is far less revolutionary.<sup>26</sup>

This is what we expect of possible changes in Taiwan's banking sector.

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<sup>26</sup> Douglass C. North, *Institutions, Institutional Change and Economic Performance* (New York: Cambridge University Press, 1990), 91.