The Changing Role of the State in Taiwan’s Financial Development

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Introduction

Financial underdevelopment is a result of financial repression. Financial repression refers to government intervention on financial market and is common in developing countries. Taiwan’s financial sector had been repressed by the 1980s for both political and economic reasons. Economically, deposit interest rate was kept high to encourage savings and curb inflation; loan rate kept low to encourage investment in specific industries; and profits of state-owned banks turned back to the Treasury for productive investment projects. Politically, limitation was imposed on banking operations and lending by state-owned banks to constrain indigenous capitalist development. As a result, a dual financial sector was created, with the formal financial system serving public enterprises and large private enterprises and the informal money market and grass-root institutions meeting the demands of SMEs.

In the last two decades, Taiwan has moved from a developmental state to one relying increasingly on market forces. The financial sector went through interest rate deregulation in the early 1980s, foreign exchange deregulation in 1987, banking

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1 Although Taiwan adopted export-oriented industrialization (EOI) policy from the 1960s onwards, industrialization was government-led. A country can have export-orientation, with the state acting as the mechanism to promote exports or with the market acting as the mechanism to drive exports. In the case of Taiwan, import control and export promotion coexisted until the 1980s.
liberalization in 1991, and consolidation of the banking sector in 2001. Regardless of liberalization, the state’s role in directing economic development remains (in a less interventionist fashion), as exemplified by financial reforms and national economic plans.

Why financial development merits attention? It is a factor of economic development. A country’s economic performance is the result of the interaction between state and private sector and the institutional settings in which they occurred (Breznitz, 2005:223). The institutional settings refer to the socio-cultural, political, financial, and economic institutions, which work together to form the industrial system. The paper finds that financial repression for the period 1950s and 80s in Taiwan created an industrial system, characterized by large SME sector; reliance on public research institutions, e.g. ITRI (for technology transfer and second-generation innovation); and on China as the main export and FDI destinations, making it a mid-level supplier in the global IT production network, a position that is dilemmatic today, albeit decades of rapid economic development.

The paper is organized as follows. First, the evolution of Taiwan’s financial system is briefly reviewed. Second, the adverse impact of financial repression as part of industrialization policy two decades ago on Taiwan’s economy today is stressed. Third, the role of the state in Taiwan’s liberalized financial sector is examined.

The Structure of Taiwan’s Repressed Financial System in the 1950s and 1970s

Political and Economic Objectives Detected Taiwan’s Financial Development

Taiwan had been a financially repressed economy by the late 1980s, with the state monopolizing the financial sector and substituting the market mechanism in terms of

2 The share of private enterprise borrowing from informal money market dropped from 69.6 percent in 1975 to 51.2 in 1985.
credit allocation. In the mid-1960s, private banking institutions accounted for only 2.7 percent of the entire banking industry (Lee, 1998:16-8). Because of a high priority to industrial development and tight control of the financial system, growth in output far exceeded that in financial resources. In explaining a nationalized financial system, the most commonly quoted reason is the KMT’s fear of financial crisis or hyper inflation which led to its defeat on the mainland (Chang, 1993:57). Another is regime survival. Hence, the KMT had to restrain the formation of big native capital class by nationalizing financial system, complemented by other measures such as dismantling of the indigenous landlord class through land reform, and conversion of Japanese property into state owned enterprises. The state’s ownership of banks and enterprise was justified by Three Principles of Sun Yat Sen, advocating public capital development (Shea, 1994:257). Additionally, a study in the development of Taiwanese banking by Lee (1998) attributed the state’s conservative financial policy to a complicated and localized banking system left by the Japanese. To ensure the soundness of the financial system, state bank employees were punished for extending loans that turned bad, making bankers very conservative in extending loans and prefer state-owned enterprises and large private enterprises. As a result of the state’s concern for both political and financial stability, loanable funds in the banking system were insignificant.

Leaving alone political interest, the banking system performed specific functions in Taiwan’s economic development. In the Japanese colonial period, it was used to promote land reform, agricultural development, and support Japanese militarization. After Taiwan’s retrocession to the KMT, financial institutions established by the Japanese were converted into state-owned banks and those formerly operating in China were reestablished, e.g. the Central Trust of China and Communication Bank. The state-owned banks were then charged with the task of financing industrialization by
making use of savings transferred from consumption to the manufacturing sector through postal savings system\(^3\) (Shea, 1994:266).\(^4\) Selective credit policy was adopted. Credit such as preferential interest rate loans and industry-specific loans was allocated to state-owned enterprises in import substituting industries. Thereafter private sector's expansion was encouraged because of the shift to labor-intensive manufacturing export-oriented industrialization (EOI) policy in the 1960s. By 1961, lending of financial institutions to the private sector exceeded 50 percent (Cheng, 1993). Nonetheless, by and large, private firms such as SMEs had to rely on grass-root financial institutions, e.g. credit co-operatives, CDFFAs, and informal money market.\(^5\) One consequence is that growth of SME size was restricted.

The Causes of Financial Liberalization from the 1980s onwards

**Financial Liberalization: a Positively Passive Response to Taiwan’s Economic Development Needs**

Financial liberalization in the 1980s was a result of various factors combined. Before the 1980s, start-up costs for labor-intensive manufacturing were low. Credit cooperatives, specialized banks, e.g. SME banks and informal money market sufficed to meet the needs of SMEs. However, into the 1980s, a nationalized financial system and informal money market no longer could meet the needs of SMEs. However, into the 1980s, a nationalized financial system and informal money market no longer could meet the needs of industrial restructuring/more capital- and

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\(^3\) Savings were collected by the Postal Remittance and Savings Bureau which were then re-deposited into the central bank and other banks.

\(^4\) Savings was the single most important source of finance. How to explain Taiwan’s high savings rate in the 50s and 60s? Besides high interest rates for depositors, shortages in disposable income, consumerables, and investables, the society was taught to practice thrift as a virtue. However, savings mobilization itself would not suffice to promote economic development without supportive policy environment and macroeconomic environment. Also, agrarian surplus was extracted to support industrial development \(以農養工\) (Cheng, 1993: 56, 59).

\(^5\) State commercial banks failed to lend to the private sector particularly the SMEs because of collaterals required for borrowing and state scrutiny for the issuing of bad loans. In order to compensate SMEs’ disadvantages in raising financing, the state offered targeted lending, e.g. SME Credit Guarantee Fund in 1974, created SME banks in 1976, and tolerated informal financial sector (Yang, 1994:292, 309-10). The informal money market was a reflection of the social networks upon which Taiwanese SMEs were constructed. Through networks of kinship, friends, and former employers, SMEs acquired financial, human, and market resources for production. In 1986, about 30 percent of firms’ borrowings (private and public) came from the informal money market, 47 percent from banks and financial institutions, 7 percent from money market, and 14 percent from capital market (Lee, 1990:36).
technology-intensive manufacturing.\(^6\) Worse, because of the nationalized financial system’s inadequacy of investment channels and financial products, excess liquidity, arising from large export earnings over decades of export promotion, inflow of hot money\(^7\), and low domestic investment\(^8\), translated into non-productive investment, e.g. speculation on real estate and stock market and underground lotteries, jeopardizing financial and economic stabilities, as expressed in the stock market and property slumps shortly after the banking reform in 1989 (Shea, 1994:257).\(^9\) Besides excess liquidity, Taiwan faced major economic and political changes, including the rising production costs, the globalization phase of industrial restructuring, lobbies of foreign bank and local business and financial communities, the U.S pressure,\(^10\) financial scandals, and political democratization.\(^11\) As a result, financial liberalization was pushed, e.g. interest rate and foreign exchange deregulations\(^12\), along with internationalization measures, e.g. import and cross-Straits economic liberalizations. The year 1991 saw the banking liberalization, marking the end of state domination in financial sector (Cheng, 1993: 57, 59).\(^13\)

On a closer look, while the financial liberalization measures taken were aimed at

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\(^6\) The increases of the relative shares of private enterprise borrowing from the curb market in 1984 and 86 (Central Bank of China, Flow of Fund in Taiwan district) and surplus fund evidenced the formal financial system’s underdevelopment.

\(^7\) US$50000 ceiling on money remittance into Taiwan and US$5 mn remittance abroad were imposed in an attempt to reduce the inflow of hot money. By contrast, expected NT dollar appreciation brought in more capital inflow. And, the appreciating NT dollar did not reduce the trade surplus because of the time lag (Lee, 1990:101, 172-3).

\(^8\) The fall in the investment ratio signaled industrial restructuring difficulties and the failure of the financial system to mobilize domestic resources, including excess liquidity, for development.

\(^9\) Excess liquidity also spawned underground investment companies (UICs) which manipulated stock prices to pay off its high short-term interest rates.

\(^10\) Financial liberalization in the 1980s was to certain degree pushed by US in large trade deficit with Taiwan (Shea, 1994:257). Foreign mutual funds and foreign securities were made available to domestic investors and insurance market opened to U.S insurance companies. Overall, external shocks e.g. oil crises in the 70s and IT bubble burst in 2001 and foreign factors e.g. US and later China are important in shaping Taiwan’s economic policies.

\(^11\) An obvious obstacle to the liberalization before political democratization was opposition from vested interest groups, including officials and kinships involved in the financial sector. State ownership of the major banks created ‘white gold politics’. For officials and regulators had privileges in applying for loans and introducing relatives and friends to be bank employees (Shea, 1994:258).

\(^12\) The problems with variable interest rates were that state-owned banks’ payments were not tied to earnings while were turned back to the Treasury, constraining banks’ growth.

\(^13\) Most new private banks established were conglomerates due to a high minimum paid-in capital for bank licenses (NT$10bn).
addressing the excess liquidity problem in the first place, brought about by external and internal imbalances, they helped accommodate economic changes. Let alone that, given the burden of increasing fiscal deficit, financial liberalization was a necessary move. In a nutshell, Taiwan’s financial liberalization can be regarded as part of economic restructuring and globalization processes.¹⁴

The Impact of Financial Repression

Economic Take Off and a Large SME Sector

After having examined Taiwan’s financial development, two questions arise. First, according to the conventional wisdom, in order to sustain economic growth, financial development should proceed the real sector development so that industries could obtain adequate finance. In Taiwan’s case, high GDP growth had been achieved and large foreign reserves accumulated¹⁵, albeit tight control of the financial system, thanks to EOI policy and growing international demand, enhanced by a well-developed downstream subcontracting network of SMEs and labor division between up-stream (SOEs), mid-stream (large private enterprises), and down-stream of the industrial sector. Because of the rapid export growth led by SMEs, a SME-based growth was pursued in parallel with continuous identification and promotion of strategic industries by the state. In short, scarce capital of the financial system intentionally built by the KMT to constrain the growth of firm size coincided with the above factors to create Taiwan’s SME dominated industrial structure.¹⁶ Noteworthily, the fact that SMEs became the engines of Taiwan’s

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¹⁴ Note that exactly while banking liberalization set in Taiwan in 1991, on the real sector side of the economy, the Statute for Encouraging Investment was replaced by the Statute for Upgrading Industry in 1991. Rather than directing credit to specific industries and export-oriented firms through financial institutions, the latter was more functional, emphasizing R&D investment using tax incentives.

¹⁵ Taiwan’s accumulation of large foreign reserves was partly the result of the Central Bank’s buying foreign currency to control foreign exchange rate, albeit increases in export surplus. Also, it was used as a means to strengthen economic and political securities.

¹⁶ The different sizes of individual enterprises and business groups in Taiwan and South Korea illustrate this point. Unlike Korean national champion firms, Chaebol, which are assigned the policy implementation role, Taiwanese enterprises did not gain strong support from the state in the KMT era because of the state’s distrust of indigenous capitalists. In some sense, Chaebol can be seen
economic growth can be seen as 一石二鳥  Killing Two Birds with One Stone, from the state’s perspective, i.e. simultaneously achieving economic and political goals. Hence, given Taiwan’s growth experience, is the conventional wisdom wrong? Yes and no. For only in the 1980s did the underdeveloped financial system prove problematic, as discussed. More importantly, Taiwan’s experience shows that the importance of financial development to economic growth varies depending on the stage of economic development. In Taiwan, financial repression and liberalization were adapted to the circumstances in which the economy developed. During the repression period, 1950s-70s, lending was tied to national building, e.g. import substituting industries, basic infrastructures and export promotion. Since the 1980s, financial sector has been gradually liberalized in view of its inadequacy, the need of internationalization, and a new development stage requiring better access to finance for firms, particularly high-tech start-ups (elaborated later).

Turing to the second question, financial repression promotes poor quality investment at the expense of potential high-yield projects. Although this argument does not seem to hold, looking at the sound development of IT sector in particular, financial repression (selective credit policy and conservative attitude towards lending) did result in an overly

as a hybrid of large private enterprise and state-owned enterprise. Regarding the relatively smaller sizes of Taiwanese firms, the culturist perspective emphasizes the socio-cultural system, i.e. familialism, albeit political explanation.

17 While SMEs were the engines SOEs (in upstream) and large private enterprises in the form of guanzixiye financial groups (in midstream) were the fuels. The fact that large private enterprises and SOEs were monitored and confined to domestic market (Berger and Lester, 2005:6) for the same political reason explained their relatively smaller sizes by international standards.

18 The 1970s saw the erosion of Taiwan’s export competitiveness due to diminishing surplus labor, rising wages, and rising protectionism in the West. The state rejected technocrats’ proposal to liberalize the financial sector to finance industrial upgrading by the private sector for the concern over macroeconomic stability and the indigenous capitalist class, as mentioned (Cheng, 1993:61, 69). In turn, the state assumed the main role of industrial upgrading, known as the ‘Ten Major Projects’, including shipbuilding, steel, machinery, airport, harbor, nuclear power, right before the outbreak of the 1st oil crisis.

19 Because of shortening product life cycle, R&D becomes more important. The financial market’s preference for projects of a quick return on investment, i.e. profit-oriented, has prevented the private sector, particularly SMEs, to conduct cutting-edge technology R&D. The development of critical technology is greatly hindered. Taiwan’s perpetual large trade deficit with Japan illustrates this point. By far, public research institutions such as ITRI has been the main driver of R&D and technological transfer. Despite its successful story of creating the semiconductor industry, to meet the demand of rapid technological change, the development of an efficient capital markets is important. It is pointed out that although Taiwan ranked fourth in the world and second in Asia for venture capital investment, the Taiwanese venture capitalists (as well as stock bonus system) were quite averse towards investing in high-tech start-ups (Berger and Lester, 2005:16).
reliance on mid-range IT manufacturing, e.g. PC-related products, hindering Taiwan’s economic performance today, as revealed in the 2001 domestic crisis due to the U.S high-tech bubble burst (elaborated below).20

Current Economic Predicament: Legacies of Financial Repression

Taiwan’s specialization in SME-based mid-range IT OEM is a position that is dilemmatic. It is a result of financial repression, enhanced by industrial policy21 and changing forms of FDI22. Taiwan’s early participation in international productions has been both a blessing and curse. While it facilitated Taiwan’s economic development and made it a major source of FDI in Asia, today it has found itself in a dilemma. First, it is facing competition from large TNCs of brands, technological, and innovative capabilities from developed countries; low-wage firms from developing countries; and existing ANIEs. Second, the fact that Taiwanese OEM firms are concentrated in hardware production means that they are more prone to relocation, whether due to lower production cost or TNC’s request to do subcontracting in third countries (Breznitz, 2005:217). Moreover, they are likely to bring their supplies with them, meaning the relocation of the entire supply chain/industrial clustering. In short, the localization of the relocated Taiwanese firms and rapid industrial upgrading of the invested countries impose strong adverse

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20 In 2001 Taiwan experienced its first recorded decline in real GDP, -2.2 percent. And, unemployment rose to a record high, about 5 percent.

21 It is argued that OEM model was advocated by technocrats considering Taiwan’s SME-based economy that lacked economies of scale to conduct cutting-edge R&D and heavy industrialization projects. Even so, the decision does seem quite obvious given Taiwan’s well-developed subcontracting networks and foreign trade experience. Compared to Taiwanese SMEs, the Korean Chaebol shows the advantage of vertical integration and scale in the global IT production chain, in terms of profitability and R&D.

22 Taiwan’s subcontracting network, export capacity, and industrial upgrading towards IT manufacturing coincided with a) the modularization of production (allowing (new) firms to focus on specific nodes in the production chains to produce final goods) and b) the emergence of new forms of foreign investment in the developing countries, focusing on contractual/non-equity agreements and joint ventures -- all of which have made Taiwan an OEM and ODM-based exporting country. Following this, reasons for new forms of FDI by TNCs: bypassing restrictions by host countries on FDI; gaining entry into markets dominated by other TNCs with better marketing knowledge or technological capacity; and extracting remaining marginal returns from maturing technology by licensing it.
effects on Taiwan’s economy. For instance, the option to invest in China not only may hamper the upgrading of traditional industries but also high-tech industries in addition to the hollowing-out problem. For the latter can achieve mass production and low unit costs by focusing on producing moderately sophisticated products instead of state of the art products for the China market, e.g. chips (Breznitz, 2005:206). It is reported that in 2005, 93.2 percent of Taiwan’s IT hardware was produced overseas, of which China accounted for almost 80 percent. Third, while Taiwanese OEM producers enjoy market access, continuity of orders, and access to technology as suppliers to TNCs, they face possibility of discontinuity of order; cost transferred from TNCs; and risk of being locked into the lower end of production chain. Fourth, the fact that many countries are pursuing best SME practices adds to Taiwan’s pressure.

Concluding remarks

The State Remains Important in a Financially Liberalized Economy

Examination of Taiwan’s financial development shows that Taiwan’s declining economy since the 1990s has been the result of various factors, including legacies of past industrial and financial policies, globalization, cross-Straits economic relationship and others. There are two cases in which the state can play a positive role in improving the economy by combining an optimum mix of market force and government intervention. First, while tight control of the financial system and selective credit policy during periods of financial repression and favorable international demand conditions created a large SME sector, facilitating Taiwan’s industrialization, they have resulted in Taiwan’s concentration in few export items such as IT commodities. This has in turn become a source of declining profitability for domestic producers and economic instability as a result of

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intensifying competition and over-production. For more countries chase after same export markets. The result of intensifying competition from other developing countries and NIEs is increasingly thinner profit margin and relocation of domestic firms. In order for Taiwan's real sector to get out of ‘thinning profit margin’ and ‘relocation’ predicaments, ongoing financial liberalization and reform should be directed to the full development of the real sector, taking into the account the fact that Taiwan's banking system has been geared to the provision of short-term working capital. Hence, a supportive financial system is required, coupled by new mindsets of entrepreneurs, technocrats, and state that see the development of innovative and R&D capabilities as a critical element in the era of rapid technological changes, besides broadening of capabilities beyond high-tech. Second, the banking liberalization in the absence of re-regulation and effective management brought about over-banking and over-lending. Increases in unsecured loans and deposit rate competition resulted in enormous bad loans, meaning that liberalization itself would not automatically facilitate financial development. The reform in 2001 served to simplify the complicated banking system, solve the NPL problem, and meet the needs of a diversified banking sector. Financial laws enacted quickened the pace of consolidation of the banking sector and solved the NPL problem. This example illustrates how market failure can be overcome by state intervention. And, re-regulation of the banking sector proved necessary to maintain both

24 Unlike early industrial development, current stage of development requires long-term working capital. However, because of the rapid changes in technology and demand and supply conditions, investments can turn out to be less productive or even wasteful. This discourages firms from making long-term investment and banks from lending to high-tech start-ups and firms making long-term investment.

25 New banks competed for market share by reducing lending rates and issuing new financial products such as cash card. This gave rise to the NPL problem (greatly reduced by 2001 reform). Nonetheless, the authority did well in regulating new banks by limiting individual and group ownership and related-person lending given the lessons in the past, i.e. ownership of any bank’s equity by any person including corporations may not exceed 5 percent and 15 percent for related persons, based on 1989 Banking Law (Shea, 1994:297). One reason that explains the lack of prudential regulation directly after the banking liberalization in 1991 is that it was never needed in the past when the state controlled the banking sector in which state employees were subject to monitoring and punishment for a certain ratio of bad loans.

26 The ratio of NPLs can be higher than that published for it is common for a loan to be extended rather than listed as a bad loan (Yang, 1994:313).
financial and socio-economic stabilities particularly in the light of high degree of international capital mobility, as exemplified by Asian Financial Crisis.

Reference


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