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Yun-han Chu *

Abstract

Taiwan was one of the few Asian economies that had emerged from the 1997-1998 East Asian financial crisis relatively unscathed. During the 2008-2009 global financial crisis, the island's shock-absorbing capability turned out to be once more quite respectable. Taiwan inherited a relatively healthy state of financial systems prior to the sub-prime loan crisis and built up a huge foreign reserve. Also foreign banks' participation in domestic loan market was quite limited. The state dominated the banking sector and closely supervised its lending policy and balance sheet. The island's macro-economic fundamentals were quite healthy and the government still enjoyed spare fiscal capacity to borrow and spend. Many elements that define Taiwan's economic resilience have been fostered by some entrenched institutional arrangements and established policy orientations over a long time. Taiwan managed to retain the bulk of these long-running sources of economic resilience despite of the tremendous external pressures by neo-liberal policy advocates to dismantle these "out-dated" policy thinking and practices. Furthermore, despite of the political turmoil after the first power rotation of 2000, the legacy of an independent and proactive central bank, whose reputation and credibility had been strengthened by its record of steering the island safely through the financial crisis as well as the Strait missile crisis, was kept intact. The legacy of prudential financial regulation was also largely kept intact with the concentration of regulatory authority in a new cabinet-level supervisory commission. Taiwan was able to cope with the 2008-09 global financial crisis thanks also to a more enabling regional environment. The political backlash against IMF-imposed austerity measures precipitated a growing awakening among East Asian policy thinkers. Most developing countries in the region have insured themselves through managing exchange rates and building huge currency reserves, so that they could be protected against the tempests of currency speculation and never again would have to call on the IMF. The ideological milieu and the cooperative institutional arrangements in East Asia have changed so much between the two crises.

Keywords: Taiwan, Central Bank of China, State-owned Banks, Fiscal Conservatism, QFII System, Financial Supervisory Commission

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“For my generation of central bankers, the rapid growth of cross-border financial transactions and international capital flows is one of the most important economic developments we have experienced over the past 30 years.... Large and sudden inflows of foreign capital lead to exchange rate overshooting, loss of trade competitiveness, domestic credit booms and asset price bubbles, all of which can elevate systemic risks and create financial fragility. It is little wonder that the subject of capital account liberalisation remains highly contentious.”

Peng Fai-nan, The Governor of the Central Bank of the Republic China, an invited article published in *The Banker*, 30 August, 2010

1. Introduction

The Taiwan case offers the key to a systematic understanding of the elements defining the economic resiliency of East Asia, not just individual East Asian economy but the regional economy as a whole. Some political economists have suggested that the reason why most East Asian economies managed to cope with the global financial crisis of 2008-09 more effectively than other regions lies in the transformation of their domestic institutions and policies after the 1997-98 financial crisis. Taiwan’s experiences will show that this view is quite partial if not too simplistic.

First of all, not all the post-crisis institutional changes and policy adjustments turned out to be conducive to strengthening their financial stability and economic adaptability. Some East Asian economies have been pressured by the United States and the IMF to adopt wide-ranging neo-liberal prescriptions – fiscal austerity, deregulation, liberalization and privatization -- after the 1997-98 crisis. The results of these domestic adjustments along the neo-liberal line were

mixed. In some areas, they have strengthened their economic vitality as well as the economy's overall international competitiveness. In other areas, they actually have made these societies more vulnerable to external financial shocks. So we have to unbundle the experiences of the post-crisis reform and transformation and their varying economic consequences very carefully.

Second, Taiwan case also demonstrates that many elements underwriting its economic resilience have had a deeper root. They have been fostered by a set of entrenched institutional arrangements and established policy orientations over the long run. Many factors that had accounted for Taiwan's outstanding shock-absorbing capability during the 1997-1998 regional crisis were still much in place and remained crucial when the government was called upon to cope with the latest and much more severe global financial crisis of 2008-09. So it is not the case that Taiwan has upgraded its economic capability to withstand the external shocks by undoing its past policies and institutional arrangements after the regional crisis. On the contrary, it is the case that Taiwan managed to retain the bulk of these long-running sources of economic resilience despite of the tremendous external pressures and relentless efforts by neo-liberal advocates to dismantle these "out-dated" policy thinking and practices in the name of financial liberalization and internationalization during the decade-long interval between the two crises.

Third, the nature of the two crises and the circumstances under which they broke out are very different. So we have to look out for some new elements that had not been of much relevance in accounting for Taiwan's superior capacity in coping with external economic shock last time but became quite important this time around. In particular, I argue in this paper that part of the reason why most East Asian economies managed to cope with the global financial crisis of 2008-09 more effectively than other regions lies in the transformation of not just their respective domestic institutions but the region's overall geo-economic configurations, ideological milieu and institutional arrangements.

Most noticeably, over the decade-long interval, all major East Asian economies have worked together to strengthen the resiliency of the regional economy as a whole. In so doing, they

collectively created an enabling environment that in turn strengthened their individual capability to cope with the 2009-09 global financial crisis. This is in stark contrast with the regional environment of the late 1990s, which had been truly unforgiving in nature as all East Asian economies had suffered from the downward spiral of competitive currency devaluation and financial contagion, victimized by the predatory tactics of the hedge funds and speculative investors, and been at the mercy of international lending agencies that were based outside the region and insensitive to their needs of focusing on essential policies and protecting the most vulnerable. In a nutshell, in the aftermath of the regional financial crisis East Asian countries concluded that *they must all hang together, or assuredly they shall all hang separately*.

2. Taiwan in comparative perspective

It has become a received view that Taiwan was one of the few Asian economies that had emerged from the 1997-1998 East Asian financial crisis relatively unscathed. The damage to the island economy has been mild by regional standard. The growth momentum was slackened but not disrupted. In 1998, Taiwan's economic growth rate was dragged down to 4.57% and the island had suffered a 9.4% drop in exports, the worst performance since 1983. But this record was by far more admirable than the rest of the region. In contrast, South Korea's economic growth rate had dropped to -6.7% in 1998. More importantly, Taiwan registered a successful recovery from the shock. The island's economic growth rate turned up to 5.42% and 6.4% in 1999 and 2000 respectively.

Taiwan's economic resilience was put under the most strenuous test during the 2008-2009 global financial crisis. Like all other export-oriented East Asian economies, Taiwan's dependence on trade through global production networks and export-led growth strategies made the island highly vulnerable to the sharp contraction of demand from the North American and European economies. Taiwan's economy slumped into recession in the second half of 2008. Its

real GDP, following a growth rate of 5.7% in 2007, registered a meager 0.73% growth in 2008 and contracted 1.93% in 2009 primarily due to a record 19% drop in the total exports. This amounted to the worst economic contraction since 1951.

Much like many other emerging economies in the region, Taiwan turned out to be more resilient than the rest of the world and is poised to lead the global economic recovery. By the first quarter of 2010, not only has Taiwan exited the recession, it has in fact recovered the entire loss in output during the so-called Great Recession. Taiwan registered an astonishing 13.59 percent (annualized) growth in the first quarter of 2010 and a remarkable 10.88 percent for the year.¹ This makes Taiwan's recovery trajectory superior to that of South Korea, which managed to bounce back at a 6.1 percent growth in 2010.²

More impressive is the resilience of Taiwan's banking sector, which has weathered the global financial crisis relatively unscathed despite the wider economy suffering its worst recession on record. Its conservative consolidated balance sheet position set to ensure the sector is well placed to navigate the turbulent global economy which is still under the threat of a double-dip recession and the debt-crisis of some weaker European economies.³ So the island's shock-absorbing capability turned out to be once more quite respectable albeit no longer as outstanding as it had been.

In a way, the story behind Taiwan's economic rebound after the 2008-09 global financial crisis is not significantly different from other vibrant East Asian economies. Most economists identify at least five common elements contributing to East Asia economies' stronger than expected economic rebound.

First, the region was relatively well insulated from the global financial meltdown as it had inherited a relatively healthy state of financial systems prior to the sub-prime loan crisis and built

1. According to the published statistics of Taiwan's Directorate-General of Budget, Accounting and Statistics (DGBAS) as of August 2011.

2. Based on Asian Development Outlook 2011, published by Asian Development Bank.

3. Fast Market Research, "Taiwan Commercial Banking Report Q3 2010", *Business Monitor International*, September, 2010

up a huge foreign reserve as a hedge against a replay of the 1997 regional financial crisis. Asset bubbles were either not alarmingly threatening or they had been contained well before the current crisis as in the case of China. Second, the degree of foreign participation in their banking sector was comparatively much lower. On average, American and European banks accounted for about 10% of the total net worth of the East Asian banking sector while the figure for Latin America is 35% and for Eastern Europe 49%.⁴

Third, most East Asian economies have shown considerable resilience, thanks in part to high household savings during good times on which they could fall back upon during lean times without having to make drastic cutbacks in private consumption. Fourth, the macro-economic fundamentals were quite healthy in most East Asian economies. Except for Japan, most governments were not heavily indebted and they still enjoyed spare fiscal capacity to borrow and spend. So most East Asian governments and central banks responded to the global financial crisis with decisive and firm fiscal and monetary actions. Last, but not least, the region's resilience should be attributed to the rapid turnaround in the region's larger, less export-dependent economies. Although adversely affected, China and India were not in recession. Their huge domestic sectors helped cushion the impact as exports constituted just 35 per cent of China's GDP and 22 per cent of India's. In particular, China has emerged as the region's new locomotive of growth as it has rapidly become the top export market for her neighboring economies, including Japan, South Korea and Taiwan, over the few years.

In addition to these common elements, Taiwan's shock-absorbing capability has also been enhanced by a set of structural characteristics which is quite exceptional in comparison with other East Asian emerging economies. First, Taiwan's economic vitality is built on a more decentralized industrial structure. Small and medium-sized enterprises (SME) still account for more than 75% of the total employed work force. SMEs in Taiwan have formed comprehensive

4. "Financial sector FDI in Asia: Brief Overview," An internal memo for the meeting of the CGFS Working Group on FDI in the Financial Sector, prepared by by Isao Hishikawa of the Bank of Japan, March 2003.

industrial horizontal and vertical networks through cooperation and division of labor among themselves and with large enterprises, creating an efficient and flexible industrial clustering. Over the last decade, both South Korea and Taiwan have achieved a level of technological capabilities that rival those of the advanced countries. In South Korea these capabilities are concentrated in a small number of relatively larger firms, *chaebols*. In contrast, they are spread across a large number of relatively smaller firms in Taiwan.⁵

Second, Taiwan was more insulated from the external financial shock because the island's economic growth has been financed almost exclusively by domestic savings. A combination of high saving rate and higher efficiency in capital utilization has allowed Taiwan to generate excess savings and become one of major sources of foreign investment in East Asia. The gross value of the foreign assets owned by Taiwan's private sector has consistently exceeded its external liabilities.

The island has become more vulnerable to the sudden movement of foreign portfolio investment as the share of the stocks owned by foreign institutional investor of the total market values of Taiwan Stock Exchange has steadily increased from less than 4 percent in 1977 to 25% in 2007. This, however, is still lower than the average level of 35% observed in South Korea before the 2008-09 crisis. In addition, Taiwan's Central Bank always stands ready to cope with sudden massive outflow of speculative capital as it is empowered to introduce capital controls and has accumulated an exceptionally large foreign reserve, the world's third largest after China and Japan.

Third, most Taiwan's big enterprises maintain a sound corporate financing structure which allows them to withstand the credit crunch during economic downturn. The debt-to-equity ratios of Taiwanese enterprises large and small are among the lowest in the world. The average ratio of large enterprises is about 100 percent, while the ratio of SMEs is around 150 percent. This

5. Hamid Etemad and Yender Lee, "Technological capabilities and industrial concentration in NICs and industrialised countries: Taiwanese SMEs versus South Korean chaebols," *International Journal of Entrepreneurship and Innovation Management*, Volume 1, Numbers 3-4 (2001): 329 - 355

is because Taiwan's financial sector is uniquely characterized by the co-existence of a conservative banking sector and a dynamic capital market. As a result, high-growth firms raised capital mainly through rights issues and initial public offering, instead of bank loans.

A full understanding of Taiwan's exceptional economic resilience, however, requires more than just an economic analysis. What is also required is an analysis of the political underpinnings of these economic structures, macroeconomic policies, development strategies and regulatory regimes. In this paper, I argue that elements of the island's economic resilience have been fostered by a set of entrenched institutional arrangements and established policy orientations. These institutional arrangements and policy orientations, in the final analysis, have been embedded in Taiwan's particular security environment, political structure and internal power configuration.⁶

3. The historical roots of Taiwan's economic resilience

In Taiwan, most elements of economic resilience had been nurtured during the four-decade long reigning of a hegemonic party. Under the political dominance of Kuomintang (KMT), the state's development strategy and policy guidelines for macro-economic management, more than anything else, had fostered a decentralized industrial structure, the module of domestically-financed growth and the dualistic nature of its financial sector. Under the KMT's long political tenure, the state's long-standing policy guideline for macro-economic management was characterized by its overriding concern over monetary and financial stability as well as fiscal conservatism. Also, its established pattern of industrial targeting was in part designed to address the deficiency of the SMEs in financing and R&D. In response to the challenge of globalization, the state had chosen a sequence of financial liberalization that gave priority to deregulating the

6. Yun-han Chu, "Surviving the East Asian Financial Storm: The Political Foundation of Taiwan's Economic Resilience" In T. J. Pempel ed. *The Politics of the Asian Economic Crisis*. Ithaca: Cornell University Press, 1999.

domestic capital market over internationalization, i.e., foreign participation. Despite the trend toward an integrated global financial market, the state had been keen in safeguarding its ability in setting monetary targets by preventing the internationalization of local currency and controlling the volatility of cross-border movement of short-term capital. Amid the trend of politicization of economic policy-making which came with the island's democratization, the state had managed to protect the autonomy of the monetary authority and contain the erosive effect of "money politics" on the health of the banking sector through institutional adjustments.

These established policy guidelines and long-term development strategy have taken roots as they were embedded in a set of institutional arrangements and entrenched ideological orientations. These prevailing structures regulated the power relations among different economic agencies within the overall state apparatus and constraint the scope of political participation by business, labor and other interest groups in economic decision-making. These entrenched ideological orientations, which reflected the collective memories and learning that the incumbent elite had acquired over a long period of time, set the parameters for policy discourse and deliberation within the state apparatus. At a more fundamental level, the incumbent elite inherited, established, maintained and adjusted these institutional arrangements and policy orientations to cope with the changing security environments and to meet the twin challenge of globalization and democratization.

These institutional arrangements and ideological orientations are not immutable, but they tend to have strong staying power. These prevailing structures were kept largely intact despite of the rapid indigenization of the KMT's power structure during the 1990s because they helped sustain the incumbent elite's steering power over the national economy as well as its ability to deliver desirable socio-economic outcomes. They were steadily weakened but not disintegrated even after the KMT lost its grip on power in 2000 because the political risk of dismantling these prevailing structure to the DPP elite oftentimes outweigh its expected utility.

Another longstanding institutional characteristic of Taiwan's economic decision-making is the privileged status of the Central Bank of China (CBC) within the overall state apparatus. The CBC is formally a part of the cabinet but in practice, the governor of CBC is always hand-picked by the president, rather than the premier. The bank occupies a unique position in the state apparatus because it is at the same time a part of the economic bureaucracy and a part of the national security apparatus, which falls under the exclusive purview of the president. As a result, the CBC has long occupied the commanding height of the state economic bureaucracy. The governor of the CBC is always considered the most senior economic minister. The CBC has been staffed by elite technocrats, who enjoyed a prestige unmatched by any other economic ministries. The governor of the CBC is not subject to cabinet reshuffling as the position is protected by a renewable term of four years. Also, most governors stayed on for a long period of time, much longer than the cabinet.

The CBC is more than just a monetary authority. It is also entrusted with an extensive regulatory authority over the banking sector and capital market. According to the Central Bank Act, the first two operational objectives of the bank are: (1) promote financial stability and (2) guide sound banking operations. The Act also empowers the CBC with a variety of monetary policy instruments, including targeted prudential measures and authorizes the CBC to maintain an orderly foreign exchange market and conduct targeted financial inspections. During the 1980s and 1990s, the CBC's supervisory and investigative authority overlapped with the Ministry of Finance.⁷ The Ministry of Finance traditionally played second fiddle to the CBC as far as banking regulation is concerned. Many finance ministers were themselves former deputy governors of the CBC. The bank was able to overrule the Finance Ministry, which deals with the constituencies in the financial sector more directly, over the sequence and timetable of financial deregulation and internationalization. The CBC also traditionally served as a check on the expansionist tendency of

7. Ching-Chang Yen, *Taiwan's Fiscal Policy: Its Role in the Asian Financial Turmoil*. Ministry of Finance, 1998. Mimio.

the planning technocrats and sets the limits on the use of credit policy in industrial targeting. The steering power of the CBC over the banking sector was further buttressed by an array of state-owned banks which virtually monopolized the first-tier banking, i.e., commercial banks, which accounted for more than two third of the total outstanding loans and discounts before the opening up of the banking section in 1992. Up until 1992, private participation was limited to the second-tier money banks consisting of regional savings and loans, city credit co-operative associations and credit departments of farmers and fishermen's association at the grass root level. During the authoritarian years, the governor of CBC usually had more say than the premier in the appointment of senior bank officials.⁸ As a result, the CBC was able to pull a number of disciplinary strings over the lending policy of state-owned banks, through the rediscount window, financial inspection and appointment power.

This arrangement was originally designed to prevent a replay of the disastrous hyperinflation and currency crisis of 1947-48, which had contributed to the defeat of the KMT leadership by the Communist regime in 1949.⁹ The CBC was entrusted with the authority to protect the island's economic stability in the name of national security and for the sake of the political security of the KMT regime.¹⁰ The CBC became the institutional embodiment of the incumbent elite's overriding concern for monetary and financial stability. During the 1970s, the two oil shocks and the crisis of diplomatic de-recognition, which functionally replaced the fading memory of the civil war, reinforced the political rationale for a privileged and autonomous CBC.

Under the steering authority of the CBC and the Finance Ministry, for almost four decades the Nationalist government has invariably maintained a positive real interest rate, minimum public-sector foreign debt, small fiscal deficit, a fixed exchange rate pegged to US

8. Shang-mao Chen. "The Political Economy of Taiwan's Banking Policy". M.A. Thesis (in Chinese), Department of Political Science, National Cheng-chi University, 1998: page 64.

9. Tun-jen Chen and Stephan Haggard. 1987. *Newly Industrializing Asia in Transition*. Berkeley: Institute of International Studies, University of California.

10. Between 1949 and 1961, as a temporary measure, the Bank of Taiwan actually performed the function of the central bank. After 1961, the Central Bank of China was reinstated as the Nationalist government retreated from its goal of "recovering the mainland".

dollar, restrictions on the convertibility of NT dollar, a rigorous regulatory regime over financial institutions, and a conservative ethos that permeated the entire banking sector. State-owned banks almost always demanded collateral for their loans. Most state-owned banks have maintained their capital/asset ratio above 12 percent, much higher than the International Bank of Settlement's 8 percent requirement. Also, Taiwan's reserve requirement has been among the highest in the world.

Furthermore, to contain the encroachment of political cronyism, the CBC and Ministry of Finance imposed on local financial institutions strictly limited scope of deposit/loan operation and geographical span and a requirement to re-deposit their surplus reserve to designated state-owned banks. Also the CBC and Finance Ministry stood ready to close down insolvent local financial institutions through forced merger and acquisition. With these controlling measures, the CBC and Finance Ministry was able to keep the non-performing loan ratio of the overall banking system at a sustainable level.

Also the KMT elite had stuck to the principle of fiscal conservatism for more than three decades. The central government regularly generated fiscal surplus year after year during much of the 1970s and 1980s and the outstanding public debt was kept at the minimum. This rigid fiscal discipline was steadily loosened during the 1990s as the KMT elite was under rising electoral competitive pressure and the pent-up demand for the expansion of social entitlement program. However, the KMT still put a legal cap on the central government's borrowing power. Under the Public Debt Law, Central Government's new borrowing each year should no more than 15% of the annual budget and be used only for fixed capital investment (rather than current consumption).¹¹ Also the total outstanding public debt is not allowed to exceed the 40% of the current GDP. Thus, on the eve of the first power handover of 2000, the central government's total outstanding debt was still less than 24% of the GDP and well below the legal limit. In addition, the

11. However, under extraordinary circumstances, such as wars, major natural disasters and epidemics, the government is allowed to introduce special budget bills which are exempted from this provision.

KMT handed over the DPP a fiscal reserve about NT\$280 billion, an equivalent of 2.7% of the GDP in 2000, which had been accumulated over the previous decade.¹²

The deregulation of the financial sector of the late 1980s and early 1990s was prompted by economic exigency. A series of ominous economic signs, the mushrooming of underground financial institutions, bubble in the real estate and stock market and rapid deterioration of private sector investment, compelled the government to take decisive measures to overhaul the anachronous financial sector. Since 1989, the government has introduced a series of measure to deregulate the banking sector. Fixed interest rate scheme was abolished. New licenses for commercial bank were issued to qualified private investors. Regional savings and loans were upgraded to medium business banks. Restrictions on the operation of foreign banks were relaxed. However, the privatization plan for state-owned commercial banks, the center piece of the banking reform, was held off until mid-1998. By the time the KMT handed over the power to the DPP in 2000, the government still effectively controlled eight of the top ten commercial banks, which accounted for over 60% of the total net worth of the entire banking sector.

Another long-standing policy objective adamantly pursued by the CBC was minimizing the island's vulnerability to external shocks. The CBC consciously built up Taiwan's shock-absorbing capacity to withstand diplomatic shocks, escalation of military tension in the Taiwan Strait, or any conceivable economic exigency. During the 1980s and 1990s, the government had built up not only a huge foreign reserve but also an exceptionally large oil and food reserve. A big cushion was justified as Taiwan would have to survive on the basis of self-help. Since 1978, Taiwan was no longer a member of IMF and World Bank. It could not count on an international rescue package in a time of currency crisis, nor bilateral emergence loans from its security partners. With dwindling diplomatic recognition, official foreign reserve has almost become a benchmark measure of Taiwan's self-confidence.

12. Yan-chien Chen, The Country's Fiscal Condition, National Policy Research Foundation, *Finance and Baking Research Paper*, No. 091.001 (in Chinese), March 2007.

This mentality explained why the CBC was very hesitant to remove foreign exchange control despite a clear trend of soaring trade surplus since early 1980s. It put off the foreign currency deregulation well until mid-1987, when the U.S. Trade Representative started putting the undervalued NT\$ on the political spotlight, when the current account surplus reached a staggering 19 percent of GNP, and when the accumulation of the trade surplus and domestic savings started to wreck havoc on the real estate and stock markets. In July 1987, the CBC finally decided to remove most restrictions on private holding of foreign exchange and to nurture the growth of a foreign exchange spot market and later futures market. However, the CBC still applied a panoply of monitoring scheme and continued to intervene heavily to prevent excessive short term fluctuation. The restrictions on the future market were lessened only gradually. The foreign exchange derivatives positions of all domestic banks were still under strict supervision by the CBC. More importantly, the CBC was resolved to prevent an internationalization of its local currency. The Central Bank continued to prohibited domestic banks from offering local currency accounts for their customers abroad and restricted the outbound movement of NT dollar. In essence, the CBC was keen in curbing the growth of an off shore foreign exchange market of the NT dollar. In so doing, the CBC was able to retain its position as the sole market maker of NT dollar. Furthermore, the foreign borrowings for Taiwan's banks were traditionally low, because the CBC restricted banks' holding/owing foreign assets/liabilities. Despite of the flooding of cheap yen in the international money market during much of the 1990s, Taiwan's domestic banks did not engage in heavy short-term foreign borrowing or the so-called "carry trade", nor participated actively in the global financial markets.

Bowing to the US pressure, Taiwan's stock market was opened to foreign institutional investors around early 1991. Under the influence of the CBC, the Finance Ministry imposed strict investment cap on foreign investors. Initially, each foreign institutional investor could invest up to US\$50 million and the total quota will be \$2.5 billion, which represents only about 2 percent of total market capitalization. Each institution was allowed to buy up to 5 percent of a single

company and total foreign ownership of a company was limited to 10 percent. Also to prevent rapid capital inflows and block off the entrance of hedge funds, the qualified foreign institutional investor (QFII) system was established in 1992. Only reputable and well-established foreign banks, insurance companies and funds management companies could apply to be QFIIs. Also the Central Bank introduced reporting procedures regarding foreign portfolio investment to track down the activities of QFIIs. As part of the down payment during the WTO negotiation with the United States, the Finance Ministry was compelled to raise the investment cap step by step. On the eve of 2007-08 financial crisis, the capital ceiling for individual foreign institutional investors was raised to US\$600 millions. The cap on ownership of individual foreign institutional investor in any listed company was set at to 15 percent and no more than 30 percent for all foreign investors.

The island's economic resilience was put to a rigorous test when the PRC employed saber-rattling strategy in the summer of 1995 and March 1996. During the first missile crisis, the stock market lost about a third of its total value. And the local currency dived by 9 percent. The CBC intervened heavily to support the NT dollar. The Finance Ministry was instructed to set up a stock market stabilization fund. All government-run investment funds and retirement funds were required to chip in and to buy in. Managing the missile crisis, as it turned out, functioned as an unintended rehearsal of the East Asian financial shock a year later.

At the zenith of the one-party authoritarian rule, the Kuomintang (KMT) relied on a proven formula for maintaining the entrenched political dominance of the mainlander elite, the emigre group that fled to the island after it was were defeated by the Chinese communist on the mainland in 1949, at the national level and for controlling a limited popular electoral process implemented at local level. The development of Korean-styled conglomerates had not been possible for the first three decades of the post-War era. The mainlander elite discouraged concentration of wealth for both political and ideological reasons. a myriad of SMEs that grew around the state-sponsored export-oriented industrialization strategy has enabled the KMT to

broaden its social base as the emerging industrial structure addressed both the growth and equity issues with high degree of effectiveness. More importantly, the monopoly or near-monopoly of the state-owned enterprises had pre-empted the private participation in financial sector, public utility sector and most of the capital-intensive industries from the very beginning.

For the first four decades of the post-war era, the business was politically weak because big businesses had depended on the state for essential economic resources. The private sector lacked organizational and ideological endowment for autonomous collective actions. More importantly, the state had been relatively strong vis-a-vis the private business because the state was endowed with a centralized political authority, an oversized military and administrative apparatus, and a huge array of state-owned enterprises. The political ascend of the business elite was not fully actualized until toward the end of 1980s. With the decease of the last strong man Chiang Ching-kuo in 1988, the cohesion of the party central leadership deteriorated and the pace of democratization stepped up. The personnel turnovers, the split within the party leadership, and the new democratic institutions provided the business community with a strategic opening for gaining a more preeminent recognition in the party power structure.

The emerging political clout of the business elite has weakened the autonomy of the state economic bureaucracy and economic officials were compelled to embrace a pro-business outlook. During Lee Teng-hui's tenure, some private capitalists, in particular, the chairmen of the three peak business organizations, were recruited to serve on the KMT's Central Standing Committee, the formal decision-making organ of the party. Furthermore, the trend of liberalization and privatization in the 1990s created a raft of rent-seeking opportunities for big business groups to seize the economic resources that were carved out of state-dominated sectors. Financial service liberalization, telecommunication deregulation, and state-enterprise privatization were among the most profitable areas. In other words, the KMT government in the 1990s had to keep a precarious balance between taking into account distributional considerations and committing to developmental goals.

Nevertheless, during the tenure of Lee Teng-hui, the influence of the special business interests over the economic policy-making still had its clear limits. The KMT central leadership still maintained the commanding height on economic decision-making while entrusting technocrats with sufficient policy autonomy. The KMT, being an over-sized, richly endowed, and autocratically governed political machine, still provided the institutional foundation for the undisrupted political dominance of its national leadership over both local factions and big business. While catering to the demands of distributional coalitions, the KMT managed to insulate a development-oriented policy network from power peddling.

The economic planning technocrats were encouraged by the overall success of the past development strategy which relied more on SMEs than big business as agent of industrial upgrading and technological innovation. The industrial upgrading strategy of the 1980s and 1990s did not discriminate against SMEs. On the contrary, the state economic bureaucracy was keen in addressing the deficiency of SMEs: through public-funded R&D support and technological transfer, the provision of venture capital and a lending guideline which stipulates that all medium business banks must extend at least 60 percent of their outstanding loans to SMEs. The planning technocrats were still able to channel resources into targeted sectors and incubated high-tech start-ups. The CBC and Finance Ministry economic technocrats still had a decisive say in devising the priority and timetable of deregulation and liberalization as well as the design of the new regulatory schemes and mechanisms.¹³

In a nut shell, as long as there was no alternative power pact in sight, the KMT elite could effectively use its unabated staying power and incontestable ability to make long-term policy commitment and to construct an unequal partnership with the business elite, under which the party-state elite set the limits on influence-buying and policy contestation.

13. Yun-han Chu, "Re-engineering the Developmental State in an Age of Globalization: Taiwan in Defiance of Neoliberalism," Meredith Jung-En Woo ed. *Neoliberalism and Institutional Reform in East Asia: A Comparative Studies*, Palgrave MacMillan, 2007. pp. 91-121.

4. Domestic transformation during the DPP era

Most of the adjustments in development strategies, policy priorities, and institutional arrangement that took place during the ten-year interval between the two crises was propelled less by the lessons learned from the 2007-08 regional financial crisis but more by the political earthquake brought about by the historical power rotation after the 2000 presidential race.

Since Taiwan emerged from the 2007-08 regional financial crisis largely unscathed, there was no compelling reason or the political urge to change the course. On the contrary, the credibility of some long-standing policy objectives and institutional arrangements, in particular the independence of the Central Bank and its core mission of preserving the country's monetary and financial stability as well as the due diligence of the regulatory agencies supervising the banking and insurance sector, had been reinforced by their proven track record.

However, the terms of public courses on island were nevertheless carried away by the neo-liberal policy prescription which was vigorously promoted by the IMF and the United States and followed by many East Asian governments in the aftermath of the financial crisis. On Taiwan, many foreign financial institutions, business leaders and neo-liberal economists criticized the technocrats' complacency and urged the government to introduce sweeping liberalization and deregulation measures. They warned that Taiwan could miss the boat as other East Asian tigers turned the crisis into opportunity for wide-ranging reform.

Some of the neo-liberal agenda was adopted by the incoming DPP elite which had long time ridiculed the KMT's past practice as party-state capitalism. However, the Chen Shui-bian administration adopted these prescriptions primarily not for its intellectual rationale. These reform agenda were selectively adopted because they fit his political strategy to dismantle the institutionalized ties between the KMT and the business community. In some cases, reform measures were adopted also because they provided his family and closest allies with new opportunity for collecting political rents.

The DPP had been highly critical of the KMT's impregnable control of state corporatist arrangements and condemned the collusive relations between state and the business elite. The DPP as a long-time opposition did not have any preexisting institutionalized channels of interaction with business interests. Nevertheless, prominent individual DPP politicians cultivated their personal ties with business donors, and increasingly with like-minded business tycoons as their political standing steadily rose.

Under Lee Teng-hui's leadership, KMT-owned enterprises were transformed into holding investment companies, which were heavily involved in joint ventures with domestic business groups having large-scale investments in land speculation, public construction, mass transportation, banking and insurance. Once Chen Shui-bian took over the presidency, his administration was determined to tear apart this interlocking network and replace KMT-centered institutionalized collusion with a president-centered spoil system.

Elected as a minority president,¹⁴ Chen had a deep sense of political insecurity and a survival instinct to grab as many resources as possible to consolidate his rule. The personnel reshuffle of the top positions in the partially privatized state enterprises and state-controlled banking and financial institutions became an important route for the DPP government to break up KMT influence and extract political rents.¹⁵ Chen hand-picked pro-DPP figures to replace senior technocrats in almost every state-controlled enterprise ranging from steel, electricity, public utilities, mass media, petroleum, airlines, sugar and salt refining, to telecommunication. The privatization of state-owned enterprises (SOEs) and banks provides another conduit for the DPP government to cajole private capitalists into the new alliance based upon exchange of favors.

In the name of consolidating Taiwan's banking sector, which had been deemed as too much saturated with small players without the necessary scale and know-how to compete internationally, the Financial Holding Company Law was enacted in 2001. This opened the door

14. The Chen Shui-bian was elected in March 2000 with only 39% of the popular vote. The KMT did not lose power over its record of economic management or its developmentalist philosophy. The KMT lost its grip on power primarily because the KMT was split into two camps and the 2000 president election became a three-way race.

15. Yun-han Chu. "Taiwan's Democracy at a Turning Point," *American Journal of Chinese Studies*, vol.11 (2005), pp.901-924.

for cross-market business and spawned a series of planned mergers and acquisition. For effective supervision over the new financial holding companies, a new cabinet-level independent supervisory agency, the Financial Supervisory Commission, was created in 2004 to unify several previously separate regulatory authorities with respective responsibility over securities markets, banking, and insurance.

In theory the chairman of the new commission is protected with fixed term and should be free of political influence. But in practice Chen appointed his political protégé to head this new supervisory body. Later on, it turned out that Chen and his wife were deeply enmeshed in the deals of financial consolidation. Most of the emerging private financial groups were the natural allies of the DPP as they had been overshadowed by the state-owned banks under the KMT tenure for too long. Unfortunately, Chen was more interested in soliciting wealth for his personal coffer than cultivating new business allies for the DPP. As the later-day judicial investigation revealed, the first lady was involved in virtually every dubious merger and acquisition deal through which the shares of state-owned banks or enterprises were fallen into the hands of some business tycoons who had thronged into the president's residence to have private audience with the first lady and offered huge kickbacks.

What Chen Shui-bian's wife could deliver was pressuring the minister of finance to offer her favorite business donors the controlling shares of state-own banks at below-market price and instructing the chairman of the Financial Supervisory Commission to expedite the review and approval process over these merger and acquisition deals. These dubious deals enriched a few of the island's wealthiest families and enabled them to build up their financial conglomerates at faster speed. However, the overall health of Taiwan's financial sector was still largely kept intact because these privately-owned financial holding companies were still under the vigilant supervision on daily basis of the various bureaucratic arms of the Financial Supervisory Commission, including the Bureau of Monetary Affairs, the Bureau of Securities and Futures, the Bureau of Insurance, and the Bureau of Examination, which were staffed by senior career civil servants and beyond the immediate reach of the President and his wife.

The scandal of bribe-taking broke out in the early part of Chen's second term and ignited a devastating political storm. Chen Shui-bian's political credibility has never recovered from this credibility crisis. The KMT-controlled parliament put many of the planned auctions of the shares of the state-owned banks on hold. The chairman of the Financial Holding Company Law was removed from office over corruption charges. The DPP-initiated financial reform was abruptly truncated. So when the KMT returned to power in 2008, the government still owned three of the top-10 commercial banks and maintained effective control over another four of the top tens. The combined net worth of the seven state-owned or state-controlled big banks still accounted for more than 43% of the total network the entire commercial bank sector (see Table 1).

Table 1. Taiwan's top 15 banks by net worth (as of June 2010)

Ranking		Ownership	Net Worth (Million of NT\$)	Share of the Grand Total
1	Bank Of Taiwan	State-owned	231,753	11.7%
2	Mega International Commerical Bank	State-controlled	151,199	7.6%
3	China Development Industrial Bank	State-controlled	129,200	6.5%
4	Chinatrust Commercial Bank	Private	120,956	6.1%
5	Taiwan Cooperative Bank	State-owned	112,612	5.7%
6	Land Bank Of Taiwan	State-owned	101,898	5.1%
7	Cathay United Bank	Private	90,993	4.6%
8	First Commercial Bank	State-controlled	90,192	4.5%
9	Hua Nan Commercial , Ltd.	State-controlled	84,158	4.2%
10	Chang Hwa Commercial Bank	State-controlled	83,675	4.2%
11	Taipei Fubon Commercial Bank Co., Ltd.	Private	82,640	4.2%
12	Citibank Taiwan Limited	Private	78,129	3.9%
13	The Shanghai Commercial Savings Bank, Ltd.	Private	72,452	3.6%
14	Bank Sinopac Company Limited	Private	63,355	3.2%
15	Taishin International Bank	Private	56,535	2.8%
Total of Top 15 Banks			1,549,747	78.0%
Total of State-owned and State-controlled Banks			855,487	43.1%
Grand Total of All 23 Banks			1,986,849	

Sources: Taiwan Financial Supervisory Commission's Banking Bureau

After the 2000 regime turnover, the institutional foundations of the developmental state were significantly damaged and the underlying logic of economic decision-making was overturned. First of all, the tradition of a strong state ended as Chen Shui-bian won the 2000 presidential election with only 39.3percent of the popular vote, followed by James Soong's 36.8percent and the KMT's Lien Chan's 23.1percent. In addition, Chen faced a KMT-dominated parliament, the syndrome of “divided government” not only crippled the DPP government throughout its eight- year reign but also undermined the coherence of the state-centered economic policy network.¹⁶

First, institutionalized channels of interest intermediation no long functioned as the way it had been. The KMT-sanctioned elite business groups were no longer recognized as the privileged spokesmen of the business community as new pro-DPP organizations were promoted by the Chen administration. Encompassing corporatist organizations became fragmented and the state-sanctioned policy consultation mechanisms were in demise across the board.¹⁷ Established institutional arrangements for industrial planning and their developmentalist orientation were gradually eroded by the political confusion and uncertainty of severe and protracted political gridlock and partisan bickering.

Second, the morale of the economic bureaucracy was severely damaged. The Chen Shui-bian administration had an innate distrust toward the established bureaucracy, which they believed had long been the KMT’s stronghold. President Chen and his Premier openly criticized the “old bureaucrats” for being numb, arrogant, and for buck-passing. Many senior technocrats opted out for early retirement due to their disagreements with DPP political appointees over controversial policies. Politically motivated appointees took over strategic positions that were supposed to be reserved for non-partisan technocrats in the developmental state apparatus. This

16. Yu-Shan Wu, “Taiwan's Developmental State: After the Economic and Political Turmoil,” *Asian Survey*, Vol. 47, No. 6 (November/December 2007), pp. 977-1001

17. Pei-shan Lee and Yun-han Chu, “The New Political Economy after Regime Turnover in Taiwan,” in Steven Goldstein and Julian Chang eds., *Presidential Politics in Taiwan*. Norwalk: EastBridge, 2008, pp. 143-169

only suppressed the morale of the economic bureaucracy even more. The rupture between the new regime and the established bureaucracy triggered the inevitable demise of the developmental state apparatus. The state apparatus became increasingly unable to map out a comprehensive development strategy and implement it consistently and with longer-term vision.

Furthermore, the antagonism between the DPP government and the business community, especially the high-tech industry (the backbone of Taiwan's competitiveness), grew considerably as the latter's pleas for normalizing trade relations with Beijing, lifting bans on direct transportation, relaxing rigid entry controls for mainland Chinese visitors, and abolishing the 40% cap on Taiwanese investments in China has fallen on the deaf ears of the DPP government for years. In the end, the DPP government's ideological bias against closer economic ties with mainland China accelerated both capital flight and an exodus of high-tech firms and talented professionals. The Taiwan stock market was hit by waves of strategic de-capitalization as more and more listed companies chose to scale down their registered capital. Foreign multinationals also opted out and scaled down their operation. Most alarming was the trend of Taiwan becoming increasingly marginalized in the region. Just as China emerged as the principal architect of the region's multilateral institutions with the launch of the AEASN-China Free Trade Agreement and the inauguration of East Asia Summit, Taiwan became the only economy in the region without a normal economic relationship with the mainland.¹⁸

Between 2000 and 2008, Taiwan's economy registered many disappointing years with sluggish growth and a slew of poor statistics. Among the East Asian tigers, Taiwan trailed Singapore, Hong Kong, and South Korea on all essential economic indicators. Taiwan's Stock Exchange fell off the world's top-15 list in terms of size of market capitalization and off the world's top-10 list in terms of trading volume. By the end of 2005, the dollar-denominated per capita income of South Korea for the first time in history overtook that of Taiwan.

18. Yun-han Chu, "Taiwan in 2006: A Year of Political Turmoil", *Asian Survey*, 47, 1 (January-February 2007): 44-51

The independence of the Central Bank became the only institutional pillar supporting Taiwan's economic resiliency that was largely kept intact during the DPP era. Perng Fai-nan was appointed by Lee Teng-hui to head the Central Bank in 1998 and Perng became the only KMT-affiliated senior economic official that was retained by Chen Shui-bian for the entire eight-year DPP reign. Lee Teng-hui, who still exerted considerable influence behind the scene during Chen-Shui-bian's first term, was a strong advocate for retaining Perng.¹⁹ Lee convinced Chen that the reputation of Governor Perng and his elite staff has become the embodiment of Taiwan's monetary and financial stability and it was simply too risky for the DPP government to replace him.²⁰ Furthermore, Chen Shui-bian's agenda of Taiwan independence and the ensuing escalation of political tension in the Taiwan Strait made the Central Bank's role as the guardian of Taiwan's shock-absorbing capacity even more compelling.

Nevertheless, the Central Bank was pressured to soften its opposition to opening up Taiwan's capital market even wider for foreign investors. The DPP government was keen in attracting foreign institutional investors to fill up the void created by the exodus of domestic investors who precipitated a torrential capital flight from Taiwan to mainland China and overseas tax havens since the DPP took office. Following the removal of the investment cap and the lifting of most restrictions on foreign ownership of listed stocks between 2000 and 2001, the QFII system was finally abolished in October 2003. Foreign institutional investors are exempted from investment caps and have no quota restrictions

However policy makers at the Central Bank were fully aware of the fact that unfettered financial liberalization and unbridled international capital flows can put Taiwan's financial stability at risk. To deal with the potential hazard, the Central Bank applied a full array of

19. For some insider analyses of Lee Teng-hui's influence over cabinet reshuffling during Chen's first term, see a special report published in China Times (at <http://forums.chinatimes.com/report/abian2000/personel/89040204.htm>) and a report published by a pro-DPP on-line news media (at <http://big5.southcn.com/gate/big5/www.southcn.com/news/hktwma/shizheng/200201230503.htm>)

20. Global Finance magazine rated Perng Fai-nan as the world's best central banker in 2005. In 2009, he became the world's only central banker winning the "A" rating for five consecutive years.

monitoring mechanisms tracking down the activities of foreign investors and did not hesitate to introduce temporary capital controls whenever the situation called for. It also continued to use all possible measures to tame the volatility in the currency market and steadily built up Taiwan's foreign reserve to hedge against the sudden exodus of speculative capital and other conceivable economic exigency. To alert the political leaders and mass media for the risk of financial instability, the Central Bank introduced in 2006 an early warning system. It issued Financial Stability Indicators every six months and starting in June 2008 the system was upgraded to a fully-fledged semi-annual Financial Stability Report.

In summary, most of the post-crisis institutional adjustment and policy changes taking place in Taiwan did not bode well. The island's economic competitiveness as well as its growth momentum was significantly undermined by the political shock and ensuing political turmoil brought about by the 2000 power rotation. The resultant realignment of government-business relations also substantially hampered the autonomy of the state economic bureaucracy and shaken off its developmentalist orientation as well as capability. Nevertheless, the legacy of an independent, resourceful and proactive central bank, whose reputation and credibility had been strengthened by its record of steering the island safely through the regional financial crisis as well as cross-Strait crises, was preserved. The legacy of prudential financial regulation was also largely kept intact with the concentration of regulatory authority in a new cabinet-level supervisory commission despite of the meddling of Chen Shui-bian and his family in the process of privatizing state-owned banks.

5. Coping with the 2008-09 global financial crisis

In many ways, Taiwan was more vulnerable to external economic shock in 2008 than during the previous financial crisis. First of all, the state has lost much its steering capability and a coherent ideological orientation. Over the previous decade, the government has failed to foster the

growth of new export sectors. This made the island's export excessively concentrated in electronics and information technology products. Also the government has not incubated Taiwan's IT producers into world-class brand-name companies. This also means a lion's share of these exports was suffering from commoditization pressures with their profit margin shrinking over time. Second, after years of sluggish economic growth and a series sweeping tax cut under the DPP rule, the government's fiscal health has steadily deteriorated. By the end of 2008, the Central Government's tax revenue only made up less than 14% of the GDP and the Finance Ministry had to raise additional income equivalent of 9% of the GDP through borrowing, collecting fees and fines and selling off state-owned assets to balance the book. Thirdly, the SOEs which had been an important policy instrument for industrial upgrading during the 1980s no longer played a significant economic role. Under the prevailing ethos of neoliberal reform of the 1990s, the bulk of SOEs in the manufacturing sector was privatized. The share of SOEs to the gross fixed capital formation has declined from over 30% around early 1980s to less than 10% since 1999. Lastly, Taiwan's capital market was no longer insulated from external financial shock. The foreign institutional investors accounted for almost a quarter of the total market capitalization.

However, comparatively speaking there were still enough cushions in place. Taiwan's Central Bank still equipped the country with enough reserve capacity to cope with economic turbulence. The ratio of non-performing loans of the entire banking sector was kept below 1% of the total outstanding loans. Taiwan's banking sector was also largely free of shadow banking activities featuring financial engineering, leveraged trading in derivatives and off-balance-sheet transactions. The overall foreign exposure of the Taiwan's financial sector in terms of its asset and liability position was still quite low. On the eve of the Lehman Brother collapse, Global Insight in its authoritative Banking Risk Rating Service ranked Taiwan as one of the emerging economies with the lowest risk, second only to Saudi Arabia, in terms of capital/asset ratio, liquidity and

risk/liability management.²¹ In a way, Taiwan's banking sector's backwardness turned out to be its source of resiliency during the global financial meltdown.

Third, with the return of the KMT and its statist mentality, Ma Ying-jeou and his economic team were not hesitant in applying a strong dosage of extraordinary measures. The Central Bank slashed the discount rate by 2.375 percentage points in seven cuts from September 2008 to March 2009 and extensively expanded the scope its Repo facility operations to provide financial institutions with enough liquidity. Most noticeably, the government offered blanket guarantee for all deposits in insured financial institutions by their full amount until the end of 2009. This extraordinary measure not only effectively stabilized the market and restored the confidence of depositors but also attracted a lot of capital inflow as wealthy Taiwanese were anxious to move their savings out of foreign stock markets, overseas asset management accounts and troubled American banks.

The government also set up a Special Task Force on Facilitating Enterprises to Obtain Operational Funds to help small and medium enterprises (SMEs) to weather through the economic storm. In particular, the government cajoled the banks to undertake extraordinary leniency, such as adjusting the rate of mortgage loans and corporate loans monthly instead of quarterly or semiannually without additional renewal fees, automatically extending commercial loans by six months for corporations that faced financial difficulties but still operated normally and paid loan interest as scheduled, and temporarily loosening collateral requirements on margin loans to ease selling pressure from margin calls.

At the height of global financial meltdown the government issued temporary ban on short-selling 150 listed shares below the previous day's closing price, suspended borrowed and margin stocks from short-selling, and narrowed the percentage fall limits of share prices and instructed state-owned financial institutions and the four government-managed funds to purchase blue-ribbon stocks to stabilize the stock market.

21. Commercial Times (Taipei), October 12, 2008.

The KMT government also expedited the passage of a special budget bill through the KMT-controlled parliament to inject NT\$500 billion into the economy through expanding investment in public works, offer every citizen a consumption voucher valued at NT\$3,600, and launch a short-term employment programs. The KMT government also took a controversial tax cut by dramatically lowering the ceiling of the estate and gift tax rates from 50% to 10% in order to attract capital remitted abroad to flow back.

Most significantly, the KMT government restored the business confidence with its conciliatory approach to cross-Strait relations. With a clearly-defined objective of seeking closer economic ties and greater political mutual-trust across the Strait, the new approach consists of five components: first, the installation of a series of high-level engagement and dialogue mechanism between the two authorities; second, a rapid movement toward normalization of trade and investment relationship; third, the acceleration as well as the deepening of economic integration and cooperation; fourth, searching for *modus vivendi* for avoiding zero-sum competition and head-on collision in the international arena; fifth, the intensification of bilateral social contacts and cultural exchange. The momentum of cross-Strait rapprochement culminated at the signing a cross-Strait Economic Cooperation Framework Agreement (ECFA) in June 2010.

It was politically safe for the KMT to reverse the DPP's confrontational approach because toward the end of Chen Shui-bian's political tenure there was a marked shift in the public opinion in favor of a normalized economic relationship with mainland China. The majority of Taiwan citizenry have come to recognize and accept the new reality: China has emerged as the second largest consumer market in the world, the largest source of tourist spending in the region (surpassing Japan) and an increasingly important source of foreign direct investment. It was no longer the case that only business owners of export-oriented sectors or people with transportable skills and investment capital favored closer economic ties with the Chinese mainland while most people working in inward-looking sectors on the island suffered from out-bound capital flow, brain drain and industrial hollowing-out. Increasingly, in the eyes of Taiwan's general public,

mainland China is no longer just a manufacturing platform or most popular destination for Taiwan's out-bound investment but potentially an important source of tourist spending, investment capital and consumer demand. The list of potential beneficiary has grown significantly to include real estate, medical service, financial sector, hotel and catering, fishery and farming, mass media, entertainment and culture industry, etc. This amounts to a large-scale realignment of Taiwan's social forces around the issue of cross-Strait economic integration with the KMT firmly occupying the centralist ground. Thus, Ma Ying-jeou's electoral victory was built up a broad-based social coalition that includes many potential beneficiaries that look forward to a political rapprochement across the Taiwan Strait.

A massive amount of private investment capital started flocking back to Taiwan since the second half of 2008 and gave the local stock market and property market a strong and timely lift. Taiwan popped up again on the radar screen of foreign multinational firms that suddenly found new possibilities of incorporating the island into their Greater China strategy. The island's service industry benefited significantly with the arrival of mainland Chinese tourists, whose number started out with 0.62 million in 2009 and jumped to 1.68 million in 2010. The intensified economic ties also enhanced the spillover effect of China's RMB4 trillion economic stimulus, which generated some timely buying order to save Taiwan's LCD monitor and major appliances producers from the brink of bankruptcy. The signing of the ECFA enabled the island to unleash its full potential in exploiting the expanding business opportunity in mainland China, which is emerging as the new buyer of the last resort. The signing of ECFA is also expected to remove the major political obstacle for Taiwan to negotiate free trade agreements with ASEAN countries and other trading partners. In a nutshell, the rapprochement in Cross-Strait relation has brought Taiwan considerable "peace dividends" just as the island was battered by the worst economic contraction in the global demand for its high-tech exports.

To sustain the island's growth momentum over the long run, the government is taking a two-pronged strategy – to promote the emerging intelligent industries to address the twin challenges

of over-concentration (in semi-conductors, notebook computers, LCD monitors and handsets) and diminishing profit margin that Taiwan's IT industry is facing and to channel investment capital and human resources into some key rising industries to diversify the island's overall structure of export. For the former, the government identified three forward-looking IT-related industries -- cloud computing, smart electric vehicles and intelligent green buildings – in which Taiwan is poised to become a significant global player. For the later the government is placing its best hope on six rising industries -- high-end agriculture, biotechnology, green energy, travel and tourism, medical care, and cultural and creative enterprises.²² Among the six, the last three (which are all service-related) industries have the greater potential for generating employment opportunities. The government has implemented the Taiwan's Service Industry Development Plan since 2009 to help the local service industries to upgrade their international competitiveness and their share in the global services trade. The success of the plan requires not just directing more R&D investment toward the service sector and a timely adjustment in the structure of Taiwan's higher education but also a stable and cooperative relationship with mainland China, whose urban consumers constitute the most promising overseas market for Taiwan's services trade.

6. The transformation of the region

Taiwan was able to cope with the 2008-09 global financial crisis, thanks also to a more enabling regional environment. The ideological milieu and the cooperative institutional arrangements in East Asia have changed so much between the two crises.

In the aftermath of the 1997-98 regional financial crisis, East Asian countries were motivated to seek mutual assistance through bilateral or regional arrangements with greater vigor. First, major East Asian economies have expanded their bilateral currency swaps mechanisms with

22. These strategies are developed and implemented by the newly established "The Executive Yuan Invest in Taiwan Task Force" headed by the Deputy Premier. Please refer to http://investtaiwan.nat.gov.tw/library/main_eng_general.jsp

their major trading partners to make a larger share of their bilateral trade to be settled in local currencies rather than U.S. dollars. Next, under the auspices of ASEAN Plus Three (APT), two regional financial cooperation initiatives, the Chiang Mai Initiative Multilateralisation (CMIM) and the Asian Bond Markets Initiative (ABMI), are well underway. The CMIM established a framework of mutual assistance among APT countries to address each others' short-term liquidity difficulties. The ABMI initiative was designed to promote the local currency bond markets and enhance the recycling of regional savings towards developing regional bond markets.

At a special meeting held in Phuket in February 2009, APT members have agreed to increase the size of the CMIM by 50 percent from US\$ 80 billion to US\$ 120 billion, and to develop a more robust and effective surveillance mechanism to support the operations of the CMIM. In their May 2009 meeting in Bali the finance ministers of APT have reached agreement on all the main components of the CMIM, including the individual country's contribution, borrowing accessibility, and the surveillance mechanism, and decided to implement the scheme before the end of the year. At the Bali meeting, the finance ministers also reiterated their pledge for expanding the role and function of Asian Development Bank (ADB). A planned capital enhancement will augment ADB's capital base to an appropriate level. A Credit Guarantee and Investment Mechanism (CGIM) will be established as a trust fund of the ADB to support the issuance of local currency-denominated corporate bond in our region.²³

While there is not yet a formal mechanism for coordinating their exchange rate policy, Asian central bankers have strengthened the regional network for dialogues and consultation through such as mechanism as the Executives' Meeting of East Asia-Pacific Central Banks²⁴ and the annual meetings of the South East Asian Central Banks (SEACEN) Board of Governors.²⁵

With growing consensus over the need to harness the volatility of currency market, an implicit

23. Yun-han Chu, "The Road to Sustainable Growth: An East Asian Perspective," Background Paper prepared for the Annual Conference of Club de Madrid, Madrid, October 2009

24. It comprises the central banks and monetary authorities of the following eleven economies: Australia, Mainland China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, and Thailand.

25. There are currently 16 member central banks and monetary authorities from East Asia.

regional monetary mechanism has gradually merged with Renminbi and Yen functioning as the twin anchorage for a synchronized and orderly currency adjustment. As a consequence, Asian economies have collectively created a more enabling environment that in turn strengthened their individual capability to cope with the 2009-09 global financial crisis.

Also, regional economic integration has accelerated with the launch of ASEAN-China Free Trade Agreement in 1999 and the inauguration of East Asia Summit in 2005. Strong growth in China and India has provided additional impetus for intra-regional trade. Over the last decade, world trade has been growing approximately 10% annually while intra-Asian trade has been galloping at 20%. All East Asian economies have re-orientated their trade so that their dependence on the U.S. and European market was partially lessened and substituted by the growing consumption power of emerging economies. In particular, China's formidable spare fiscal capacity for anti-recession expansion and its insistence on a slow and orderly appreciation of its currency has injected the region with an important stabilizing force during the Great Recession of 2008-09.

Last but not the least, the political backlash against IMF-imposed austerity measures and its underlying ideological bias have precipitated a growing awakening among the East Asian policy thinkers. They have become more vocal about the flaws and biases in the US-dominated multilateral institutions of global economic governance and the U.S. policy makers' complacency in prolonging the unsustainable global economic imbalance. Asian political leaders have come to question the policy credibility of the IMF, whose invasive policy prescriptions were blamed in the region for having exacerbated the 1997-1998 meltdown. East Asia as a whole has become more confident of its own philosophy and policy preference in maintaining the balance between state and market, between economic openness and social protection, and between competition and equity. More and more Asian leaders, perhaps with the exception of Japan, also began to question the legitimacy and effectiveness of G8, the IMF and the World Bank since their rules of representation and decision-making no longer reflected the weights and new responsibilities of

emerging economic powers from East Asia and other regions. The proposal for the creation of a regional monetary fund and a vibrant regional bond market sent a strong signal to the world that the region was ready to walk out of the intellectual tutelage of the IMF and US.

While most East Asian economies, with the exception of China, were pressured to lift restrictions on their capital accounts over the last decade, policy makers in the region also became more aware of what kind of hazards that speculative capital flows might bring. East Asian policy makers have learned from each other, especially from countries that had suffered the most from the 1997-98 financial crisis (such as Thailand and South Korea) and countries that had emerged from the previous financial crisis relatively unscathed (such as China and Taiwan).²⁶ Increasingly it has become a shared understanding among East Asian policy makers that surging short-term capital inflows is prone to overheat the economy, speed up growth of bank credit and money supply and create speculative bubbles in stock markets and the real estate sector. Once the bubbles burst, sudden financial reversals result in a breakdown in the financial system.

Over the last decade most developing countries in the region have insured themselves through managing exchange rates and building huge currency reserves. So that they could be protected against the tempests of currency speculation and never again would have to call on the emergency lending windows of the IMF. More and more East Asian policy makers recognized the imperative to build up their risk management capability in an increasingly riskier environment brought about by US-engineered financial globalization and US-indulged global economic imbalance. Many of them have equipped themselves with monitoring mechanisms for tracking down the cross-border movement of the speculative capital and scrutinizing the balance-sheet of their banking institutions and large corporations, in particular the foreign liquidity of large

26. Kavaljit Singh, *Taming Global Financial Flows: Challenges and Alternatives in the Era of Financial Globalisation*, Zed Books, 2000.

banks.²⁷ All these policy measures and institutional capacity had saved Taiwan from a financial crisis last time.

Although Taiwan is not a full member of this emerging East Asian community but it is fully embedded in this more enabling regional environment. So Taiwan has benefited indirectly but substantially from the region's newly-installed stabilizing mechanisms. The fact that many other Asian monetary authorities had emulated Taiwan's policy-induced risk-managing capacity after the 1997-98 crisis simply enhanced the credibility of the island's central bank and reinforced its prudential approach to regulating the short-term capital flow and curbing the harmful volatility in the foreign exchange market. This time around the task of warding off speculative attack on New Taiwan Dollars has become much easier when most neighboring economies are also fully-armed and ready to reign in the predatory hedge funds and market speculators. Taiwan's monetary authority no longer feels the pressure to defend itself for applying vigilant capital controls because this time around many other emerging economies are doing virtually the same to tame the capital and property market.²⁸

7. By way of conclusion: ideas matter

During much of the 1990s and early 2000s, policy makers at Taiwan's Central Bank were the lonely advocates for prudential regulation over short-term capital flow and foreign exchange market. They fought hard with the rising tide of financial liberalization. They not only had to face up the political pressures from abroad especially the United States and the IMF but also the prevailing intellectual current that discredited all forms of government control over cross-border capital movement. Their philosophy and practices were repeatedly ridiculed by local

27. Robert McCauley and Jens Zukunft, "Asian Banks and the International Interbank Market", BIS Quarterly Review, No. 72, June 2008.

28. Temporary capital controls are imposed by Indonesia, South Korea, Brazil and Russia. See Kavaljit Singh, "Emerging markets consider capital controls to regulate speculative capital flows", Occasional Papers, Public Interest Research Centre, New Delhi, July 5, 2010.

neo-liberal-minded economists and pro-business mass media and commentators as being too conservative, parochial and backward.

Then the global financial crisis brought about a sea change in the ideological arena. Overnight the mainstream economists became speechless as their intellectual enterprise is crumbling like a house of cards.²⁹ Overnight all Asian policy makers have come to recognize the inherent vulnerabilities and systemic risks in the existing international monetary system. They become confident and bold enough to take issues with their counterparts in the United States and Europe. They rebuked the view that a savings glut from Asian surplus nations was the main culprit of the global crisis. Instead, they pointed out that central banks in the developed world were complacent about the gigantic risks that asset price bubbles posed to the real economy of jobs, production, savings, and consumption and that the U.S. Fed's repeated efforts to contain the damage of the burst of bubble to the real economy through aggressive easing of interest rates have merely delayed the necessary structural adjustment and market correction and produced bigger asset price bubbles later on and aggravated the problem of "moral hazard".

Even the IMF is nowadays reversing its long-standing view.³⁰ By the time of the 2008–09 Icelandic crisis, the IMF endorsed the use of capital controls under exceptional circumstances. By February 2010 the IMF fully reversed its earlier position, saying that capital controls can be useful as a regular policy tool even when there is no crisis to react to, though it still cautions against their over use.³¹ Influential voices from the ADB and World Bank also joined the IMF in advising there is a role for capital controls.

At long last the prudential approach that Taiwan's central bankers have stubbornly and adamantly adhered to for the last three decades is vindicated for its intrinsic merit. Taiwan's monetary authority finally has found a more hospitable soil at home for cultivating its philosophy

29. Paul Krugman, "How Did Economists Get It So Wrong?" *New York Times*, September 2, 2009.

30. A recent paper prepared by the Strategy, Policy, and Review Department of the IMF stated that "in certain cases countries may consider price-based capital controls and prudential measures to cope with capital inflows." See IMF, "How Did Emerging Markets Cope in the Crisis?", IMF Policy Paper, 15 June 2010.

31. Lex team "Capital controls", *Financial Times*, June 10, 2010

and policy practices. No episode better illustrates the sea change in the market of ideas on the island than a weekly column by the Editor of *Business Weekly*, Taiwan's top business magazine. In her column, the Editor openly apologized to Governor Pong Fai-nan for ridiculing his decision to shut down the Non-Deliverable Forward (NDF) market for NT dollar at the crest of the regional financial crisis eleven years ago as "an inconceivable move to turn back the clock." "We were too naïve and too much indoctrinated by the surrogates of Wall Street then," said she.³²

32. Yi-ling Kuo, "Governor Pong, We Were Wrong," *Business Weekly*, No. 1145, November 12, 2009.

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Abstract (in Japanese)

要約

台湾は、1997-98年の東アジア金融危機から、比較的無傷なまま立ち現れてきた、数少ないアジア経済の一つである。衝撃を吸収する同国の力が優れていることは、2008-09年の世界金融危機でも明らかとなった。まず台湾は、サブプライムローン危機以前から、相対的に健全な金融システムを引き継いできており、巨額の外貨準備も積み上げていた。外国銀行が国内の銀行貸出に占める割合はかなり限定的であった一方で、国家は銀行セクターを支配し、銀行の貸出とバランスシートを注意深く監督していた。さらに台湾のマクロ経済指標はかなり健全であり、政府の財政能力には借入の面でも支出の面でもまだまだゆとりがあった。

このように台湾の経済的回復力を構成する多くの要素は、長い年月をかけて確立された制度的な配置と政策の方向性によって強化されてきたものである。ネオリベラル政策の提唱者はこれらの時代遅れの政策思考やその実践を止めるよう、大きな圧力を国外からかけてきたが、それでも台湾は長い間続いてきた経済的回復力の源の大半を維持することができた。さらに、台湾の中央銀行の評判と信頼性は、金融危機や台湾海峡のミサイル危機の際に同国経済を安全に導いたことで高まっていたが、史上初めての政権交替が2000年にあった後も、政治的混乱があったにもかかわらず、独立的で行動的な中央銀行の遺産はそのまま残されていた。また、金融機関のプルーデンシャル規制の伝統も、閣僚レベルに相当する新しい監督委員会に規制の権限を集中することで、大半が保持されていた。

台湾が2008-09年の世界金融危機に上手く対処できたのは、東アジア地域の環境がそれを可能にしたお陰でもある。IMFの課した緊縮政策に対する政治的反動で、東アジアの政策決定者達の覚醒が進んだのである。すなわち、地域内のほとんどの途上国は為替レートを管理し、巨額の外貨準備を積み上げることで、通貨投機の嵐から身を守り、二度とIMFの助けを借りる必要がないようにしたのである。東アジアにおけるイデオロギー的環境と協調的な制度配置は、二つの危機の間に大きく変わったのであった。



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Thomas B. Pepinsky