New Financial Politics in Taiwan, Thailand, and Malaysia

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Abstract

Based on the analytical framework of new institutionalism, this project compares the financial politics and institutional relationships in Taiwan, Thailand, and Malaysia. Financial politics and institutions include both those of banking and security markets. The major finding is that the financial crisis in these three countries was a result of the oligopolistic alliance among the state, political parties, conglomerates, and local factions. The alliance excluded the direct participation of foreign financial institutions and caused the distortions of local financial markets. However, institutional similarities and differences among these three countries existed. In Taiwan, the KMT had continually controlled the state, and been a major player in the banking and security markets. Being controlled by the KMT, the state financial regulators, such as the Central Bank and Securities and Futures Commission, could not effectively monitor and punish violators of market rules. New conglomerates established new banks and security companies. They earned handsome profits via privileged information and avoided state regulations through their representatives in the Legislature. Local factions contributed to the deterioration of local financial institutions, because of their close connections with the KMT and conglomerates during elections. Both Thailand and Malaysia had a similar institutional system as in Taiwan. But in Thailand, a non-autonomous state, patronage party system, financial conglomerates, and expensive local factional politics caused the financial crisis. By contrast, Malaysia suffered less and recovered faster than Thailand did. This was due to the fact that the Malaysian state was relatively autonomous, the UMNO had dominated its members and opposition parties, local factional politics was weaker, even though privileged conglomerates had weaken Malaysian financial systems.

Keywords

Taiwan, Thailand, Malaysia, Financial Politics, Financial Crisis, New Institutionalism

A Crisis Lurking behind the Success

The 1997 Asian financial crisis revealed that Asian economic miracles are not all the same. The Taiwanese miracle looked more durable than those of other first-tier Newly Industrializing Economies (NIEs) such as South Korea, Hong Kong, and Singapore, as well as those of the second-tier NIEs such as Malaysia, Thailand, and Indonesia. Many Taiwanese economists, then, rushed to find the economic reasons for Taiwan's resilience. These reasons included a successful industrial upgrading in the late 1980s, the prevalence of small and medium-sized enterprises, high domestic savings, a sound corporate financing, diversified export markets, and a foreign exchange reserve of over US$900 billion.[1] It is true that, in terms of growth rates, Taiwan did better than its Asian neighbors after the crisis broke out. Taiwan registered a 4.9% growth rate, as compared to Korea's -7.0%, Hong Kong's -5.0%, Singapore's 0.7%, Malaysia's -7.5%, Thailand's -8.0%, and Indonesia's -15.3%.[2]

However, lurking behind the cozy growth rates were serious structural problems in Taiwan's credit and stock markets, which were reflected by other indicators. Taiwan's stock price indexes dropped 33.7% from June 1997 to June 1998, which was lower than Hong Kong's -37.4%, Malaysia's -45.1%, and Indonesia's -43.1%, but higher than South Korea's -23.3%, Singapore's 28.2%, Thailand's -31.2, and the Philippines' -30.4%. The figure after June 1998 was even worse for Taiwan: Taiwan registered a continuous drop of -20.7%, while all other Asian neighbors registered two-digit growth rates between 11.0% (Philippines) and 91.8% (South Korea). Even Indonesia's figure of -7.6% looked more benign than Taiwan's. The exchange rate fluctuations told a similar story in comparison. From June 1997 to June 1998, the Taiwan dollar depreciated 13.9%, a drop greater than Hong Kong's 0%, a little smaller than Singapore's -15.3%, and much smaller than those of all other Asian countries. However, most of the currencies of other Asian countries bounced back faster than Taiwan's after June 1998. The Taiwan dollar's exchange rate appreciated by 6%, higher only than Singapore's 1.1% and Hong Kong's 0.1%, and lower than South Korea's 14.4%, Thailand's 12.9%, Malaysia's 7.5%, and Indonesia's 39.3% (*Central*

[1] Paul C.H. Chiu, "ROC's Experiences in Responding to the Asian Financial Crisis," *Economic Review*, International Commercial Bank of China, no.304 (1998), pp. 1-7; Jiatong Shea, "Taiwan and the Asian Financial Crisis," *The Central Bank Quarterly*, no.20(June 1998),pp.5-10; International Monetary Fund (IMF), *World Economic Outlook* (Washington, DC: IMF,1998).
[2] See IMF, *World Economic Outlook*.

Bank of China 1999).[3]

The durability of the Taiwanese miracle was further undermined by two more facts. One is that Taiwan had similar financial crises before the 1997 crisis broke out. Since 1990 Taiwan had experienced almost yearly stock market crashes (averaging drops of about 44% in value). The other is that, in the period of 1997-1998, George Soros was present neither in Taiwan's stock market nor in its foreign exchange market. Nor was foreign capital important in Taiwan's stock market. Because of tight regulations, foreign capital constituted less than four percent of the total market value in early 1999.[4]

I do not suggest that international factors played no role in Taiwan's crisis in 1997-1998. Indeed, the reduction of trade with other Asian nations and a competitive devaluation pressure after July 1997 caused substantial damage to the trade-dependent Taiwanese economy. However, these international factors alone cannot well explain those economic crises before 1997 and the stagnation of the non-trade sectors after 1997 in the Taiwanese case, for which domestic institutional factors are probably a better explanation.[5]

Why Did Malaysia Do Better Than Thailand?

This paper also aims to provide a political-institutional explanation for why the relatively dynamic economies of both Thailand and Malaysia suffered devastating blow from the 1997 financial crisis, and why Malaysia seemed to suffer less and recovered faster than Thailand did. In terms of the initial impact of the crisis on the economy, Thailand's real GDP growth rates for 1997 and 1998 were -1.3% and -9.4% respectively, as compared to its impressive averaged annual growth rate of 9.6% between 1986 and 1996. Its foreign exchange reserves were almost depleted from about US$30 billion in the mid-1990s to US$0.8 billion in August 1997. Thai currency depreciated from 26 baht to a dollar in March 1997 to 54 baht per dollar in

[3] Central Bank of China. 1999. *Monthly Report of Financial and Statistical Data, Taiwan, January 1999.* Taipei: Central Bank of China.

[4] *United Daily News,* February 20, 1999, p.1.

[5] Yunhan Chu also offers a political-institutional explanation for the Taiwanese case. However, he underestimates the problems in the credit and stock markets, while overestimating the autonomy and capacity of the Taiwanese state. See Yunhan Chu, "Surviving the East Asian Financial Storm: The Political Foundation of Taiwan's Economic Resilience," in *The Politics of the Asian Economic Crisis,* ed. T.J. Pempel, (Ithaca, NY: Cornell University Press, 1999).

January 1998. The index of Securities Exchange of Thailand dropped from 705 points in March 1997 to 459 points a year later.[6]

In Malaysia, its real GDP growth averaged 8.7% from 1991 to 1996. In 1997 and 1998, the growth rates were 7.8% and -7.5%. Malaysia's currency, ringgit, fell from RM2.5 per dollar in July 1997 to RM4.88 a dollar in January 1998, a loss of almost 50% of its value. Its foreign exchange reserve fell from US$28 billion in June 1997 to US$11.7 billion in May 1998. The KLSE stock market index fell from 1271 in February 1997 to 477 in January 1998; the market value of stocks lost about 66%.[7]

In terms of recovery, Thailand's GDP registered a positive 4.2% in 1999. Its currency rebounded to 37.8 baht to a dollar (45% of its pre-crisis value), foreign exchange reserves increased to US$31.9 billion, and stock market index rose by 12% as compared to the previous year. By contrast, Malaysia seemed to have a stronger recovery. Its GDP grew by 5.4% in 1999, ringgit's exchange rate rose to 3.8 per dollar (54% of its pre-crisis value), the amount of foreign exchange reserves was US$32.2 billion, and the stock market index rose by 79% as compared to the previous year.[8] The Malaysian recovery was even more impressive given the fact that it did not ask for financial assistance from the International Monetary Fund (IMF). On 20 August 1997, when both the baht and Thai foreign exchange reserves hit the bottom, Thailand received from the IMF a $17 billion rescue loan (out of the $50 billion multiyear package loan).[9]

Focusing on international factors, economic explanations for the Asian financial crisis have come from both left and right. The leftists, represented by Bello, blamed the Asian financial crisis on too much and too fast capital liberalization. [10]The rightists, represented by the IMF, criticized the Asian countries for too little and too slow liberalization. This paper suspects that both criticisms might have missed the target. [11]The fact that serious financial crises had occurred in both Thailand and

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[6] www.mof.go.th/ther_2/index_ther.html, 4/12/2000; *FEER* 7/9/98, 67.

[7] Neac.gov.my/neac/publications/curr.shtml, Neac.gov.my/neac/publications/action3r.shtml, 4/12/2000.

[8] Taiwan Economic Research Institute, 1999, 2000, *Guoji Jingji Dongtai Zhibiao* (Indicators of International Economic Currents), Nos. 564, 580, Taipei.

[9] In 1997 and 1998, both Thailand and Malaysia received bilateral aid from Japan. However, due to Japan's larger investments in Thailand than in Malaysia, Thailand received more than three times the amount of aid than Malaysia did (www.mofa.go.jp/policy/oda/summary/1999/d_g2_02.html, 7/10/2000).

[10] Walden Bello,."East Asia: On the Eve of the Great Transformation?" *Review of International Political Economy*, Vol.5, No.3 (Autumn 1998): 424-44.

[11] Stanley Fischer, "The Asian Crisis: A View from the IMF." Address at the Midwinter Conference of the Bankers' Association for Foreign Trade, Washington, DC, January 22, 1998.

Malaysia before 1997 suggests that the 1997 financial crisis be in large part due to domestic reasons. The financial attack by international speculators, such as George Soros, was only the last straw breaking the camel back. In the early 1990s, Thailand's economy ran into deep recession due to overheated investment in the real estate and stock market. In Malaysia, the economy suffered from high ratio of non-performing loans in the mid-1980s. Therefore, the major cause of the Asian financial crisis is more domestic than international. This domestic cause is the rise of new financial politics in these Asian nations.

New Financial Politics and New Institutionalism

For many Third World countries, a new breed of financial politics emerged in the 1980s, which gradually replaced the old industrial and financial politics and became the cornerstone of political economy in these countries.[12] Susan Strange has analyzed in detail the rise of international "casino capitalism" in the 1980s, which caused significant declines of state power over the financial capitalist in Western countries.[13] With the proliferation and fast expansion of financial instruments in world markets, capital became divorced from production and assumed a life of its own. This financial revolution made possible that profits derived from capital transaction could be independent from and larger than industrial or agricultural production. Also, a distinctive nature of the international capital flow after the 1980s was the dominance of freewheeling private capital over public loans, which were closely monitored by governments and the IMF. The rapid expansion of private capital greatly increased the instability of domestic and international financial systems.[14]

The political and economic impact of the new financial revolution is most prevalent on Third World countries and has also generated significant differences

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www.imf.org/external/np/speeches/1998/012298.htm.

[12] The most representative work on the old financial politics is probably the book edited by Stephan Haggard, Chung H. Lee, and Sylvia Maxfield, eds., *The Politics of Finance in Developing Countries* (Ithaca, NY: Cornell University Press, 1993). The old financial politics refers to the politics involved in the distribution of credit to industrial production, while the new financial politics is different not only in terms of sectors (banking, securities, and foreign exchanges) but also in terms of institutions. For the sake of simplicity, I treat the old financial politics as part of the industrial politics. Financial politics is also different from money politics in that the former refers to state-business connections in the financial businesses, while the latter is not restricted to financial businesses.

[13] Susan Strange, *Casino Capitalism* (Oxford, U.K.: B. Blackwell, 1986).

[14] Miles Kahler, "Introduction: Capital Flows and Financial Crises in the 1990s." In Miles Kahler, ed. *Capital Flows and Financial Crisis* (Ithaca, NY: Cornell University Press, 1998).

between the old industrial politics and the new financial politics. Table 1 summarizes the relative differences between industrial production and financial business (mainly banking, security investment,[15] and foreign exchange transaction). Based on the comparison between industrial production and financial business, Table 2 contrasts the differences between industrial politics and financial politics.

[Table 1 about here]

In the past, capital and labor were treated equally as the main production factors. Neither alone can generate profit for the owner. For most Third World countries, their comparative advantage in labor-intensive industries means that their capital/labor ratio is relatively low. Industrial production requires land to build factories and materials to produce final products. The major technology form exists in machinery. The transportation of voluminous materials, machinery, and final products necessarily incurs various costs and risks. Once the products are made, they needed to be marketed and sold to downstream producers or consumers, which again incurs certain costs and risks. The profit maturity is comparatively long between the production order is received and the final profit being realized. For instance, an industrial firm may receive an overseas order in the winter, look for materials, loans, workers, and machinery in the spring, process the materials in the summer, ship the products to overseas markets in the autumn, and finally receives its payment in the winter. The profit margin for standardized labor-intensive products, which most Third World exports consist of, is usually low between 3% to 6%. While the profit margin is low, the demand for such low-end industrial products is often quite stable, thus creating stable income streams for producers.

By contrast, financial business (e.g., banking, security investment, and foreign exchange transaction) requires a relatively large amount of capital and small number of employees (composed mainly of financial analysts, accountants, and lawyers). This results in a relatively large capital/labor ratio for the financial business. It requires relatively little office space and almost no material inputs. The main technology form is the information about various financial markets and the knowledge to conduct

[15] "Security" is a broader term than "stock." Securities consist of government bonds, corporate debentures, shares (stocks), and a few other financial instruments. Except for specific identification, "security" and "stock" will be used interchangeably.

financial transactions in particular business environments. Because of the development of modern communication system, the transfer of capital across borders incurs very little physical cost and risk - those caused by unexpected political interference excluded. The profit margin in financial business is relatively large. Security investments in matured economies can expect a return of more than 10%. It is usually higher in those fast-growing economies. Foreign exchange speculation can generated even higher returns as evidenced by the windfall profits earned by international speculators in the European currency crisis in the early 1990s and the Asian currency crisis of 1997. High profit margin also means great instability in income stream, which is the nature of the casino capitalism Susan Strange referred to.

These significant differences between industrial production and financial business lead to quite different dynamics between industrial politics and financial politics. Table 2 summarizes these differences.

[Table 2 about here]

In developing countries, the implication of low capital/labor ratio for industrial politics centers around class politics, e.g., the encouragement of entrepreneurship, the allocation of scarce capital, and the suppression of or compensation for the labor, which expands with labor-intensive industrialization. Class politics occurs when the state decides to which entrepreneurs the incentive policies will apply, and whether the state chooses to suppress or compensate the workers. Industrial entrepreneurs will lobby for assistance from the state to resolve problems of land acquisition and material imports. The assistance can take the form of low taxes on land acquisition or use, redrawing of zoning areas, and low tariffs on material imports. Political maneuver is required in the formulation and implementation of all these policies. Since most of the technology of industrial production in developing countries is imported, entrepreneurs can lower their cost of production by asking for low tariffs on technology imports. The politics of tariff adjustment is involved again. The import of machinery, raw materials, and the export of final products require reliable and efficient transportation systems. Therefore, the state needs to engage in long-term and extensive infrastructure building. Politics occurs during infrastructure project design, contracting, and implementation process. Since most developing countries do not have the capacity to do marketing and retailing in world markets, the cost and risk of marketing is handled by trading companies from industrialized countries or by OEM (original equipment manufacturing) arrangements with foreign buyers. Because the maturity of profit for industrial production is relatively long, entrepreneurs need state assistance in the provision of hard currencies to buy raw materials, technology, and to pay workers, taxes, and transportation costs. The politics of preferential loans emerges at this juncture. The profit margin for industrial production is relatively small for the standardized export products of developing countries. Therefore, if entrepreneurs intend to maximize their profit, they need to engage in tax evasion or the lobbying for low taxes at all stages of production. Finally, since the profit of industrial production is often determined by world market fluctuation, the government can help the industries to weather the market fluctuation through assistance measures. This leaves a large room for political decision as to which industry or firm, and how much the assistance should be provided. State assistance may not come when the collapse of a few firms does not affect the industry as a whole, or when the collapse of a few industries (e.g., sunset industries) does not seriously affect the whole economy. If the state does provide assistance, other firms or industries may form political pressure to stop or to expand such assistance, thus, enlarging the state's political cost for such action.

By contrast, financial business entails a different set of political consideration and behavior. Class conflict is diffused because winners and losers in the financial business are determined less by their class nature than by their asymmetrical access to privileged information. Due to the high capital/labor ratio, the state faces less pressure from the employees of financial business than that of labor-intensive industries. Even if it does, political pressure generated by the white-collar employees of financial business may be less explosive than that of industries. Financial politics emerges when owners of financial business need the state's assistance to expand their capital supply via loose monetary policies or expanded business activities. The lobby activities will concentrate in a few monetary and regulatory agencies of the state. The financial business does not need to spend much political effort to acquire land and resources. Because the technology form of financial business exists in knowledge or information, owners of financial business will compete for privileged information in order to maximize their profits. Political bargaining occurs between financial business owners and a few monetary and regulatory agencies. Since there is little transportation cost and risk associated with financial transaction, little politics is involved here.

Similar is the politics associated with marketing cost and risk. Due to its relatively short profit maturity, the success of financial business is highly dependent on privileged information from the state. The legitimate profit margin of financial business is relatively large, especially that of the security market. However, financial business owners can further maximize their profit by manipulating accounting and tax information. The politics occurs when the state decides to enforce its regulations or to collaborate with the financial business owners by cooking the accounting books. Even for the banking business in which interest rates are regulated by the state, the profits generated from manipulating collateral assessment, lenient loan standards, and distorted accounting procedures can be enormous. Also, to protect this large profit from competitors, existing owners will lend strong support for market entry restrictions, especially against foreign players. Finally, since financial business provides capital to all other businesses in the economy, and it is sensitive to contagion effect, the state has little choice but to offer quick and comprehensive assistance to the financial business when a major financial crisis occurs. The political cost for such assistance is widely distributed across the unorganized taxpayers through tax increase, or to the future taxpayers through long-term government bonds.

From the above comparison, financial politics stands out differently from industrial politics in terms of the small number of key decision-makers involved, large and unstable profit, and relative simplicity of state-business interaction. It addresses to the major concerns of new institutionalism more than industrial politics does.[16] In developing countries where the public/private sphere is not clearly divided, financial politics offers a fast track to fame and fortune. All it takes is to engage in the collection of privileged information from the state and to prevent the state from effectively implementing its monitoring and enforcement mechanisms. The collective action of collusion is relatively easy to reach since the number of key decision-makers is small, while the cost of collusion is evenly distributed across the unorganized or future taxpayers.

As suggested by Haggard and Maxfield in their analysis of the financial politics

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[16] This paper follows the neo-institutional analysis. The major works include: Sue E.S. Crawford and Elinor Ostrom, 1995, "A Grammar of Institutions." *American Political Science Review*, 89 (3 September): 582-600; Douglas C. North, *Structure and Change in Economic History* (New York：W.W.Norton, 1981); Douglas C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge：Cambridge University Press, 1990); Oliver E. Williamson, *Markets and Hierarchies：Analysis and Antitrust Implications* (New York: The Free Press, 1975); Oliver E. Williamson, *The Economic Institutions of Capitalism* (New York : The Free Press, 1985).

in Third world: "the effectiveness and efficiency of government action depend heavily on the 'disciplinary capacity' of the state and that no general rules on the benefits of liberalization can be established without reference to the broader institutional and political milieu."[17] The actual operation of financial politics may vary across developing countries according to the internal attributes of and interaction among the institutional actors of the state, political parties, conglomerates, and local factions. For the state, I will examine the political independence and administrative capacity of the regulatory agencies for financial business, i.e., the central bank, the finance ministry, and security exchange commission. However, the independence and capacity of regulatory agencies does not come out automatically, it is formulated and conditioned by party politics. The nature of the ruling party and the relationship between the ruling party and opposition parties may define the scope and intensity of financial politics.

Since the state is rarely insulated from the society in most developing countries, the power and composition of the conglomerates may affect the operation of financial politics, which by nature is a game for the chosen few. With the "Third Wave of Democratization" knocking on the door of developing countries, elections become more competitive for political parties. Local factions, which serve as canvassers of votes, may affect the election outcome one way or the other. In order to pay off the local factions for both legitimate and illegitimate vote canvassing in increasingly competitive elections, ruling political parties are more likely to expand the room for financial politics to cover campaign expenses. Finally, similar to protectionist industrial politics, financial politics is prevalent when the domestic financial markets are concentrated and when foreign financial players are restricted or excluded from the markets.

The following sections will compare the cases of Taiwan, Thailand and Malaysia to elucidate the above theoretical arguments. The time period being examined is from the 1980s to the 1990s, with more emphasis on the 1990s. The last section summarizes the comparison and draws policy implications for financial reforms.

Major Actors and Their Institutional Attributes in

[17] Stephan Haggard, Chung H. Lee, and Sylvia Maxfield, eds., *The Politics of Finance in Developing Countries*, 295.

Taiwan[18]

I define the scope and major arguments of this paper in the following ways. First, among Taiwan's financial markets, I study the credit market and the stock market, excluding the insurance market and the informal financial market. In the credit market, the major actors are individual and corporate borrowers, public and private banks, foreign bank subsidiaries, credit unions, farmers' and fishermen's associations (their credit departments), as well as their regulators such as the Central Bank, the Ministry of Finance, the Legislature, and related semi-public enterprises. In the stock market, the major actors include individual and corporate investors, stock and investment companies, foreign investors, and government funds, as well as their regulators. In addition to these actors, our research focus and major arguments concentrate on those formal and informal institutions, which influence and constrain the interactions among these actors. Formal institutions include relevant constitutional provisions, laws, executive orders, and organizational structures. Informal institutions consist of norms, habits, and mutual expectations. These actors and institutions together constitute the Taiwan financial markets of this paper.

Secondly, the KMT (Kuomingtang, the nationalist party) maintains more cooperative than conflictive relationships with other major actors in the financial markets.[19] I assume that the ultimate organizational goal of the KMT is to maintain its status and privileges as the ruling party. Although internal conflicts exist within the party, the KMT must suppress them and has successfully done so in order to mobilize enough votes in elections. In Taiwan's peculiar electoral history, rules, and culture, this means the KMT has to pump in massive amount of money to engage in legal (e.g., propaganda) and illegal (e.g., bribing voters and vote-collectors) mobilization activities.[20] Where does the money come from? Since political liberalization began

[18] This section is a revised version of Chengtian Kuo, Shangmao Chen, and Zonghau Huang, 2000, "The Politics of Taiwan's Financial Reforms." Manuscript.
[19] On Taiwan's institutional relationships among the state, the KMT, conglomerates, and local factions, see Chengtian Kuo, and Tzengjia Tsai, “Differential Impact of the Foreign Exchange Crisis on Taiwan, Japan, and South Korea.” *Issues and Studies,* 34(11/12, 1998), pp.144-180.
[20] Central to Taiwan's electoral history, rules, and culture is the single-nontransferable-vote rule (SNTV). The island is divided into many medium-sized electoral districts. Each district can elect one or more representatives, depending on the size of the district. The SNTV system encourages the formation of local factions for vote mobilization. Vote-collectors (zhuangjiao) are those local vote-mobilizers who, through their networks of relatives and friends, can deliver a guaranteed amount of votes for candidates.

in the 1980s, the clandestine transfer of government funds to the KMT's coffers has been greatly reduced, due to the enhanced monitoring by opposition legislators. Alternatively, through its expanded party enterprises,[21] the KMT began to find profit opportunities from the enlarged and lucrative financial markets in order to finance rising campaign expenses. Party legislators, bureaucrats, and KMT party enterprises assumed the responsibility of fund raising. The KMT has manipulated various formal and informal institutions to extract campaign funds at the expense of the public, and thus contributed to the major distortions of Taiwan's financial markets.

Thirdly, the state has become both a passive and active collaborator in distorting Taiwan's financial markets. During the martial law period, the bureaucracy dominated the Legislature in the economic policymaking process. Furthermore, the scale of and the number of participants in the financial markets were small. Laws and regulations governing the financial markets were few and simple. However, by the end of authoritarian rule, the Legislature had asserted its control over the bureaucracy. The bureaucracy became increasingly subject to the political influence of legislators and had to tolerate, and even collaborate with, the distortions of the financial markets. Critical among the government bureaucracies is the Central Bank, which since the 1970s has lost its financial leadership and political independence. Taiwan's current political environment does not allow for administrative neutrality. The bureaucracy will continue to tolerate the market distortions, with occasional implementation of superficial reforms. But when major economic crises occur, a committed new leader emerges, or the ruling party changes hands, the bureaucracy will be able to reclaim its neutrality and effectively monitor and regulate the financial markets.

Fourthly, Taiwan's conglomerates grew rapidly in the mid-1980s and have become major players in Taiwan's policy-making process.[22] Those conglomerates, which make profits based on market protection or government licensing, tend to become actively involved in politics in order to protect or expand their established interests. These business activities include real estate development, construction, petrochemicals, steel, transportation, insurance, stocks, and banking. These

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[21] Lizhen Qiu, "Guomingdang Dangying Jingji Shiye Fazhan Lishi Zhi Yenjiu 1945-1996" [A Study of the History of the KMT Economic Enterprises 1945-1996] (MA. Thesis, National Taiwan University, 1997) and Ganlin Xu , "Zhenzhi Zhipei Huo Shishang Luoji" [Political Domination or Market Logic]. *Taiwan Shehui Yenjiu Jikan* 28 (December 1997), pp. 175-208, provided detaile studies of the history of the KMT enterprises.

[22] For a succinct history of Taiwan's conglomerates, see Chenpu Duan ed., *Taiwan Zhanho Jingji* [Taiwan's Postwar Economy] (Taipei: Renjian, 1994).

conglomerates influence policymaking through campaign contributions to friendly legislators, or by sending their own representatives to legislative bodies at various levels. These representatives then dominate the relevant committees, assuming the roles of both umpire and player. In addition, these representatives can take advantage of the supervisory role of the legislature over the bureaucracy in order to influence the implementation of specific laws. Since there is no effective norm or law governing the conflict of interests at various levels of representative bodies, the political and economic influence of conglomerates will continue to grow in Taiwan's political economy.

Due to the nature of financial transactions, the distorting influence of conglomerates is most prominent in these financial markets. In contrast to the importance of fixed capital in agricultural, mineral, and manufacturing production, the access to and control over relevant information is critical to the operation of financial markets. In the credit market, information access and control will affect the credit of borrowers and the value of collateral, the trust of depositors on banks, and the supervision of government agencies over credit institutions. Similarly, in the stock market, information access and control will influence stock prices and the ability of government agencies to monitor illegal trading activities. I do not suggest that conglomerates can always get access to the right information and process it correctly. Nor do I suggest that conglomerates have no conflict of interests among them. I do suggest, however, that by establishing strong political and economic networks, Taiwan's conglomerates have much better access to these kinds of information than average economic actors, and have made exorbitant profits at the expense of the latter.

Fifthly, during the authoritarian rule, Taiwan's local factions played a critical role in local elections (at the provincial, county, city, and town levels).[23] In order to maintain its legitimacy, the KMT had to form a patron-client relationship with local factions. With democratization proceeding rapidly in the 1980s and 1990s, the political influence of local factions expanded as well, and spilled over to the financial markets. So far, however, the influence (and distorting effect) of local factions has been limited to local credit markets, such as credit unions, farmers' associations, and fishermen's associations. They have had only very limited or indirect influence over the national credit and stock markets. Therefore, this paper will not elaborate on the

[23] For the classic text on Taiwan's factions, see Mingtong Chen, *Paixi Zhengzhi Yu Taiwan Zhengzhi*

role of local factions, except in the case of local credit market.

Finally, financial liberalization is skewed in Taiwan's financial markets. The liberalization of capital flow proceeded at a fast pace in the 1980s. But various investment barriers have persisted against those foreign firms that intend to build up market networks in Taiwan. These investment barriers include the limitation on foreign ownership of local banks and stocks, high capitalization requirements, the limited scope of business activities, etc. The constraints imposed on foreign firms in the financial markets have protected local banks and stock companies from significant competitive pressure. But the "hot money" circulating in the financial markets has indirectly served to aggrandize the influence of the oligopolistic alliance, which is the dominant player in the markets.

Figure 1 summarizes the above description of major actors and their relationships.

[Figure 1 about here.]

Distortions in Taiwan's Financial Markets

This section will describe the distortions in Taiwan's financial markets, including both the credit market and the stock market. The main problems with the credit market are the high percentage of non-performing loans, the expansion of bad loans, and the frequent occurrence of bank-runs. The major problem with the stock market is its frequent and large price fluctuations, a detailed description follows.

The Credit Market[24]

By February 1999, the average percentage of non-performing loans[25] in Taiwan's seven largest public banks was 4.91%, about US$9.45 billion, a new record in

Bianqian [Factional Politics and Taiwan's Political Development] (Taipei: Yuedan ,1995).

[24] In Taiwan, the official definition of credit (financial) institutions include domestic (large) banks, medium business banks, local branches of foreign banks, credit unions (cooperative associations), farmers' associations (their credit departments), fishermen's associations (their credit departments), investment and trust companies, postal savings system, and life insurance companies, see *Taiwan Statistical Data Book,* (1998), pp.149-50.

[25] According to the revised definition of the Ministry of Finance, non-performing loans include two parts: one is the amount of principals not paid back on due days; the other is the amount of loans whose interest has not been paid for more than three months. The percentage of non-performing loans is the amount of such loans divided by the total amount of all loans. See Xuewen Li “Sheme Shi Yufang Bilu” [What is the Percentage of Non-Performing Loans?], *Shangye Zhoukan,* no.501, (1997), p.64..

Taiwan's banking history.[26] The sixteen new private banks accumulated on average 3.49% non-performing loans in their portfolio, totaling about US$2.37 billion.[27] These numbers will continue to rise, as many of these loans were used indirectly to finance failed stock speculation last year[28] and the economic toll of the September 21 earthquake skyrocketed.

Although these numbers were relatively small as compared to those of other Asian countries (all exceeded 10%) after the exchange crisis broke out, the comparisons should also be made within the country. Before 1993, the average percentage of non-performing loans in Taiwan's private and public banks was kept below 1%. By 1994, the percentage had increased to 1.5%, and it increased by 1% per year afterwards to 4.47% in 1998.[29] At that rate, the percentage will approach those of other Asian countries in just five years. The earthquake of September 21 will be gas on the fire.

The worsening of the credit structure was even more serious at the local level. According to statistics published by the Central Deposit Insurance Corporation of the Finance Ministry, the average percentage of non-performing loans in farmers' associations was 6.7% in 1996. The number increased to 9.2% in 1997, and 11.7% in 1998. The same statistics for credit unions increased from 6.13% in 1996 to 7.8% in 1998. The total amount of such loans was estimated to be over US$5 billion.[30]

As a result of the increase in non-performing loans, the amount of bad loans rose sharply. The amount of bad loans is calculated by the difference between the amount of non-performing loans and the amount of collateral attached to the loans. Before the 1980s, Taiwan's banks adopted very stringent collateral conditions for loans. Loans required collateral (real estate, machinery, liquid assets, etc.) of about the same value as the amount of the loans, and banks usually deliberately undervalued these assets. Therefore, banks incurred very little loss even if borrowers were defaulted. Since the 1980s, however, due to the institutional factors discussed in the next section, banks began to relax the collateral conditions by lowering the value requirement and by more generously assessing the value of collateral. Furthermore, as stock market transactions expanded in the 1980s, banks began to accept stocks as collateral.

[26] For simplicity, the exchange rate between the US dollar and the Taiwan dollar is calculated at 1:32.
[27] In 1992, the government allowed the establishment of new private banks. Before then, most of Taiwan's banks were state-owned.
[28] *China Times*, March 16, 1999, p.1.6.
[29] <http://www.cbc.gov.tw/magazine/index.html>, April 1998.

Therefore, when the stock market crashed in 1998 and stock prices tumbled by half, the banks wound up with a larger amount of bad loans than they expected. By the end of 1998, a conservative estimate of the amount of bad loans of all banking institutions (national and local) was about US$94 billion, half of the total amount of non-performing loans.[31]

In September 1998, as a result of the increase of non-performing loans and bad loans, Moody's Investors Service downgraded the credit ranking of Taiwan's ten banks.[32] Uncertainty in the credit institutions have led to twenty five bank-runs at national banks and local credit institutions, an average of about once every other month, since August 1995.[33]

The Stock Market

Taiwan's stock market was established in 1962. But its size and the number of participants were small before the mid-1980s. The stock market indices were below 1,000; the total stock value was no more than US$17 billion; and fewer than 474,000 people participated in the market. Since 1987, the year the martial law was lifted, stock prices have inflated rapidly. In February 1990, the stock market index reached its all-time high of 12,682, the total stock value was more than US$193 billion (1989 figure), and more than 4.2 million people became stock buyers. But in the next eight months, the index fell to 2,485, and the total stock value fell by 56.6% to US$83.8 billion. The 1990 stock crash was not unique in Taiwan's stock market. From 1990 to 1998, there was on average one big crash every year. The average percentage of the drop in value was about 44%.[34]

In addition to the above statistics, four sets of statistics reveal the weaknesses of Taiwan's stock market. First, from 1988 to 1997, Taiwan's stock turnover rate averaged about 350%, much higher than its counterparts in Singapore, Hong Kong, New York and Tokyo, where the number was usually below 100%. The high turnover

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[30] See <http:/www.cdic.gov.tw/list.html>, April 1999; and *China Times,* March 30, 1999, p.1, 6.
[31] *China Times*, March 10, 1999, p.1.
[32] Shuping Ren, “Yinhang Yingjianye Mianlin Yanzhong Chongji” [Banks and Construction Companies Facing Serious Challenge], *Shangye Zhoukan,* no.564 (1998), pp.31-32.
[33] See Ruixiang Wang, “Gaixuan Fengbao Zheng Weixie Nonghui Jinrong” [Re-election Storm Is Threatening the Finance of Farmers' Associations], *Shangye Zhoukan*, no.476 (1997), pp.30-32; and *United Daily News,* July 8, 1999, p.3
[34] Renhe Lin, *Gupiao Touzi De Weiji Chuli* [The Crisis Management of Stock Investment] (Taipei: Lian-Jing, 1998); and Taiwan Stock Exchange Corporation on the Internet at < http://w3.tse.com.tw>, March, 1998.

rate means that most of Taiwan's investors are short-term speculators. Secondly, the stock price/dividend ratio for the same period of time averaged about 32:1, lower than Japan's 54:1, but higher than those of Hong Kong, Singapore, South Korea, and New York, all of which were below 20:1. The high price/dividend ratio implies that Taiwan's stocks are over-priced. Thirdly, from 1988 to 1997, about 28% of investors' capital came from short-term loans borrowed from various investment companies. After 1993, the figures fluctuated between 35% and 42%. The high ratio of loans in stock investment makes stock prices extremely sensitive to short-term changes in political and economic conditions.[35] Finally, the average rate of fluctuation (the highest index minus the lowest in one year) of Taiwan's stock market for the period of 1989 to 1998 was 5.25%, higher than New York's 2.1%, Tokyo's 3.1%, Singapore's 3.0%, and Korea's 3.6%.[36]

Institutional Causes of Financial Market Distortions

The above description of the distortions in Taiwan's financial markets demonstrated that the 1997-1998 economic recession in Taiwan was not caused solely, if at all, by international speculators. Structural weaknesses made Taiwan's financial markets susceptible to changes in the external environment. Symptoms of such structural weaknesses had appeared frequently before the 1997 exchange crisis broke out. In other words, economic recession on the 1997 scale had happened before in Taiwan and will happen again if these structural distortions are not properly analyzed and tackled. This section argues that the oligopolistic institutional relationships among the KMT, conglomerates, local factions, and representatives are the major cause for Taiwan's financial market distortions.

The Credit Market

Nationalist scholars may blame the distortions of Taiwan's credit market on excessive competition.[37] From 1989 to 1998, the total number of credit institutions in Taiwan was 452, with 5,574 branch offices. On average, the branch offices have

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[35] *Republic of China Stock Statistics 1997.*

[36] Lining Dai, "Toushi Zhengquan Shichang—Wenti Yu Duice" [Analyzing the Stock Market: Problems and Policies], *Zhengquan Guanli* 12:.9(1994), pp.1-15, and by authors' calculation.

[37] President Lee Teng-hui, a Cornell Ph.D. in economics, made this argument. See *United Nightly*

increased by 225 every year since 1991.[38] Although excessive competition may be one of the major causes for the low profit rates of these banks, it cannot fully account for their high ratios of non-performing loans. The oligopolistic alliance among the KMT, conglomerates, local factions, and representatives directly or indirectly encouraged these banks to accumulate bad loans.

First, the KMT was a major player in the credit market. During the authoritarian rule, the KMT maintained convenient access to the state's coffers to support a huge party machinery and astronomical campaign expenses. With the pace of democratization proceeding rapidly, the KMT had to find alternative sources of finance. Thus, the KMT expanded its party enterprises during the 1980s, and entered the banking and investment fields.[39]

The KMT's financial center is the Business Management Committee (BMC, Dangying Shiye Guanli Weiyuanhui), which was created in August of 1993 by the Fourteenth National Party Congress to coordinate the expanded party enterprises. By 1994, the KMT "had invested in 104 firms divided into ten special categories and administered by seven holding companies, as follows: (1) Central Investment Holding Company: financial, petrochemical, and general enterprises. (2) Kuang-Hwa Investment Holding Company: gas and technology enterprises. (3) Chii-sheng Industrial Company: construction and land development. (4) Jen-Hwa Investment Holding Company: special projects. (5) Kingdom Investment Holding Company: insurance. (6) Asia Pacific Holdings: overseas enterprises. (7) Hua-Hsia Investment Holding Company: communications. By the end of 1998, the total assets of KMT enterprises amounted to US$200 billion, which ranked fifth among Taiwan's 100 largest conglomerates. Through these holding companies, the KMT has been able to control and manage four banks: the Gaoxion Enterprise Bank, the Zhonghua Development Industrial Bank, Fanya Bank, and Huaxin Commercial Bank.[40] In 1999, the Zhonghua Development Industrial Bank, which was the vault of the KMT's enterprises, ranked first among Taiwan's 150 financial institutions both in terms of net

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News, March 1, 1999, p.4.

[38] <http://www.boma.gov.tw/sat05doc.htm>, April, 1998.

[39] The KMT's Central Investment Holding Company (Zhongyang Touzi Gongsi) was established in 1971. But its earlier investments concentrated on its own subsidiaries and petrochemicals. In the 1980s, all KMT holding companies rapidly diversified their portfolios to cover other sectors, especially the financial sector. See Ganlin Xu, "Zhenzhi Zhipei Huo Shishang Loji", pp.175-208.

[40] *Shangye Zhoukan*, no.605 (1999), pp.84-111.

profit rate (before tax) and of return on assets.[41] Thus, the KMT was not only the largest banking institution in Taiwan, but also among the most profitable. This reminds us of Imelda Marcos' famous response to a reporter's question about the profitability of crony enterprises in the Philippines back in the early 1980s: "They are smarter people."

Secondly, conglomerates dominated the credit market. All sixteen new banks were established by Taiwan's conglomerates, with important political figures on these banks' boards of directors or as their shareholders.[42] The political connections helped these banks to get operating licenses. About half of them, however, immediately adopted very lenient loan policies toward their subsidiary enterprises and toward these political figures.[43] Most of these loans later became non-performing loans or bad loans. An epitome of these banking problems is the Fanya Bank, which was established by the Changyi Conglomerate in central Taiwan. The father (Tianshen Yang) and son (Wenxing Yang) of the conglomerate have served as representatives in local and national legislatures. In the 1990s, the bank provided large amount of dubious loans to local and national politicians for two purposes. One was to get legislative approval of large-scale construction project, including a gigantic entertainment park and an expensive subway system. The other was to climb up the political ladder. In 1994 Wenxing Yang successfully ran for the office of vice-speaker of the provincial assembly, defeating the candidate nominated by the KMT party central. But the Fanya Bank ran into deep trouble since and was taken over by the KMT in 1999.

Thirdly, local factions controlled the local credit market. During the authoritarian rule, the KMT formed a patron-client relationship with local factions. Local factions mobilized their relatives and friends to support KMT candidates (usually factional leaders) to confer legitimacy to the immigrant party from China. In exchange, the KMT granted licenses to these factions to operate oligopolistic businesses, such as credit unions, farmers' associations (including the credit department), fishermen's associations (including the credit department), and

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[41] *Shangye Zhoukan*, no.603 (1999), pp.76-131.

[42] Shangmao Chen, *Taiwan Yinhang Zhengce De Zengzhi Jinji Fenxi* [A Political- Economic Analysis of Taiwan's Banking Policies] (MA. Thesis, National Chengchi University, 1998), pp.89-95.

[43] Although banking regulations prohibit these new banks from lending money to their directors, some banks circumvent regulations by lending money to each other's directors, with tacit agreements of such transactions reached under the table.

transportation companies.[44] Local factions employed these oligopolistic rents to consolidate their factional cohesion and to buy votes in elections.

During the 1980s, the opposition party, the Democratic Progressive Party (DPP) made large gains at various levels of election by ideological appeals to independent voters. The pressure from the DPP and the SNTV voting rule made KMT candidates more dependent on factions for basic support. As competition among candidates increased, the price of votes rose as well. In the 1998 legislative election, the price of each vote averaged about US$80. The average number of votes required to elect a legislator was about 40,000. So, the initial cost for each candidate was about US$3.2 million. In addition, since candidates did not contact their voters directly, but via vote-collectors at different administrative levels, it was easy to add another US$3 million or more to the campaign expenses in order to beat the offer of their opponents.[45]

The cash flow for these election purposes usually came from local credit institutions, which were not subject to close supervision by the central government. Before each election, legislative candidates with over-valued collateral would apply for loans from credit institutions. After the election, these credit institutions would continue to give out easy loans to campaign contributors. Thus, non-performing loans and bad loans accumulated until bank-runs occurred.

Fourthly, representatives helped legalize credit market distortions. Before 1986, the Legislature was filled with representatives elected in mainland China before 1949, and had little influence in national policymaking process. In 1986, after a constitutional revision, the Taiwanese were able to elect one-third of the legislators. In 1992, the people of the island elected all legislators, with the exception of a few overseas representatives. Legislators began to assert their legislative power over the financial administration, especially after the lifting of martial law in 1987.

The financial administration lost its political autonomy in banking policies in two areas. One was the decline of the Central Bank's political autonomy in credit policies. Before the 1980s, the Central Bank was the highest authority in Taiwan's banking matters. In 1979, the Central Bank changed its institutional affiliation from the most powerful Presidency to the Executive Yuan, which was subject to legislative

[44] Mingtong Chen, and Yunhan Chu, *Quyuxing Lianhe Duzhan Jingji Difang Paixi Yu Shengyiyuan Xuanju* [Regional Oligopolistic Economy, Local Factions, and Provincial Assembly Elections] (National Science Council Report, 1992), p.89.

[45] The first book recording in detail the KMT's vote-buying machinery is written by a 24-year party cadre Bixia Zhan, *Maipiao Canhuilu* [Confession of Vote-Buying] (Taipei: Shangzhou, 1999).

supervision and political influence. During the episode of licensing new banks in the late 1980s and early 1990s, the Central Bank did not participate in the policymaking and implementation process; it was the Ministry of Finance that orchestrated the entire process. Then, in the revision of the banking law in April 1997, the Central Bank was further downgraded as an equal, if not lower, partner of the Ministry of Finance. Finally, in terms of the composition of the Central Bank's board of directors, I have found the rapid expansion of directors who were either government officials directly subject to political pressure or representatives of private banks. Together, they outnumbered state-owned bank officials and scholars on the board.[46] The presidency of the Central Bank has also seen three turnovers in the past ten years, as compared to twice in the previous forty years.[47] In other words, legislators preferred to work with and expand the power of the Ministry of Finance, which was subject to legislative supervision, than with the Central Bank, which had a tradition of political autonomy.

The other area where the financial administration revealed the loss of political autonomy to the Legislature was the revisions of the banking law. Before the 1980s, banking law revisions were minor,[48] infrequent, and led by the financial administration; the Legislature usually rubber-stamped the bills. Since the mid-1980s, new legislators elected in Taiwan have asserted their political power by revising critical articles in the administration's bills or by submitting their own reform bills. In the 1985 banking reform, the Legislature revised four of the twenty-five articles proposed by the administration. In the 1989 reform, the administration proposed seventeen articles; sixteen were revised. And in the 1995 reform, the Legislature itself proposed and passed two important items of banking reform, against the wishes of the Ministry of Finance.[49]

Why would the Legislature assert its political power? It was because a small group of legislators were closely associated with the banking industry through directorship, shareholding, or loan relationships. Furthermore, since no effective conflict-of-interest laws have existed in the Legislature, most of these legislators joined the Legislature's Finance Committee, which had authority over banking policies. When new banks applied for licenses in the late 1980s, nine legislators were

[46] Central Bank, *Zhonghua Mingguo Zhongyang Yinhang Zhi Zhidu Yu Gongnen* [Institutions and Functions of the ROC Central Bank] (Taipei: Central Bank, 1991), pp.152-65.
[47] Shangmao Chen, *Taiwan Yinhang Zhengce De Zengzhi Jinji Fenxi*, p.151.
[48] The only exception during this period was the 1975 banking reform, whose purpose was to overhaul the 30-year-old banking law.

shareholders of ten different banks. During the administration's evaluation process, these legislators frequently voiced their concerns and made specific proposals to protect the interests of those conglomerates that owned these banks. What did these legislators get in return? They purchased the unlisted stocks of the banks at about US$3 a share. Once the new banks were established and listed their stocks, their stock prices immediately doubled or tripled.[50]

In 1992, when the Taiwanese elected all legislators, the number of legislators with banking background increased: twenty-seven had formal relationships with banks or credit unions. Among the twenty-seven legislators, twenty were shareholders of the new banks; sixteen were directors or supervisors of banks, credit unions, or other financial institutions. After the 1995 election, fifteen legislators were directors or supervisors of financial institutions. The 1998 election brought in twenty-one legislators with banking interests.[51]

Finally, the role of foreign banks in Taiwan's banking industry has been limited. Since the banking liberalization of the 1980s, foreign banks have established more subsidiaries in Taiwan and their banking activities have increased as well.[52] However, the Taiwanese government has maintained some critical constraints on foreign banks and prevented foreign banks from taking a larger share of Taiwan's banking market. The major constraints are a high capitalization requirement, high reserve ratio, and limited scope of banking activities. For instance, not until 1994 did the government lift the regulation that foreign banks could not accept Taiwan dollar deposits and had to wait for two years before establishing each additional branch. Before 1994, foreign banks could establish branches only in Taipei and Kaohsiung, not in other cities or in the countryside. Only three new branches were allowed annually for all foreign banks. Currently, there remain restrictions on the amount of Taiwan dollar deposits, foreign employees, the capitalization of bank branches, the establishment of bank subsidiaries, and other banking affairs.[53]

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[49] Shangmao Chen, *Taiwan Yinhang Zhengce De Zengzhi Jinji Fenxi*, p.149.
[50] Junyi Li, *Choulou De Lifayuan* [The Ugly Legislature] (Taipei: Formosa., 1995), p.158.
[51] Tiancai Kang, and Jinchuan Zheng, “Liwei Jinquan Guanxi Quanmian Jiepou” [An Analysis of the Relationships Between Legislators and Business], *Shangye Zhoukan*, no.587 (1999), pp.32-48.
[52] For the history of Taiwan's banking liberalization, see Junbao Yen, *Taiwan Diqu Yinhang Fazhan Sishinian* [The Forty Years of Development of Taiwan's Banks] (Taipei: Zhonghua Zhenxinsuo,1991).
[53] Wei Ding, "Taiwan Jinron Huanjing Bianqian Dui Waishang Yinhang De Chongji Yu Yingxiang" [The Shock and Impact of the Transformation of Taiwan Financial Environment on Foreign Banks] (MA. Thesis, National Taiwan University, 1995); and Ministry of Finance, Changyong Jinron Fague Huibian [Collection of Financial Regulations Frequently Used] (Taipei: Bureau of Monetary Affairs,

In fact, in terms of percentage, the influence of foreign banks has increased little since the 1980s. The number of local branches of foreign banks increased from twenty-one in 1980 to forty-three in 1990 and to sixty-nine in 1997. But the ratio of foreign bank subsidiaries to domestic bank subsidiaries increased little, from 4% in 1980 to 6% in 1990, and declined to 4% in 1997. The amount of loans provided by foreign banks subsidiaries increased from US$2.7 billion in 1980 to US$6.1 billion in 1990 to US$12.6 billion in 1997. But during the same period of time, Taiwan's credit unions, farmers' and fishermen's associations, and medium business banks each had exceeded foreign bank subsidiaries not only in terms of the amount of loans but also in terms of the growth rates of such loans. Hence, the percentage taken by foreign bank loans of the total of all such loans declined from 32% in 1980 to 13% in 1990 to 12% in 1997.[54] Indeed, there has been banking liberalization, but foreign banks have not been able to improve their small market shares in Taiwan due to the local oligopolistic alliances.

Thus, the 1997-1998 banking crisis in Taiwan was caused less by external factors than by the oligopolistic alliance among the KMT, local factions, conglomerates, and representatives, with the administration as a tacit collaborator. The KMT controlled four banks to expand its financial and political influence. Conglomerates established new banks to subsidize their subsidiaries and to consolidate political connections. Local factions survived on the oligopolistic rents of local credit institutions in order to finance campaign expenses. Therefore, a symbiosis of the KMT, representatives, local factions, and conglomerates existed. The financial administration, with declining political autonomy since democratization began in the 1980s, could not but collaborate with this financial oligopoly.

The Stock Market

Taiwan's economists have described Taiwan's stock market as a bubble economy. They explain the distortions of Taiwan's stock market in terms of information asymmetry and irrational expectations. Most of Taiwan's stock buyers are individuals. They tend to follow the signals of a few volume investors or television stock advisers. When stock prices far exceed their normal levels (e.g., the price/dividend ratio is higher than 20:1), individuals investors continue to buy stocks,

Ministry of Finance, 1998).

even borrowing money to do so, until the bubble bursts. Then, they sell their stocks in panic even when prices are far below their normal levels.[55]

Taiwan's economists are correct in their description and explanation of the weaknesses of Taiwan's stock market. But the fundamental problem with the distorted market structure was the oligopolistic alliance among the KMT, the conglomerates, and representatives. Together, they exerted political influence on the operation of Taiwan's stock institutions, such as the monitoring institution of the Taiwan Stock Exchange Corporation, the monitoring and enforcement institutions of the Securities and Futures Commission, the macroeconomic policies of the Central Bank, and the security policies of the Finance Ministry.[56]

First, conglomerates dominated the stock market. In August 1988, the government liberalized the stock market and permitted the establishment of new stock companies. In the next two years, 349 new stock companies were established. Almost each of the top 100 conglomerates owned a stock company. For conglomerates, there were four layers of profits associated with owning a stock company. One was the lucrative profit of stock transactions. The other was the reduction of management fees for stock transactions. The third one was the profit gained from manipulating the prices of the conglomerate's stocks. And finally, the conglomerate could explore other investment markets through the stock company.[57]

In order to maximize each layer of the above profits, conglomerates built up political connections. These conglomerates needed to know in advance whether an important policy that would affect stock prices might pass or be defeated in the Legislature, so that they could buy and sell stocks before the market reacted. They needed to know whether the Ministry of Finance proposed the increase or reduction of taxes on stock transactions. When a conglomerate engaged in illegal stock transaction, it needed political guardians to interfere with the investigation by government authorities. And finally, many conglomerates competed for government procurement projects. A successful bid would raise the prices of the conglomerate's stock prices.

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[54] *Taiwan Statistical Data Book* 1998, pp.149, 163.

[55] Zongxian Yu, and Jinli Wang, *Taiwan Paomo Jingji* [Taiwan's Bubble Economy] (Taipei: Zhongkuo Jingji Qiye Yanjiusuo, 1998).

[56] For more detailed analysis of the operation of these stock institutions, see Zonghao Huang, Taiwan Gupiao Shichang Zhi Zhengzhi Jingji Fenxi (A Political Economic Analysis of Taiwan's Security Market). Master thesis, National Chengchi University, 2000.

[57] Shengyuan Zang, *Cong Jinqian Youxi Yu Jinrong Jieyan Kan Taiwan Jinquan Zhengzhi Zhi Xingcheng* [A Look at the Formation of Money Politics from the Perspectives of Money Game and Financial Liberalization] (MA. Thesis, National Taiwan University, 1993).

All of the above information and profit opportunities could be obtained by supporting particular legislators or by sending their own conglomerate members to the Legislature, especially to the Legislature's Finance Committee and Economic Committee. Thus, I have found legislators actively interfering with the normal transaction of Taiwan's stock market, as described below.

Secondly, representatives interfered with market transactions. Zhenhuan Wang[58] has found that among the 294 legislators elected between 1969 and 1992, half of them simultaneously held enterprise positions as presidents, vice presidents, CEOs, deputy CEOs, directors, supervisors, or consultants. In the 1980s and early 1990s, at least ten legislators (and/or their spouses), including the speaker and the vice speaker, owned or invested significantly in stock companies.[59] The number of such legislators increased to fifteen after the 1998 election.[60] These legislators have had high reelection rates and have been regular members of the Finance Committee, which makes policies regulating stock transactions.

Two incidents exemplify the legislature's interference with market transactions. One concerned the taxes imposed on the transaction of stocks and on stock companies. For tax fairness purposes, from 1988 to 1993, the Finance Ministry tried several times to raise the tax on stock transactions to 1.5%. But the Legislature not only defeated these proposals; on the contrary, it continued to lower the taxes to 0.3%. During the same period of time, the Ministry tried frequently to impose taxes on stock companies; all attempts failed.[61]

The other incident was the Hongfu Stock Company scandal in 1994. The company engaged in large-scale illegal stock transactions, with many legislators involved. The owner was also a legislator. When the Investigation Bureau searched the owner's house, at least eighteen legislators showed up to successfully interfere with the investigation. The investigation ended up with prosecutions of some minor managers. Other legislators involved in the scandal have continued to serve as legislators. The owner of the stock company was set free and became involved in a few scandals from time to time afterwards.[62]

Thirdly, the KMT became a major player in the stock market. In 1987, the

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[58] Zhenhuan Wang, *Shui Tongzhi Taiwan* [Who Governs Taiwan?] (Taipei: Juliu, 1996), p.149.
[59] Junyi Li, *Choulou De Lifayuan*, pp.76-80.
[60] Qinru Li, "Xiajie Liwei Caifu Shili Dapuguang" [Exposure of the Financial Power of the Next Legislature], *Xinxinwen*, no.19 (1999), pp.51-59.
[61] Zhenhuan Wang, *Shui Tongzhi Taiwan*, pp.157-62.

Taiwanese government lifted martial law. The opposition party was able to monitor the connection between the state's coffers and the KMT's. In response, the KMT reorganized its enterprises to find alternative sources of financing. Former Minister of Finance, Lide Xu, took up the mission as the newly appointed chairman of the Finance Committee of the KMT in August 1988. From 1988 to 1993, Xu successfully introduced a modern management system to KMT party enterprises in order to raise their competitiveness. Furthermore, Xu began to expand joint ventures among KMT enterprises as well as between KMT enterprises and private conglomerates. Stocks became critical instruments for such joint ventures.

In June 1993, the KMT established a new investment coordination committee, the Business Management Committee (BMC), as described in the previous section. The BMC enabled the KMT to institutionalize consultation with conglomerates with regard to joint ventures and political matters. In 1993, the Committee consisted of six KMT enterprise presidents, one scholar, and eight presidents or CEOs of private conglomerates. In 1996, two more conglomerate representatives were added. All ten private conglomerates derived their revenues mainly from protected domestic markets, such as real estate, construction, banks, and stock companies, which made political connections critical to their profits.[63] Major producers of export-oriented electronic products were absent from the Committee. The Committee met once a month to respond quickly to market changes.

Through the seven holding companies and their joint ventures, the KMT was able to influence stock prices. In 1995, these seven holding companies controlled and managed three stock companies: Dahua, Fuhua, and Huaxin[64]. Two more stock companies, Zhonghua and Fanya, were added later to the KMT roster.[65] If conglomerates had an advantage in manipulating stock information as described before, the KMT certainly ranked above all other conglomerates in information manipulation. For instance, Fuhua Stock Company was the largest stock company in Taiwan in 1999. In terms of net profit before tax, it ranked seventeenth among

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[62] Junyi Li, *Choulou De Lifayuan*, pp.80-82.
[63] Shuzhen Tan, "Guomingdang Dangguanhui De Bimi Zhiyi" [One of the Secrets of the KMT Business and Management Committee], *Xinxinwen*, no.480 (1996), pp. 90-93.
[64] Yonghuang Liang, "121 Jia Dangzi Shiye Zonglan" [An Overview of the 121 Party Enterprises], *Wealth Magazine* (April, 1995), pp. 102-108.
[65] Huijuan Huang, "Yibaida Qiye Jituan Diaocha" [An Investigation of the Largest 100 Enterprises], *Shangye Zhoukan*, no.605 (1999), pp.84-111.

Taiwan's 150 financial institutions.[66] In fact, in all the past stock crashes, KMT enterprises never suffered as severely as other conglomerates did. On the contrary, KMT enterprises usually made handsome profits during economic recessions, although less than during economic recoveries. The difference between conglomerates and the KMT was that as the ruling party, the KMT controlled the decisionmaking and policy implementation process of major economic policies that might affect stock prices.

Fourthly, the state could not but be a passive and active collaborator in stock market distortions. On the passive side, the state agencies, which might affect stock market transactions, did not have effective supervisory power. The Central Bank lost its political autonomy as described in the last section. The Securities and Futures Commission of the Finance Ministry, which was in charge of regulating stock market transactions, had not been an effective monitoring authority for three reasons. It had a small budget. Its staff members were few; the organization's bylaws authorized 242 staff members to deal with more than 400 foreign and domestic stock and investment companies.[67] And its legal and political status in the bureaucracy was low; it was not an independent commission, nor did it have the rank of a department, as its counterparts in the United States and Germany do.

On the active side, the state formulated policies to stimulate stock prices before all presidential and legislative elections. These policies included the reduction of stock transaction taxes, the increased entry of government funds (pension funds, postal savings, social security funds, etc.) to the stock market, the lowering of administrative barriers against foreign capital, the Central Bank's loosening of the money supply, and the relaxation of other stock market regulations. The purpose was to create an image of the KMT's strong governing capability. It also served the KMT enterprises to make extra profits for campaign expenses. Once the elections were over, stock prices usually tumbled.[68]

Finally, foreign investors have not been major players in Taiwan's stock market. It is undeniable that the number of foreign investors and the amount of foreign capital in Taiwan's stock market have increased rapidly in the past ten years. Taiwan's

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[66] *Shangye Zhoukan*, no.603 (1999), pp.76-131.
[67] <http://www.sfc.gov.tw>.
[68] Mengxia Li, "Jieyenho Xuanju Yu Zhence Guanxi Zhi Jiantao" [A Study of the Relationships between Elections and Economic Policies in the Post-Martial Law Period] (MA. Thesis, National Chengong University, 1997), pp.60-63.

individual investors also often follow the investment strategies of foreign investors. However, the government has retained important restrictions on foreign investors. Foreign investment companies, if buying and selling Taiwanese stocks, cannot accept Taiwanese clients for such transactions. Before 1999, each foreign investor could own at most 15% of a local company's stocks. All foreign investors could possess at most 30% of a local company's stocks. In February 1999, in an effort to stimulate the crashed stock market, both percentage limits were raised to 50%. However, the total value of foreign investment in Taiwan's stock market was still lower than 4% of the total market value.[69] Through these foreign investment companies, "hot money" frequently came in and left the Taiwan stock market for short-term speculation. Because of the above investment constraints, few foreign companies were interested in long-term investment.

Thus, I found that the oligopolistic alliance among the KMT, conglomerates, and representatives, with the state as both a passive and an active collaborator, has caused the distortions in Taiwan's stock market. Conglomerates dominated the market. Representatives helped legalize market distortions. The KMT itself became a major player in the market. And the state was incapable of regulating market distortions.

Financial Reforms in Taiwan

How to reduce the distortions in Taiwan's credit and stock markets? During and after the 1997-1998 crisis, the Taiwanese government adopted several measures to address these problems.[70] In the credit market, the government reduced the banks' business taxes, lowered reserve requirements, and helped to write off bad loans by dubious measures (e.g., redefine bad loans and relax repayment conditions). It formulated plans to take over the bad loans of insolvent local financial institutions. In the stock market, government assistance measures included the supply of US$5 billion low-interest mortgage loans to help real estate stocks, the establishment of a US$100 billion "stock-rescue fund" to buy stocks,[71] the reduction of taxes on stock

[69] *United Daily News*, February 20, 1999, p.1.

[70] Zihua Huang, "Due Woguo Caijing Zhence De Jianyen" [Proposals of Financial and Economic Policies for Our Country], *Taiwan Jingji Yenjiu Yuekan* (November 1999), pp. 8-11.

[71] The rescue fund consisted of the workers' pension fund, the workers' insurance fund, postal savings, and the government employees' pension fund. In 1990, the government allowed the pension fund to invest in stocks. In 1996, it expanded the investment levels and activities of the insurance fund and the

transactions, and the relaxation of transaction regulations.

I agree with liberal economists that all of these Keynesian reform policies serve only to prolong the crisis or to create a cosmetic short-term recovery. The crisis will repeat itself, perhaps on a larger scale, if the underlying institutional distortions are not properly addressed. The government has contemplated a number of mild structural reforms.[72] However, most of these reforms either remain in the oven or lack implementation details. I agree also with liberal economists that the further liberalization of the financial markets, the strengthening of the government's monitoring capacity, and the reduction of government regulations will reduce market distortions. But I propose that these liberal reform policies will not be effective or adopted if those institutional relationships that caused the market distortions are not adjusted.

In the following, I will make six reform proposals based on the institutional relationships depicted in Graph 1. Graph 1 points out the institutional causes of market distortions and provides for six points of entry for reform policies. These reform policies are ordered according to their impact on the existing political-economic structures. They are financial liberalization, the reestablishment of the Central Bank's autonomy and leadership in financial policies, the promulgation of conflict-of-interest laws in legislative bodies, the removal of monopoly rights granted to local factions, the turnover of the ruling party, and the strengthening of the power of corporatist business associations.

(1) Financial liberalization. Financial liberalization will increase the scale and competition of financial markets. More importantly, the presence of foreign actors will complicate the relationships among the KMT, conglomerates, local factions, and the state. An oligopolistic alliance will be more difficult to sustain. Financial liberalization here refers not only to the liberalization of capital flow, but also to the encouragement of foreign financial institutions to establish branches in Taiwan and engage in the same business activities as their Taiwanese counterparts do. If financial liberalization entails only financial flow liberalization, it will reinforce the distortion effects of the oligopolistic alliance, since the alliance will have more leverage of

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government pension fund. See Wanyi Dai, "Zhenfu Liyon Yinhangtuan Ji Teding Jijing Ganyu Gushi De Xiaoguo" [The Effects of the Government's Interventions in the Stock Market through Banking Groups and Special Funds] (MA. Thesis, National Zhongzhen University, 1997), pp.11-14.

[72] These mild reform measures include efforts to increase the efficiency of public banks, the encouragement of mergers of financial institutions, the adoption of a credit-rating system, and the

influence, as has happened in South Korea, Thailand, Malaysia, and Indonesia. I urge the Taiwanese government to adopt investment incentive policies toward foreign financial institutions similar to those it had toward foreign manufacturing companies in the 1960s. These incentives include the enlargement of foreign ownership, the expansion of the scope of investment, the reduction of red tapes, the encouragement of technology (management know-how) transfer, and tax incentives for reinvesting profits in the economy. Since financial liberalization is a necessary component in Taiwan's application for WTO membership, the political obstacles to this reform measure will probably be the least among all six proposals.

(2) The reestablishment of the Central Bank's autonomy and leadership in financial policies. In the past twenty years, researches have found a positive relationship between central bank independence and economic development.[73] An independent and powerful Central Bank will be able to resist the political interference of political parties, conglomerates, representatives, and local factions. It can effectively monitor and punish cheating in market transactions. Furthermore, it can maintain the long-term stability of the economy, which will assist long-term development, instead of short-term speculation, of credit and stock markets. Therefore, I propose that the Central Bank be relocated from the Executive Yuan to the Presidency and become an independent commission like its American and German counterparts. The Central Bank should have the highest authority over financial policies, not share the power with the politically dependent Finance Ministry. It should report to the Legislature, but it should keep an independent budget (e.g., financed by banking taxes) not to be reduced by the Legislature. The board of directors of the Central Bank should increase the number of professional economists and reduce the number of private bank representatives. Their tenure should exceed those of elected officials. The President should appoint directors with two-thirds approval from the Legislature in order to get bipartisan support, or appoint new

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establishment of an independent financial supervisory commission.

[73] On the relationship between economic development and central bank independence, see John Goodman, "The Politics of the Central Bank Independence," *Comparative Politics* 23:3 (April 1991), pp.329-49; John Goodman, *Monetary Sovereignty: The Politics of Central Banking in Western Europe* (Ithaca: Cornell University Press, 1992); C. Randall Henning, *Currencies and Politics in the United States, Germany, and Japan* (Washington, DC: Institute for International Economics, 1994); Maxwell J. Fry, Charles A. E. Goodhart, and Alvaro Almeida, *Central Banking in Developing Countries: Objectives, Activities and Independence* (New York: Routledge, 1996); J. Lawrence Broz, "The Origins of Central Banking: Solutions to the Free-Rider Problem", *International Organization* 52:2 (Spring 1998), pp.231-268; William Bernhard, "A Political Explanation of Variations in Central Bank

directors with the majority support of existing directors in order to strengthen the continuity of the Bank's professional integrity. The Securities and Futures Commission should also acquire a similar strengthening of political independence. Since the presidential race of the year 2000 is filled with uncertainty, the KMT badly needs a politically dependent Central Bank and the Securities and Futures Commission for raising campaign money. This reform proposal will not likely materialize until after the election.

(3) Promulgation of conflict-of-interest laws. One of the institutional causes of financial market distortions in Taiwan was the participation of representatives in legislative committees that deal with their businesses. Thus, there have been so-called "stock legislators," "banking legislators," and "conglomerate legislators" who have acted both as umpires and players in the legislative process. To reduce such conflicts of interests, I propose that the Legislature pass laws prohibiting such behavior at all levels of representative bodies. In addition, campaign contribution laws, party enterprise laws, and property declaration laws for public officials will complement the above reform measure, but will also encounter more political obstacles. In January 1999, the departing Legislators passed a mild code of conduct concerning conflicts of interests. So far, however, the code has been left in the attic by the new Legislature. I do not see much hope in enforcing this reform proposal by the new Legislature, since more factional leaders, gangsters, and conglomerate representatives have entered the Legislature than before.[74]

(4) The removal of monopoly rights of local factions. For the moment, local factions have had limited influence on the national credit market and the stock market. But on local credit institutions, their corrosive effects have been obvious and deteriorating. I propose to take the credit departments out of farmers' and fishermen's associations and transform them into local branches of a national agricultural/fishery bank, which would be subject to the independent Central Bank's supervision. Local credit unions should be merged with or reformed into commercial banks, and be opened to non-local members (including foreign investors). These reform measures will dilute the influence of local factions and expand monitoring mechanisms.

Independence", *American Political Sciences Review* 42:2 (June 1989), pp.311-327.

[74] Of the 225 new legislators elected in 1998, ninety-two had a business background. Of these ninety-two legislators, seventy-two were in the business of construction, mass media, banking, and stocks, which could benefit a great deal from the legislative power. See Tiancai Kang, and Jinchuan Zheng, “Liwei Jinquan Guanxi Quanmian Jiepou” [An Analysis of the Relationships Between Legislators and

However, these reform measures will encounter strong political opposition from the KMT, which has increasingly relied on factions for vote mobilization, and from the new legislators, who are factional leaders.

(5) Since most of the above reform proposals will affect the vital interests of the KMT, they are not likely to materialize, unless either the new KMT president has sufficient political influence and wisdom or the new president does not belong to the KMT. Hungtington has argued that a democracy is consolidated only when a country passes the "two-turnover test," i.e., the government changes hands between parties twice. [75] I argue similarly that after two turnovers of the Taiwan government, the old oligopolistic alliance will probably be shaken loose. Conglomerates might follow legal methods to do the lobbying, bureaucrats might adhere more sincerely to the principle of administrative neutrality, and the legislature might recruit more representatives with legal background than with business or gangster experiences.[76] This reform proposal lies ultimately with the uncertainty of voters' choice.

(6) Strengthening business associations. Scholars have found a positive relationship between corporatism and economic development (e.g., Freeman).[77] In his research on Taiwan's economic development, Kuo found that state corporatism was the most important factor for the island's economic success. I propose that the Taiwanese government establish corporatist institutions in credit and stock policies. [78] These reform measures include the establishment of corporatist associations for stock companies and banks, the recognition of these corporatist associations as the only legitimate representatives in national policymaking processes, and the authorization of semi-official powers to these associations (e.g., monitoring power and enforcement capabilities). These reform measures will not generate as many political obstacles as the previous four proposals do. However, they will require a considerable amount of organizational talent and costs.

Business], *Shangye Zhoukan*, no.587 (1999), pp.32-48.

[75] Samuel Huntington, *The Third Wave: Democratization in the Late Twentieth Century* (Norman, OK: University of Oklahoma Press, 1991).

[76] Mingtong Chen conducted a statistical analysis of the impact of party turnover on the crime rate and the amount of bad loans in Taiwan's counties and cities. He found that in the past five years, KMT-controlled counties and cities tended to have higher crime rates and larger amount of bad loans than DPP-controlled ones did, see Mingtong Chen, "Heijin Xianshi Paihangbang" [Ranks of Counties and Cities in Black and Gold] (Mimeo, 1999).

[77] See John R. Freeman, *Democracy and Markets: The Politics of Mixed Economics* (Ithaca: Cornell University Press, 1989).

[78] Chengtian Kuo, *Global Competitiveness and Industrial Growth in Taiwan and Philippines,* (Pittsburgh: University of Pittsburgh Press, 1995).

Summary and Implications of the Taiwan Case

This paper has demonstrated that financial market distortions, rather than foreign speculators, were the major cause of Taiwan's economic recession during the foreign exchange crisis of 1997-1998. The distortions of the credit and stock markets, in turn, were the result of the rent-seeking behavior of the oligopolistic alliance of the KMT, conglomerates, local factions, and representatives. In order to prevent the economic recession from recurring, it is not sufficient to simply adopt Keynesian expansionary policies to stimulate the economy. Instead, reform policies should focus on adjusting the institutional relationships among the four oligopolistic actors.

After the victory of the DPP candidate Chen Shui-bian in the presidential election of 18 March 2000, preliminary evidence so far has further supported the arguments of this paper. The number of non-performing loans in agricultural cooperatives continued to rise, due to their loss of political speculation in the presidential game. By June 2000, fifty agricultural cooperatives had non-performing loan ratio exceeding 30%. The total amount of non-performing loan was close to US$60 billion (*China Times* 6/22/2000, 1). By the end of May, the ratio of non-performing loans of the seven major public banks averaged more than 5%, totaling more than US$110 billion (*United Daily News* 6/13/2000, 21). In other words, Taiwan's foreign exchange reserves could no longer pay for the non-performing loans of these banking institutions.

In response to past distortions of the stock market, the Legislature finally passed the Security Exchange Act, which had been tabled for eight years, and expanded a little the investigation power of the Securities and Futures Commission (*United Daily News* 7/3/2000, 23). Banks started to call on KMT enterprises to refurbish their collateral requirements due to past underestimation of their collateral values. These banking recalls have caused the KMT to shut down unprofitable enterprises and withdraw about US$30 billion from various stock companies in order to restructure its fragile financial assets (*Economic Daily News* 7/1/2000, 13).

The above statistics about Taiwan's financial markets not only reveals the structural weaknesses of the long-term domination of the oligopolistic alliance of the KMT, the state, local factions, and conglomerates. It also demonstrates that the party turnover has corrected somewhat past distortions of the financial markets. However, the deterioration of Taiwan's financial markets might continue for a few months before they get better. One reason is the apprentice time lag for the DPP officials to take control of the administration and to negotiate with the KMT-dominated Legislature. The other reason is that non-performing loans are defined as loans whose interests and principals have not been paid for six months. Many of the political loans given out by various financial institutions before May 20 (the inauguration date for the new presidency) will face the six-month examination by November. It is still too early to assess the full impact of party turnover on Taiwan's financial markets.

Financial Politics in Thailand

Scholars generally agree that Thailand's financial crisis in 1997 was mainly caused by a lack of transparency and accountability in its financial institutions. This section will explain how the state, political parties, conglomerates, and local factions contributed to the weaknesses of Thai financial institutions. However, various institutional reforms introduced after the crisis may have significant, positive impact on the health of Thai financial politics.

The State

Since the establishment of a constitutional monarchy in 1932, Thailand has maintained a British-style parliamentary system, in which the King serves as a nominal head of the government, while the Prime Minister is the real head of the executive and is responsible to the parliament. While the King in a few critical junctures had exerted political influence to affect Thai's political development, he remained aloof from everyday politics most of the time.[79] This political aloofness helped the longevity of King Bhumibol Adulyadej's reign from 1946 to the present, but probably indirectly contributed to the constant turnover of the Prime Ministers due to their lack of overt support from the highly esteemed king. Military coups were the direct causes for the instability of the cabinet governments. From the establishment of

[79] One such critical juncture was the "Black May 1992 incident." When General Suchinda Kraprayoon named himself as an unelected Prime Minister and ordered a bloody crackdown on protesters, King Bhumibol intervened and caused General Suchinda to resign. In October 1973, the King also intervened in favor of student protesters.

constitutional monarchy in 1932 to 1991 when the last coup occurred, Thailand experienced sixteen coup attempts. Nine of these sixteen coup attempts succeeded in overthrowing existing governments.[80]

The instability of the cabinet governments had a corrosive effect on the behavior of appointed officials of the government, i.e., Prime Ministers, department secretaries, and under secretaries, etc. Having a short vision of the future, they tend to maximize their political and economic gains in the short term and ignore long-term development. Corruption was therefore rampant under uncertain future. This contributed to what Xuto called a "political vicious cycle" in Thai politics: A military coup abolished the government in the name of eliminating corruption. Once the coup leaders installed a new government, corruption resumed its steam because politicians did not expect long political life.[81] Then, another coup was raised to abolish this corrupt government. In such an uncertain political environment, state agencies tended to lack the necessary political autonomy to implement long-term development projects.

Many scholars have characterized the Thai politics before the 1980s as a bureaucratic polity, referring to the dominance of the military governments over political parties and business.[82] Doner and Laothamatas further attributed Thailand's economic success of the 1980s to such a polity. Whether the bureaucratic polity alone contributed to the economic success is a historical debate,[83] which is beyond the scope of this paper. But in order to explain the 1997 financial crisis, the bureaucratic polity thesis is no longer applicable to the Thai case. Alternative conceptions of the Thai state after the 1980s are necessary for the analysis of Thai financial politics. Hutchcroft suggests that the Thai state has become more like the Philippine patrimonial state. Laothamatas observes the transformation of Thai state-business

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[80] Paul D. Hutchroft, "After the Fall: Prospects for Political and Institutional Reform in Post-Crisis Philippines and Thailand." Paper presented at the Annual Meeting of the American Political Science Association, Atlanta, Georgia, September 2-5, 1999, 17.

[81] Somsakdi Xuto, ed. *Government and Politics of Thailand* (New York: Oxford University Press, 1987), 201-202.

[82] John L.S. Girling, *Thailand: Society and Politics* (Ithaca, NY: Cornell University Press, 1981).

[83] Two simple reservations can be raised against the bureaucratic polity thesis. One, the same bureaucratic polity did little to help the Thai economy before the 1980s; for instance, under the "development-oriented" Marshal Sarit Thanarat and Marshal Thanom Kittikachorn regimes. Clark D. Neher, *Southeast Asia in the New International Era*. 3rd ed. (Boulder, CO: Westview Press, 1999), 25. And two, most analysts of Thai politics would agree that Thailand experienced significant democratic transition in the early 1980s. The bureaucratic polity of the early 1980s should have experienced transformation as well. Richard E. Doner, and Anek Laothamatas, "Thailand: Economic and Political Gradualism." In Stephan Haggard and Steven B. Webb, eds. *Voting for Reform: Democracy, Political*

relation from "bureaucratic polity to liberal corporatism." Or, as Sidel puts it, Thailand has transformed "from bureaucratic polity to bossism." These conceptions seem more cogent for analyzing Thai financial politics.[84]

In Thai financial politics, the highest regulatory agencies did not have political autonomy both in terms of their organizational design and actual practice. The Prime Minister was ultimately responsible for all financial policies. But the more direct supervisor was the Minister of Finance, who had real control over Thailand's central bank (the Bank of Thailand) and the Security Exchange Commission. After the expansion of democratic elections of the 1980s, most of the Prime Ministers and cabinet members, including the Finance Ministers, were recruited from popular provincial politicians who were notorious adherents of patronage politics.[85]

The Finance Minister had real political control over the Bank of Thailand by both organizational design and actual practices. The predecessor of the Bank of Thailand was the Thai National Banking Bureau, set up in 1939 as a subsidiary of the Finance Ministry. The Bank of Thailand Act of 1942 expanded and elevated the Bureau to a central bank. According to the Act, the Finance Ministry supervised all affairs conducted by the Bank. The cabinet nominated or removed the governor and deputy governor of the Bank, with the ceremonial approval of the King. Other directors of the Bank were recommended by the Finance Minister and approved by the cabinet.[86] The Finance Minister decided on the amount of salary of the Bank's top officials. In actual practice, the Finance Minister could fire the governor and deputy governor. This means, not only did the Finance Minister have the legal jurisdiction over the Bank of Thailand, it also had real political influence over the governors, deputy governors, and directors of the Bank of Thailand.

The short tenure of the Bank's governors might indicate the Bank's lack of political independence. Since its establishment in 1942, the Bank of Thailand has had nineteen governors, averaging one turnover every three years. Among them, eight had

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Liberalization, and Economic Adjustment. (New York: Oxford Press, 1994).

[84] Hutchcroft, Paul D. Hutchcroft, "After the Fall: Prospects for Political and Institutional Reform in Post-Crisis Philippines and Thailand." Paper presented at the Annual Meeting of the American Political Science Association, Atlanta, Georgia, September 2-5, 1999. Anek Laothamatas, *Business Associations and the New Political Economy of Thailand: From Bureaucratic Polity to Liberal Corporatism* (Boulder, CO: Westview, 1992). John T. Sidel, "Siam and Its Twin? Democratization and Bossism in Contemporary Thailand and the Philippines." *IDS Bulletin,* Vol.27, No.2, 1996, 56-63.

[85] Daniel E. King, "Thailand in 1996: Economic Slowdown Clouds Year." *Asian Survey,* Vol.37, No.2 (February 1997), 162.

[86] www.bot.or.th/govnr/public/history/rol&respon-e.html, 4/12/2000.

tenure less than thirteen months.[87]

In the Thai banking community, the Bank of Thailand was regarded as a "benevolent lender" to troubled banks, especially to banks owned by the military or by relatives of the King, e.g., the Thai Military Bank and the Siam Commercial Bank.[88] The Bank had a finely differentiated structure with twenty-three functional departments (called "groups," including the "Supervisory Group") and a large staff numbered over 5000 by the end of 1999. However, the Bank seemed to exercise its "lender of the last resort" function more often than its supervision function. Among the neglected areas of supervision, the Offshore Bangkok International Banking Facility and the non-performing loans turned out to be the Achilles' heels to Thai financial system in 1997. In 1993, the Bank of Thailand granted permission for commercial banks to operate offshore banking businesses, but it failed to closely monitor the turbulent market or to control the liquidity and capital ratios of banks.[89] Imprudent loan policies unchecked by the central bank led to high ratio of non-performing loans in the banking system. Before the 1997 crisis broke out, the Bank of Thailand allowed individual banks to "camouflage their non-performing assets and to rehabilitate themselves over the years".[90]

During the 1997 financial crisis, the Bank of Thailand was ordered by the Finance Minister not to release the true figures about the crisis, which resulted in a damaging delay of proper actions to control the crisis. The Bank cooked the accounting book by reporting only the spot component of swap transactions, while the future component, totaled US$30 billion (almost the same amount of Thai foreign exchange reserve then), was not mentioned. After the crisis, an independent investigation commission described the Bank as "led by people who promoted or were the victims of political interference".[91]

After the 1997 crisis, the Bank implemented a number of financial reforms requested by the International Monetary Fund. The Bank set up the Financial Restructuring Authority and the Asset Management Corporation to sell off unviable

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[87] Data received from the email by the Information and Public Relations Group, Bank of Thailand, 4/24/2000.
[88] *FEER* 5/21/98, 62-63; 9/10/98, 6.
[89] Scott MacDonald, "Transparency in Thailand's 1997 Economic Crisis." *Asian Survey, Vol.*38, No. 7 (July 1998), p.691. and Philippe Delhaise, *Asia in Crisis: The Implosion of the Banking and Financial Systems*. (New York: John Wiley & Sons, 1998 (Asia)), 84.
[90] Philippe Delhaise, *Asia in Crisis: The Implosion of the Banking and Financial Systems*. (New York: John Wiley & Sons, 1998 (Asia), 82.
[91] *FEER* 5/21/98, 62

financial institutions and help viable ones.[92] For those banks and finance companies unable to recapitalize before the end of 1998, the Bank intervened to restructure their management and capital structure. The Bank published more realistic loan classification and provisioning standards to reduce book-cooking practices and to speed up the writing off of non-performing loans. For itself, the Bank implemented its modernization program "aimed at redesigning the organizational structure, streamlining work processes, and changing its corporate culture." Experts from G7 central banks provided recommendations for the program. A new Bank of Thailand Act was drafted to strengthen the Bank's independence and accountability in conducting monetary policy. The Bank would also tighten its rules governing potential conflicts of interest of the Bank's executives and staff in order to strengthen the supervision of the financial system.[93] However, the sustained high ratio of non-performing loans seemed to indicate that the effectiveness of these reform measures was yet to realize. In June 1999, total non-performing loans added up to US$70 billion, about 48% of loans outstanding.[94]

In addition to the Bank of Thailand, the Finance Ministry also had jurisdiction and real control over the security exchange authorities. Before 1992, there was no central authority governing the exchange of securities and other financial intermediaries. The security market was modest. With the economic boom of the late 1980s, businesses began to issue various securities to meet their capital needs. Beginning in 1987, the government's bold initiatives to privatize infrastructure projects and state enterprises further added ammunition to the security market. In May 1992, the Securities and Exchange Act came into force to regulate the security market. The Act established the Securities and Exchange Commission (the SEC), which formulated overall policies and provided guidance to its executive arm, the Office of the Securities and Exchange Commission (the Office).

Both of the SEC and the Office were under the jurisdiction and real control of the Finance Ministry. The SEC board of directors comprised the Finance Minister as the Chairman, the Governor of the Bank of Thailand, Permanent-Secretary of the Finance Ministry, Permanent-Secretary of the Commerce Ministry, Secretary General

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[92] www.mof.go.th/ter1999/Thai_E_R.html, 4/12/2000.

[93] www.mof.go.th/ther_2/index_ther.html, 4/12/2000. See also Doner and Ramsay's (1999) analysis of the Bank's internal problems and its reforms. Richard F.Doner, and Ansil Ramsay, "Thailand: From Economic Miracle to Economic Crisis." In Karl D. Jackson, ed. *Asian Contagion: The Causes and Consequences of a Financial Crisis* (Singapore: Institute of Southeast Asian Studies, 1999).

of the Office, and four to six members appointed by the cabinet upon the recommendation of the Finance Minister. The last category of members consisted of representatives of security companies trading in the Securities Exchange. The composition of the SEC revealed that all of its members were either political figures or those who maintained close relationships with the Finance Minister. [95]

The Office had a differentiated structure with fourteen functional departments, including the Department of Market Intermediaries Supervision, the Department of Investment Management Supervision, the Office of Market Supervision, and the Enforcement Department. The Office had its own budget generated from its investment profits.

However, the Secretary General of the Office was recommended by the Finance Minister and appointed by the cabinet, thus, subjecting the Secretary General to political pressure. In actual practice, the Office was lax on its supervisory functions, as evidenced by the widespread insider trading in the security market. When the security market was in trouble, officials of the Finance Ministry often responded to investor complaints and disregarded government policies to strengthen the market discipline.[96]

In late 1997, the Thai government asked for financial assistance from the Asian Development Bank (ADB). As part of the conditions, the Thai government adopted the "Policy Matrix" specified by the ADB to amend the SEC Act. The Matrix included measures to restructure the SEC to make it more efficient, self-regulatory and politically independent, in order to strengthen the SEC's supervisory and enforcement powers.[97] Many of the reform proposals, however, have not been passed through the legislature. Therefore, their impact on Thailand's financial politics remains to be seen.

Political Parties

The history of the Thai party system could be characterized as one of multi-party, personality-based, ecliptic, turncoat, and regionalized system. It was a multi-party system because never was there a single party able to win parliamentary majority or

[94] www.mof.go.th/ther_2/index_ther.html, 4/12/2000.
[95] www.sec.or.th/about/profilee.html, www.sec.or.th/mis/act/chap5.html, 4/13/2000.
[96] Paul Handley, "More of the Same? Politics and Business, 1987-96." In Kevin Hewison, ed., *Political Change in Thailand: Democracy and Participation* (New York: Routledge, 1997), 106..

even 32% of the seats.[98] All cabinets were formed by a coalition of political parties. Most of the political parties were personality-based in the sense that a powerful political figure, usually a strong military leader or an ex-Prime Minister, created a party to house his personal followers. For instance, the Chart Pattana Party was created by former Prime Minister, General Chatichai Choonhavan; former army leader Chavalit Yongchaiyudh established the New Aspiration Party; other smaller parties like Social Action, Prachakorn Thai, Nam Thai, Palang Dharma were still controlled by their founders. Only the Chart Thai and the Democratic Party did not belong to any individual. Ideology or policy platform was less an organizational principle than patron-client relationship. Due to their patronage nature, once the leaders of these parties lost their influence or withdrew from politics, their parties usually died with their creators. Because politicians joined political parties not for ideological reasons but political interests, many politicians changed their party affiliations before elections to the ones that could provide the best offer, e.g., financial incentives or cabinet posts. For example, in the 1996 election, the New Aspiration Party was able to defeat its rival, the Democrat Party, by a small margin of two seats because the NAP received a large number of turncoats from the Chart Thai Party. [99] Finally, in the elections of 1992 and 1995, major political parties were divided among regional lines. Democrats drew their support from the South, Chart Thai dominated the Central region, Palang Dharma received the largest vote share in Bangkok, and Chart Pattana and New Aspiration controlled the Northeast region.[100] Financial constraints and the lack of ideological appeals probably explained the regionalization of Thai political parties.

The above characteristics of Thai party system tended to encourage politicians to treat their offices as personal propriety, by which to maximize their short-term interests before the coalition government collapsed or before a military coup occurred. At the beginning, politicians extracted rents from agricultural productions by helping the owners to get concession permits and export assistance - a practice continued up

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[97] www.sec.or.th/newact.html, 3/22/99.

[98] David Murray, "Thailand's Recent Electoral Reforms." *Electoral Studies,* Vol.17, No.4 (December 1998), 526.

[99] Daniel E. King, "Thailand in 1996: Economic Slowdown Clouds Year", 161.; David Murray, "Thailand's Recent Electoral Reforms", 525; Surin Maisrikrod and Ducan McCargo, "Electoral Politics: Commercialisation and Exclusion," in Kevin Hewison, ed., *Political Change in Thailand: Democracy and Participation* (New York: Routledge, 1997).

[100] Maidrikrod and McCargo, "Electoral Politics," 144.

to date. As the industrial production picked up its momentum in the 1980s, politicians extracted campaign contributions from industrialists by representing their interests in government procurement projects, infrastructure building, export assistance, and tax evasion.

However, with the expansion of the financial system in the late 1980s, including both the security market and the banking market, politicians found more convenient ways to raise campaign money or to distribute patronage. Politicians could use their position to acquire privileged information about government policies that might affect stock prices or interest rates. They could get legal campaign contributions in the form of low-priced pre-listing stocks, and sold the stocks at market rates for huge profits in a few months. Politicians could put pressure on the state's supervisory agencies not to investigate the insider trading of security companies, the over-extended loans of banks, and the under-reported profits of financial owners.

Democratization of the 1990s, and particularly the 1997 constitutional reform would probably change Thailand's financial politics. The student demonstration against the military government in 1992 seemed to put an end to the military part of the vicious cycle mentioned before. No military coups have been attempted since 1992. For politicians, the uncertainty of political future caused by surprised military coups would be reduced. They could focus more on long-term development achievements to win popular support.

The democratization movement of the Thai society also led to the revision of the constitution in 1997, with an aim to reduce patronage politics. One clause of the new constitution specified that a member of the parliament must register for a political party at least 90 days before the election date. This clause was designed to reduce the number of turncoat politicians and the patronage associated with this practice. Another constitutional clause set the educational qualification for representatives to bachelor's degree, in the hope that many of old-style politicians would be disqualified. The new constitution also changed the multi-member districts to single-member districts, which would make vote buying less effective. Finally, the new constitution required all eligible citizens to vote in elections and referenda. Its aim was to dilute the effectiveness of vote buying by national politicians and local canvassers.

Accompanying with the constitutional revision were other measures to reduce patronage politics. For instance, the House abolished the Development Fund for representatives (about $200,000 for each MP); the money was previously used to patronize supporters.[101] The Election Commission became an independent agency from the Ministry of Interior to run and monitor elections. In the past, the Ministry of Interior had conducted elections in dubious manner: it either failed to suppress fraud or collaborated with rigging ballot boxes.[102]

These constitutional and legal innovations will not eliminate financial politics overnight. However, they constitute new constraints on the practice and effectiveness of financial politics. The real results remain to be seen.

Conglomerates

Before the 1980s, Thai economy in the countryside was dominated by landed gentry, developers of natural resources, and smugglers. In the urban areas, the predominant capitalists were conglomerates consisted of large banking families, industrialists and traders in monopolies and oligopolies. Due to the nature of the businesses, they were strong supporters of the military and civilian bureaucrats who provided these privileges.[103]

In the late 1980s and early 1990s, new conglomerates emerged and their direct and indirect participation in politics increased.[104] Many business elites participated in the newly liberalized elections and were appointed cabinet members.[105] These were the industrialists associated with Thailand's export success as well as the investors in real estate and security market. Representative of these new conglomerates were the BMS group (mostly economists in government, universities, banks, and businesses), Pairoj Piempongsarn and colleagues (mostly real estate companies), the Shinawatra group (in the oligopoly of telecommunication business), Song Vatcharasriroj (security-market investment group), and the Group of 16 (young members of the parliament). In addition to these civilian conglomerates, the military started to establish its financial arms, including the Thai Military Bank and a number of

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[101] Philip S. Robertson, "The Rise of the Rural Network Politician: Will Thailand's New Elite Endure?" *Asian Survey*, Vol.36, No.9 (September 1996), p.933.

[102] David Murray, "Thailand's Recent Electoral Reforms", 528-31; Surin Maisrikrod and Duncan McCargo, "The Electoral Politics".

[103] John L.S. Girling, *Thailand: Society and Politics* (Ithaca, NY: Cornell University Press, 1981); Kevin Hewison, *Power and Politics in Thailand: Essays in Political Economy*, (Manila: Journal of Contemporary Asia Publishers, 1989); Akira Suehiro, *Capital Accumulation and Industrial Development in Thailand*, (Bangkok: Chulalongkorn University Social Research Institute, 1985).

[104] Anek Laothamatas, *Business Associations and the New Political Economy of Thailand: From Bureaucratic Polity to Liberal Corporatism*, (Boulder, CO: Westview, 1992).

[105] Suchit Bunbongkarn, "Elections and Democratization in Thailand." In R.H. Taylor, ed. *The Politics of Elections in Southeast Asia* (Washington, DC: Woodrow Wilson Center Press, 1996), 190.

investment companies.

The new conglomerates found a faster and easier way to wealth by investing in security market and engaging in banking activities. Through innovative bookkeeping exercises, preferential stock allocations, insider trading, and the privileged information received from their political connections, they could manipulate security prices for instant and handsome profits.[106] These new conglomerates strengthened their bonds with state officials through joint investments in the security market.[107]

The 1997 crisis brought some changes on the part of the new conglomerates. Under the pressure of the IMF, the Thai government issued new regulations on corporate bookkeeping, insider trading, and conflict of interest. The Securities and Exchange Act was revised to strengthen transparency. Many financial firms were ordered to close down or change their management. A total of 58 insolvent and liquidity strapped finance companies were suspended by the end of 1997. The Bank of Thailand further intervened in a total of six commercial banks and twelve finance companies in 1998 to change their management and practices.[108] In 1999, the Bank prosecuted 40 executives from defunct finance companies.[109] The rest were under tight supervision by the government and the IMF. If implemented effectively, these new rules would greatly reduce the room of financial politics for conglomerates.

Local Factions

Local factions were the cornerstones of Thai patronage politics, especially in the countryside.[110] Because of severe poverty, low education level, and the lack of government welfare programs, village people in the northern and southern provinces depended on local patrons (called chao pho, or "local gods") for basic needs. These local patrons were either landed gentry, village heads, teachers, exploiters and traders of natural resources (e.g., timber, tobacco, sugar) or smugglers (e.g., opium, weapons). In everyday life, they provided jobs, goods, loans, and services (e.g., wedding or funeral) to village people. At the time of election, these local patrons served as canvassers of votes. The effectiveness of vote collection by these canvassers

[106] Paul Handley, "More of the Same? Politics and Business, 1987-96", 100-102.
[107] *FEER* 12/10/98, 62
[108] www.mof.go.th/ter1999/Thai_E_R.html.
[109] *FEER* 11/4/99, 13.
[110] John T. Sidel, "Siam and Its Twin?" *IDS Bulletin*,, 56-63.

was supported by the Buddhist culture and by the threat of violence.[111] They did not have strong party identification, nor did they adhere to specific politicians. Those candidates who offered the highest price got all the votes each canvasser could master. There was little direct contact between candidates and voters.[112]

The multi-member district system further encouraged vote buying. Similar to the campaign strategies in the SNTV (single-non-transferable-voting) systems of Japan and Taiwan, Thai candidates could concentrate their campaign on a particular area of an electoral district in order to get elected. It was not necessary to get the majority of district votes. Vote buying, therefore, became an effective way to garner the minimum number of votes.[113]

Because the local factions had no ideological loyalty to politicians but would open for bidding at each election, campaign costs increased dramatically. The requirement of large amount of cash flow drove the politicians to the banks and security market, thus, contributing to the expansion of financial politics.

Since the 1990s, efforts have been made to reduce the influence of local factions in elections. The 1997 constitutional revision prescribed an independent Election Commission to hold and monitor future elections. The government initiated development and welfare programs to the remote areas, which could reduce the dependence of village people on the chao pho. Economic boom in urban areas also encouraged labor migration, which could undermine the cohesion of network ties.[114] The constitutional change of the electoral system from multi-member districts to single-member districts will probably reduce, though not eliminate, the influence of local factions.

Limited Foreign Participation

Despite its active capital liberalization programs and large inflow of foreign

[111] Philip S., Jr. Roberson, "The Rise of the Rural Network Politician: Will Thailand's New Elite Endure?" *Asian Survey, Vol.3*6, No.9 (September 1996).; Anek Laothamatas, "A Tale of Two Democracies: Conflicting Perceptions of Elections and Democracy in Thailand." In R.H. Taylor, ed. *The Politics of Elections in Southeast Asia* (Washington, DC: Woodrow Wilson Center Press,1996), 221.

[112] Surin Maisrikrod and Duncan McCargo, "The Electoral Politics".

[113] In Thailand, governors of provinces were appointed by the Ministry of Interior, not by local elections. Most of these governors were selected from powerful chao pho. Thus, the multi-member district system seemed to be a more important contributor to the establishment and consolidation of local factions than the election of local administrative officials was.

[114] Philip S., Jr. Roberson, "The Rise of the Rural Network Politician", 937.

capital since the early 1980s, Thailand's banking and security markets were highly protected from foreign financial institutions before the 1997 crisis broke out. According to Dobson and Jacquet, Thailand provided an open capital account and national treatment for various foreign financial instruments.[115] But in the banking market, foreign ownership of domestic banks and finance companies was limited to twenty-five percent. Foreign banks could have at most three branches, with one outside Bangkok. ATMs were regarded as branches. Foreign banks had a reserve requirement of 125 million baht and were required to invest in low-yield government bonds. The number of foreign employees in these banks was also regulated.

In the stock market, foreign equity participation in finance company joint ventures was limited to forty-nine percents. Foreigners could not get licenses as brokers, dealers, traders, or underwriters. New entrants must be approved by the Finance Minister and the cabinet. Capitalization requirement for foreign companies was calculated according to local branch assets, not global. Foreign portfolio investment was restricted to minority of shares.

The above data confirms both the left and right explanations of Thailand's financial crisis. There was indeed large inflow of foreign capital in terms of the value of various financial instruments, but there was also insufficient market liberalization in terms of the direct participation of foreign companies in local financial markets. The result was that the inflow of foreign capital only served to increase the size of the pie, while it was the same domestic financial actors that had the exclusive power to divide the pie. Since the capital account was open, international speculator was able to build up a mirage of financial market boom and, then, took the sweet pie filling and left the sour frosting and crust behind.

Summary of the Thai Case

The 1997 financial crisis of Thailand could be explained as a result of the financial politics generated by a non-autonomous state, patronage party system, speculative financial conglomerates, and expensive local factional politics. The Bank of Thailand and the Security Exchange Commission did not have sufficient political autonomy in their institutional design. Nor did their officials avoid corrupt practices.

[115] Wendy Dobson and Pierre Jacquet, *Financial Services Liberalization in the WTO*. (Washington, DC: Institute for International Economics, 1998).

Political parties in Thailand could be characterized as personality-based, ecliptic, turncoat, and regional. Their patronage nature helped to expand financial politics. In the late 1980s and early 1990s, conglomerates emerged to make instant profits from speculative financial markets, through their political connections with state officials and politicians. The strength and volatility of local factions contributed to the skyrocketing of campaign costs, compelling politicians to rely on financial markets for huge and instant cash flow. Finally, direct participation of foreign companies in local financial markets was restricted to protect major actors of the Thai financial politics. Since the late 1990s, several significant reforms have been introduced to put Thai financial politics under control, whose effects remain to be seen.

Financial Politics in Malaysia

Although the Malaysian economy also suffered a serious blow from the 1997 financial crisis, it did not suffer as much as the Thai economy did. It recovered from the crisis stronger than the Thai economy did, and the Malaysian recovery was achieved without the financial assistance from the IMF. Therefore, a satisfactory explanation needs to account for both the failure and success of the Malaysian economy during the 1997 crisis. The following sections discuss the roles of the state, political parties, conglomerates, and local factions in Malaysia's financial politics.

The State

Since its independence in 1957, Malaysia has followed its British colonizer to adopt the constitutional monarchy, in which the Prime Minister, not the King, had the real political power. In contrast to the instability of Thai cabinet governments, however, the Malaysian government was free from military coups and has been controlled by the UMNO-led coalition of political parties. Only five changes of premiership have occurred, and the last one, Mahathir Mohamad has stayed in his office since 1981. This stability of the government plus the British legacy of a professional bureaucracy allowed the Malaysian state to maintain relative political autonomy and administrative efficiency, as compared to its Southeast Asian neighbors.[116] Furthermore, the ruling coalition has been able to command a two-thirds majority in the Parliament, except for a short period in 1969. The parliament or its committee system has not been a major influence in the formulation of national policies.[117]

This is not to say that the Malaysian government was corruption-free. In fact, government corruption was always a hotly debated issue in Malaysian elections, and it partially contributed to the 1997 financial crisis as well. However, the corruption seemed to concentrate in redistribution policies (monopolies, infrastructure construction, real estate development, government procurements, etc.) and did not significantly affect the export sectors after the late 1960s.

The major redistribution policies were associated with the New Economic Policy (NEP) from 1970 to 1991. The NEP was promulgated by the Malay-dominated government in response to the 1969 racial riots between the Malays and the Chinese. The state tried to balance the Chinese dominance in the economy through ethnic regulations and state (and quasi-public) enterprises. It was in these sectors where corruption was widely reported. Chinese businesses would use Malay heads to acquire government assistance. Positions of state enterprises and their procurement projects were rewarded to political supporters.[118] Investors with strong political connections could use privatization projects to make large gains in the security market.[119] After 1991, the NEP was replaced by the National Development Policy, which retained the ethnic bias of the NEP.

In 1986, under the leadership of Mahathir Mohamad (assumed premiership in 1981), Malaysia implemented comprehensive export drives, which included the reduction of red tape and various liberalization measures. Opportunities of corruption

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[116] In his study of the Malaysian civil service (MCS), Puthucheary (1987, 107) comments: "The MCS enjoys a position of power perhaps unequalled by any oth4er civil service in a democratic country. Its members belong to the same ethnic background as many of the political leaders and are tied by common educational and kinship links. Most importantly, because of the trust and confidence that the political leaders had in the civil service and especially in the MCS officers, they have been given a more important role in political decision-making than would otherwise have been the case." According to the annual surveys conducted from 1995 to 1999 by the Political and Economic Risk Consultancy, Ltd. (Hong Kong), Malaysia's corruption scores were consistently lower than those of India, China, Indonesia, Thailand, and the Philippines (http://www.asiarisk.com/lib10.html, 7/6/99..

[117] Gordon P. Means, *Malaysian Politics: The Second Generation* (New York: Oxford University Press, 1991), 294-95.

[118] For a detailed discussion on the relationships between the state and business during the NEP era, see Jomo (1986). Crouch explains how the NEP regulations to encourage bumiputeras to buy non-Malay company shares turned out to benefit non-Malays, members of royal families and local UMNO leaders. Harold Crouch, *Government and Society in Malaysia* (Ithaca, NY: Cornell University Press, 1996).

[119] *FEER* 4/23/98, 76.

were thus not eliminated but greatly reduced. The mixture of efficiency and corruption of the state bureaucracy was also reflected in the financial bureaucracy - the central bank and the Security Exchange Commission.

The central bank of Malaysia is Bank Negara Malaysia. It was established by the Central Bank of Malaya Ordinance in 1958. Its colonial predecessor was the Board of Commissioners of Currency. Therefore, as compared to the Bank of Thailand, Bank Negara had a headstart by inheriting an efficient and autonomous institution from its colonial master.

The institutional features of Bank Negara had certain strengths as well as weaknesses. As in Thailand, Bank Negara was established under the Ministry of Finance. The policy of the Bank was entrusted to its Board of Directors, which consisted of nine to twelve members, including the Governor, Deputy Governors, the Secretary General (or Deputy Secretary General) of the Finance Ministry, and five to eight members who were not officials or representatives of private interests.[120] The Finance Minister appointed and dismissed only the Deputy Governors, while the Prime Minister appointed and dismissed the Governor and all other members of the Board with the ceremonial approval of the King. The above information revealed that, as compared to its Thai counterpart, Bank Negara had more political autonomy in its governing structure and personnel. Even though the Bank was located under the Finance Ministry, it was the Prime Minister, not the Finance Ministry, who had real control over the Bank.

The relative long tenure of the Bank's governors also indicated the political autonomy of the institution. Since its establishment in 1959, the Bank has had six governors, averaging one turnover every six and a half years.[121] The Bank of Thailand has a turnover every three years.

Bank Negara had exercised effective discipline over Malaysia's banking system. The ratio of non-performing loans stood only 3.6% of total loans on the eve of the 1997 crisis.[122] The ratio grew to 9.1% in March 1998, a relatively small number as compared to Thailand's 48%. The Bank learned its lesson from the banking crisis of the mid-1980s, when the ratio of non-performing loans was 34%. The crisis prompted the Bank to enforce banking regulations more rigorously and to insist on

[120] Central Bank of Malaysia Act 1958, www.law.nyu/centralbankscent…alaysia-Central%20Bank%20Act%20519.html, 4/12/2000.
[121] www1.bnm.gov.my/about/history.html, 4/21/2000.

transparency.[123]

There were two major structural problems of the banking system. One was the over-extension of loans to the property sector and loans for the purchase of stocks and shares. The other was the close linkage between banks and security finance companies. In 1997, loans to the property sector accounted for 26% of total loans. Loans for security investment during the period of 1993-97 grew at 35% on average.[124]

After the crisis, the Malaysian state adopted IMF-style austerity programs to reduce government expenditures and to reform the banking sector. Among other measures, Bank Negara changed the classification of non-performing loans in arrears from six to three months. It asked banking institutions to make monthly reports of their financial status, and Bank Negara implemented more rigorous and intensive supervision, including monthly stress tests on banking institutions. Fragile banks were order to merge together.[125] Except for the provision of more information, no criticism or reform was directed toward Bank Negara, indicating the relative efficiency of the Bank.[126] If Bank Negara was not the major cause of the 1997 crisis, which state agency was?

The weak link in the Malaysian financial crisis of 1997 seemed to be the Securities Commission. The Malaysian government established the Securities Commission in 1993, one year after its Thai counterpart. According to the Securities Commission Act of 1993, the Securities Commission reported to the Finance Minister, who also appointed all the nine members of the Commission, including the executive chairman, deputy chief executive, and seven private and government representatives.[127] Therefore, like the Thai Securities Exchange Commission, the Malaysian statue of the Securities Commission did not allow it too much political independence from the Finance Ministry or from the pressure of private interests. Past Finance Ministers had used the position to benefit their relatives and proteges; Daim

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[122] Neac.gov.my/neac/publications/prior.shtml, 4/12/2000.
[123] Philippe F. Dehaise, *Asia in Crisis: The Implosion of the Banking and Financial Systems* (New York: John Wiley & Sons (Asia), 1998), 146.
[124] Neac.gov.my/neac/publications/prior.shtml, 4/12/2000.
[125] Neac.gov.my/neac/publications/policy.shtml, Neac.gov.my/neac/publications/objective3.shtml, 4/12/200.
[126] Under the Statistics Act of 1965, government agencies, including Bank Negara, restricted the amount of data made available to protect confidentiality. In March 1998, the government adopted measures to promote transparency regarding financial and corporate statistics. Neac.gov.my/neac/publications/ob2act3.shtml, 4/12/2000.

Zainuddin, the Finance Minister from 1984 to 1991, was probably the most controversial one.[128]

Furthermore, the Finance Minister had direct influence over the supposedly private regulatory body of the Kuala Lumpur Stock Exchanges (KLSE). By the Securities Industry Act of 1983, the Minister could "approve a stock exchange and to appoint any person to the stock exchange's committee," or to dismiss any committee members at any time.[129]

During the 1997 crisis, the regulators of the security market, the KLSE and the Securities Commission, received many criticisms from the public and the government's reviews. Both regulators were criticized for their lack of firm and decisive action against breaches of regulations. They were weak in monitoring and enforcement activities.[130] However, these structural weaknesses were part of the new financial politics in Malaysia. Under the New Economic Policy, the government could order corporations to transfer up to 30% of their shares to government approved Malay individuals or companies before the actual listing. This had provided instant profits to UMNO elites and their relatives, as the opposition in late 1994 exposed such scandals.[131]

Despite the correct diagnosis, no concrete measures have been promulgated to address these organizational and implementation problems. Most of the reform still focused on the transparency of security transaction.

Political Parties

Malaysia's political party system exhibited three characteristics. First, most of the political parties were ideological or ethnic-based, and conducted campaign on these lines. Secondly, the United Malays National Organization (UMNO) held a tight leash over its party members, its party allies, and over opposition parties. And thirdly, internal squabbles and defections plagued the opposition parties.

Most of Malaysia's political parties were ideological or ethnic-based. On the opposition side, the major opposition parties were the Chinese-based Democratic

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[127] sc.com.my/html/organisation/members.html, 4/13/2000.
[128] *FEER* 2/19/98, 16-17.
[129] www.klse.com.my/website/about/orgstruc.html, 4/21/2000.
[130] Neac.gov.my/publications/objective3.shtml, 4/12/2000.
[131] James Chin, "The 1995 Malaysian General Election: Mahathir's Last Triumph?" *Asian Survey*, Vol.36, No.4 (April 1996), 400-401.

Action Party (DAP), and the Malay-based Parti Islam SeMalaysia (PAS). The DAP always campaigned on the issue of racial discrimination, especially in the commercial area; its main base was in the Penang State. The PAS was noted for its Islamic fundamentalism, aiming to turn Malaysia into an Islamic state. Its major constituency was in the Kelantan State.

The ruling coalition, Barisan National (National Front), was composed of three large ethnic political parties (the Malay-based UMNO, the Chinese-based Malaysian Chinese Association, and the Malaysian Indian Congress) and a few other smaller parties. Barisan Nasional was able to maintain uninterrupted rule not only because it was a coalition of ethnic parties, but also because it adopted development policies which created the vast majority of the professional and middle class across ethnic lines.[132]

UMNO has maintained strong control over its members and other political parties. In terms of internal discipline, UMNO leaders used federal and state government posts, parliamentary seats, and numerous state and quasi-state enterprises to reward followers. Large campaign expenses for individual politicians were covered by UMNO's rich coffers - the Fleet Holdings, the Hatibudi Sendirian Berhad, and the Renong Berhad conglomerates, which held interests in hotels, television, retailing, real estate, construction, and banking at both national and local levels.[133] The mass media, owned or tightly controlled by Barisan Nasional, provided the best news image and advertisement for politicians in remote areas.

Dissidents within the party faced expulsion and/or government harassment under the Internal Security Act and Sedition Act. UMNO experienced only two major internal crises in 1987 and 1998. In the aftermath of the UMNO election in 1987, the party was split into two factions. Team A was led by Prime Minister Mahathir, and Team B was composed of UMNO vice-president Tengku Razaleigh Hamzah and old guards who were dissatisfied with Mahathir‘s leadership. Two years later, Team B left UMNO and established a new party, Semangat 46. However, the coalition of Gagasan Rakyat Malaysia (People’s Might), formed by Semangat 46, the DAP, and the PAS, failed to shake down Barisan Nasional’s two-third majority in the 1990 parliamentary

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[132] Harodl Crouch, "Malaysia: Neither Authoritarian nor Democratic," in Kevin Hewison, Richard Robison and Garry Rodan, eds., *Southeast Asia in the 1990s: Authoritarianism, Democracy and Capitalism*, (Sidney: Allen & Unwin, 1996).
[133] James Chin, "The 1995 Malaysian General Election:", 402.; Harold Crouch, *Government and Society in Malaysia*, 214-16..

election. By the 1995 election, Gagasan Rakyat had disappeared. Both the DAP and the Semangat 46 lost seats to the Barisan Nasional. The other crisis of the UMNO occurred in 1998, in the midst of the financial crisis, Deputy Prime Minister Anwar Ibrahim and his supporters attempted to force Mahathir to take an early retirement. But Mahathir fought back fiercely. In July 1998, he published the names of hundreds of companies and individuals that won privatization contracts or benefited from a bumiputra share allocation in recent years. Anwar and his supporters were among the names.[134] Anwar was later removed from his posts as Deputy Prime Minister and Finance Minister, and sentenced to a six-year term on charges of corruption (a violation of the Internal Security Act) and homosexual behavior (a violation of the Islamic Law). Anwar‘s supporters, rallying behind Anwar’s wife, formed a lose coalition to challenge Barisan Nasional in the 1999 general election. Although it lost some seats to the PAS, Barisan Nasional maintained its three-quarters majority in the parliamentary seats. The National Justice Party, organized by Anwar's wife, won only five seats.[135]

Why would the Chinese, who had the economic power, continually support the Malay-dominated Barisan Nasional? Although UMNO championed the interests of the bumiputeras (the Malays), economic interests of the Chinese were never seriously hurt but enhanced. The promotion of Malay interests was implemented through state enterprises and government subsidies, while the economic interests of the Chinese concentrated in the private sectors of commerce, banking, and real estate. Furthermore, the clandestine use of Malay heads to circumvent government regulations was so widespread that the Chinese elites benefited as much from government promotion policies as the Malays did.[136] Furthermore, the nightmare of the 1969 racial riots remained fresh in the mind of old generation Chinese. The massive killings of the Chinese in Indonesia in the late 1990s served only to strengthen the Malay-Chinese‘s belief that a stable and moderate Malay government could better protect their interests and lives than other extremist communal parties.[137]

UMNO‘s continued dominance over other political parties was maintained through various control instruments of the authoritarian government. Most of the mass media (television stations and newspapers) were either owned by the Barisan

[134] *FEER* 7/2/98, 11.
[135] *FEER* 12/9/99, 17.
[136] Harold Crouch, *Government and Society in Malaysia*, 218.

Nasional or tightly controlled by the government.[138] Criticisms of the government often ended up with the charge of sedition or instigating racial conflicts prohibited by the Internal Security Act, which also allowed the police to detain political opponents without trial. The Malaysian government routinely resorted to these harassment techniques during election campaigns.[139] The opposition could not depend on the legal system either, since the ruling coalition maintained two-thirds majority in the parliament, which allowed the government to frequently pass constitutional amendments to expand administrative powers at the expense of the opposition.[140] In fact, the Supreme Court have become subordinated to the will of Mahathir since he removed some of the judges who opposed him during the UMNO split of 1988. [141]In the same year, the Parliament passed a constitutional amendment permitting the Supreme Court to conduct judicial review only when the Parliament grants.[142] Furthermore, the British-style single-member constituencies combined with the government's partisan gerrymandering of electoral constituencies had favored the centrist Barisan Nasional over the fundamentalist or extremist opposition parties.

Finally, internal squabbles and defections plagued the opposition parties. Most of Malaysian parties were organized in authoritarian way. When factional divisions occurred within a party, they usually ended up with a split of the party rather than going through democratic turnover of party leadership.[143] After losing the 1990 election, many supporters of Semangat 46 returned to UMNO for more patronage and promising career future. The party won only six seats in 1995, and none in 1999. The DAP began serious infighting after it lost badly the 1995 election. In the 1999 election, it increased its parliament seats by one only; it was nine in 1995.[144]

Conglomerates

The main cause of the Malaysian economic crisis in 1997 seemed to lie in the market. It was a case of market failure without proper government preemptive checks.

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[137] Gordon P. Means, *Malaysian Politics*, 294-95.; *FEER* 3/18/99, 6
[138] James Chin, "The 1995 Malaysian General Election:",.401.
[139] Ibid, 396.
[140] Gordon P. Means, *Malaysian Politics*, 294-95.
[141] K.S. Jomo, "Elections' Janus Face: Limitations and Potential in Malaysia." In R.H. Taylor, ed. *The Politics of Elections in Southeast Asia* (Washington, DC: Woodrow Wilson Center Press, 1996), 100.
[142] Clark D. Neher, *Southeast Asia in the New International Era*, 124.
[143] Gordon P. Means, *Malaysian Politics*,287.

In the late 1980s and early 1990s, Malaysian conglomerates rapidly expanded their financial subsidiaries in response to the booming economy and the expansion of the capital market. Both the state and private financial institutions overextended their loans to the real estate and capital markets. As savings lacked behind investment, these financial institutions supplemented their capital needs by resorting to mutual borrowing, dubious accounting procedures, and external borrowing.[145]

The domino effect of the 1997 crisis was caused by the close links among Malaysia's banks, finance companies, securities houses, and merchant banks. Banks controlled from 50 to 100% of the shares of their financial subsidiaries. Mutual borrowing was extensive among these financial institutions.[146] Conglomerates like the Antah Holdings Group, the Melewar Group, the Arab Malaysian Group, the R.J. Reynolds and Land & General Groups, as well as the UMO-controlled Fleet Holdings, Hatibudi, and Renong Berhad, all exhibited such complex financial relationships among their subsidiaries and between conglomerates. Furthermore, many of the financial relationships were not linked to the competitive export sector but rather to the expansion of real estate and security markets of the 1980s and 1990s.[147]

The expansion of the real estate and financial markets contributed to the rise of financial politics in Malaysia. Political elites found new ways of making instant profits by pricing their official responsibilities and privileged information related to these business activities. For instance, the Malaysian banking industry was dominated by two largely government-owned commercial banks, which provided frequent contact between the conglomerates and state officials.[148] One of the state-owned bank, Bank Bumiputra, was noted for its dubious loans to well-connected business people, including a sour loan to an ethnic Chinese real estate investor who lost his gamble in Hong Kong's real estate market in 1997. The sour loan cost the entire equity of Bank Bumiputra, which was supposed to lend money to bumiputeras only.[149]

UMNO candidates increasingly depended on conglomerates to raise funds. It

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[144] *FEER* 6/18/98, 21; 12/9/99, 17.
[145] Zainal Aznam Yusof, "Financial Services: The Role and Tasks Ahead." In Hoe Yoke Teh and Goh Kim Leng, eds., Mal*ysia's Economic Vision: Issue and Challenges (M*aysia: Pelanduk Publications, 1992), 273, 291-93, 315.; Pilippe F. Dehaise, *Asia in Crisis*,147.
[146] Philippe F. Dehaise, *Asia in Crisis* ,151.
[147] Edmund Terence Gomez, and K.S. Jomo, *Malaysia's Political Economy: Politics, Patronage and Profits*. (New York: Cambridge University Press, 1997), 119-20.
[148] Zainal Aznam Yusof, "Financial Services, 298-99.
[149] Philippe F. Dehaise, *Asia in Crisis*, 145.

was done through insider trading and manipulation of share prices of politically controlled conglomerates.[150] Before UMNO convened its General Assembly, these conglomerates would launch coordinated attack on the stock market index. After the market plunged, they bought back their stocks and later distributed the profits to candidates who invested their campaign money at the "right time."

Local Factions

As in Thailand, patronage politics also existed in Malaysian rural areas. Village heads served as canvassers at time of election. However, for a number of reasons, Malaysian local factions did not play as an important role as those did in Thailand or in other Asian nations. First, Malaysian electoral system adopted the British-style single-member constituencies, instead of the multiple-member constituencies of Thailand. Therefore, the relative importance of a single village or faction to a candidate was smaller in Malaysia than in Thailand. Secondly, political parties in Malaysia differentiated from one another based on ethnic or ideological lines. Although patronage politics existed, the appeal to communal interests and concrete development projects were more important than vote buying in attracting voters.[151] Thirdly, Malaysian elections were relatively free of irregularities and voter coercion, which happened quite often in Thailand. Finally, UMNO's local leadership was gradually replaced by "urban-based businessmen-cum-weekend politicians," whose political and economic fortunes depended more on UMNO central leadership than on local connections.[152] So were locally elected state governors and representatives, whose performance depended on development funding from the central government.[153]

As a result of the reduced role of local factions, Malaysian politicians did not face the pressure of large cash flow during elections as their Thai counterparts did. Therefore, the arena for financial politics was reserved for the top political and economic elites, rather than for the local factions.

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[150] Edmund Terence Gomez, and K.S. Jomo, *Malaysia's Political Economy*,124.

[151] Amri Baharuddin Shamsul, *From British to Bumiputera Rule: Local Politics and Rural Development in Peninsular Malaysia*, (Singapore: Institute of Southeast Asian Studies, 1986); Harold Crouch, *Government and Society in Malaysia*, 195.

[152] Edmund Terence Gomez, and K.S. Jomo, *Malaysia's Political Economy*,121.; and Clark D. Neher, *Southeast Asia in the New International Era*,135.

[153] Abdul Rashid Moten, "The 1999 Sabah State Elections in Malaysia: The Coalition Continues." *Asian Survey*, Vol.39, No.5 (September/October 1999), pp.792-807.

Limited Foreign Participation

As in Thailand, Malaysia has adopted active capital liberalization programs and attracted large inflow of foreign capital since the early 1980s. But, similar to Thailand, Malaysia's banking and security markets were highly protected from foreign financial institutions before the 1997 crisis broke out. According to Dobson and Jacquet, Malaysia opened its capital account and provided national treatment for various foreign financial instruments in local financial markets (except for insurance).[154] But in the banking market, foreign equity in domestic banks was limited to thirty percent or less. They were not allowed to establish new branches, while ATM's were regarded as branches. Non-financial joint ventures could borrow only up to forty percent of loans from joint-venture banks. Foreign banks could not do business with state-owned enterprises, nor did they have access to local capital market. As in Thailand, foreign banks in Malaysia faced higher capital requirements than their local counterparts.

In the stock market, foreigners were allowed 100 percent ownership of fund management company if the company handled only foreign funds. If not, the ownership was restricted seventy percents. New joint ventures of stock companies were subject to economic needs test. All forms of foreign equity were tightly controlled. Initial public offerings were generally restricted to Malaysian investors, the bumiputeras. Finally, the amount and sectors of foreign portfolio investment were also restricted.

Similar to the Thai case, the above data confirms both the left and right explanations of Malaysia's financial crisis. There was indeed large inflow of foreign capital in terms of the value of various financial instruments, but there was also insufficient market liberalization in terms of the direct participation of foreign companies in local financial markets. The consequence was similar to the Thai case that since the capital account was open, international speculator was able to build up a mirage of financial market boom and, then, took the pie filling and left the sour frosting and crust behind.

[154] Wendy Dobson, and Pierre Jacquet, *Financial Services Liberalization in the WTO* (Washington, DC: Institute for International Economics, 1998), 39-40.

Summary of the Malaysian Case

Malaysia suffered less and recovered better than Thailand from the 1997 crisis. The explanation was that Malaysian financial politics, although inflamed by conglomerates, was kept in bay by a relatively autonomous state, the dominance of the Barisan Nasional, and weak local factions. Bank Negara was able to maintain relatively high efficiency and political autonomy, while the Securities Commission was relatively weak. Barisan Nasional was able to use various reward and punishment instruments to consolidate its cohesion and to suppress opposition parties. Because of the single-member constituencies, the communal base of political parties, and the relatively clean elections, local factions did not play an active role in Malaysian financial politics. Similar to Thailand, the Malaysian financial politics was active due to stringent restrictions of direct foreign participation in local financial markets.

Summary and Conclusion

Taiwan

The main problems with Taiwan's credit market are the high percentage of non-performing loans, the expansion of bad loans, and the frequent occurrence of bank-runs. The major problem with the stock market is its frequent and large price fluctuations. The distortions in Taiwan's financial markets demonstrated that the 1997-1998 economic recession in Taiwan was not caused solely, if at all, by international speculators. Structural weaknesses made Taiwan's financial markets susceptible to changes in the external environment. Symptoms of such structural weaknesses had appeared frequently before the 1997 exchange crisis broke out. In other words, economic recession on the 1997 scale had happened before in Taiwan and will happen again if these structural distortions are not properly analyzed and tackled.

The 1997-1998 banking crisis in Taiwan was caused less by external factors than by the oligopolistic alliance among the KMT, local factions, conglomerates, and representatives, with the administration as a tacit collaborator. The KMT controlled four banks to expand its financial and political influence. Conglomerates established new banks to subsidize their subsidiaries and to consolidate political connections. Local factions survived on the oligopolistic rents of local credit institutions in order to finance campaign expenses. Therefore, a symbiosis of the KMT, representatives, local factions, and conglomerates existed. The financial administration, with declining political autonomy since democratization began in the 1980s, could not but collaborate with this financial oligopoly.

Similarly, the oligopolistic alliance among the KMT, conglomerates, and representatives, with the state as both a passive and an active collaborator, has caused the distortions in Taiwan's stock market. Conglomerates dominated the market; almost each of the top 100 conglomerates owned a stock company. Legislators who owned or invested in stock companies helped legalize market distortions, because they had high reelection rates and were regular members of the Finance Committee, which made policies regulating stock transactions. The KMT itself became a major player in the market through its ownership of four stock companies and through its party BMC to coordinate investment policies with major conglomerates. And the state was incapable of regulating market distortions. The Central Bank lost its political autonomy. The Securities and Futures Commission of the Finance Ministry had not been an effective monitoring authority, because it had a small budget, its staff members were few, and its legal and political status in the bureaucracy was low.

Thailand

The 1997 foreign exchange crisis of Thailand could be explained as a result of the financial politics generated by a non-autonomous state, patronage party system, financial capitalists, and expensive local factional politics. The Bank of Thailand and the Security Exchange Commission did not have sufficient political autonomy in institutional design. Nor did their officials avoid corrupt practices. Political parties in Thailand could be characterized as personality-based, ecliptic, turncoat, and regional. Their patronage nature helped to expand financial politics. In the late 1980s and early 1990s, financial capitalists emerged to make instant profits from speculative financial markets, through their political connections with state officials and politicians. Finally, the strength and volatility of local factions contributed to the high-rise of campaign costs, forcing politicians to resort to financial markets for huge cash flow. Since the late 1990s, several significant reforms have been introduced to put Thai financial politics under control, whose effects remain to be seen.

Malaysia

Malaysia suffered less and recovered better than Thailand from the 1997 crisis. The explanation was that Malaysian financial politics, inflamed by privileged capitalists, was kept in bay by a relatively autonomous state, the dominance of the Barisan Nasional, and weak local factions. Bank Negara was able to maintain relatively high efficiency and political autonomy, while the Securities Commission was relatively weak. Barisan Nasional was able to use various reward and punishment instruments to consolidate its cohesion and to suppress opposition parties. Because of the single-member constituencies, the communal base of political parties, and relatively clean elections, local factions did not play an active role in Malaysian financial politics.

General Lessons for New Financial Politics

What lessons can be drawn from this analysis? In an edited volume devoted to the Asian financial crisis, Haggard and MacIntyre correctly recommend that:

> The problems Asia faces are not simply those of shoring up the balance of payments in the short run, or even restructuring foreign debt. Rather, the problems are more deep-seated ones requiring a range of institutional as well as policy reforms: strengthening central banks and financial regulators; improving corporate governance and transparency; encouraging the development of soundly regulated equity and debt markets; cleaning up weak banks; and rooting out corruption."[155]

While echoing these reform goals, this paper provides more details and more comprehensive institutional reforms. First, the central bank and the security exchanges commission should be made politically independent from the Finance Ministry and have the legal status as a ministry. Secondly, while the market should be liberalized, transparency and compliance in market transaction is critical. The financial regulatory agencies should exercise effective monitoring and enforcement to reduce cheating behavior and excessive market fluctuations. This can be done only when the financial regulatory agencies acquire sufficient staff and budget to perform these functions. Thirdly, while party turnovers are important to reduce long-term

[155] Stephan Haggard, and Andrew MacIntyre, "The Political Economy of the Asian Economic Crisis." *Review of International Political Economy,* Vol.5, No.3 (Autumn 1998), 385.

patronage politics, the number of effective political parties should be reduced to constrain short-term patronage politics. This can be done by introducing a legal threshold of vote percentage in national elections for political parties in order to qualify for economic and political benefits, as practiced in Germany. Fourthly, conflict of interest laws should be formulated for legislators and administrators to reduce the direct participation of conglomerate representatives in the legislature and administration. Fifthly, the electoral system of single-member constituencies seems to be able to reduce financial politics at the local level. But the more fundamental solution to local patronage is for the state, through extensive industrial development projects, to create a strong middle class (farmers, workers, and small-and-medium enterprise owners) in the countryside with independent and self-sufficient income. Finally, while both capital liberalization and financial reforms are desirable in the long run, the speed of one process should keep pace with the other in order to avoid excessive market fluctuations (when liberalization is too fast) or insufficient capital flow (when liberalization is too slow). Even some of the liberal economists seem to converge with the leftists on that the Asian financial crisis was a result of financial liberalization too much and too fast, and recommend that financial reform is a "necessary precondition to" full-scale internationalization.[156]

[156] Wendy Dobson, and Pierre Jacquet, *Financial Services Liberalization in the WTO* , 9.

Table 1. Relative Differences Between Industrial Production and Financial Business

	Industrial Production	**Financial Business**
Capital/Labor Ratio	Small	Large
Land and Materials	High	Low
Technology Form	Machinery	Information and Knowledge
Transportation Cost and Risk	High	Low
Marketing Cost and Risk	High	Low
Profit Maturity	Long	Short
Profit Margin	Small	Large
Profit Stability	Stable	Unstable

Table 2. Relative Differences between Industrial Politics and Financial Politics

	Industrial Politics	**Financial politics**
Capital/Labor Ratio	Promote entrepreneurship, suppress or compensate workers	Secure capital from monetary policies
Land and Resources	Low taxes, zoning, low tariffs on material imports	Little
Technology Form	Low tariffs	Knowledge or privileged information
Transportation Cost and Risk	Infrastructure building	Little
Marketing Cost and Risk	Trading companies, OEM	Little
Profit Maturity	Balance of payment subsidies	Privileged information
Profit Margin	Low taxes or tax evasion at various stages	Manipulation of accounting and tax information
Profit Stability	Government rescue comes slowly and selectively	Oligopoly; Government rescue comes quickly and comprehensively

Figure 1. Institutional Relationships in Taiwan's Credit and Stock Markets