DEMOCRATIZATION AND THE TRANSFORMATION PROCESS IN EAST ASIAN DEVELOPMENTAL STATES: FOCUS ON FINANCIAL REFORM IN KOREA AND TAIWAN

Dr. Haeran Lim
CNAPS Visiting Fellow, Korea, 2007-2008
Associate Professor of Political Science, Seoul National University

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I. Introduction

This study explores the effects of democratization on the transformation process of East Asian developmental states, focusing on financial reform in Korea and Taiwan after the Asian crisis.

Korea and Taiwan are regarded as typical examples of developmental states. Both countries experienced rapid growth under authoritarian regimes and have continued sustainable development after their transitions to democratic rule in the late 1980s. To varying degrees, Korea and Taiwan also share other similar characteristics such as Confucian culture, national division, small and open economies, high quality human resources, high interest in education, and slow processes of democratic consolidation with economic stagnation. As Cumings (1987) stated, when the two countries are compared to the rest of the world, the similarities are remarkable.

However, there are also salient differences between the two countries. Each has responded differently to the pressures of globalization, democratization, and informatization. Korea was severely hit by the Asian crisis, whereas Taiwan weathered the storm with relatively minor damage. The differences revealed through intra-regional comparison suggest that each country has followed path-dependent development. This is contrary to the argument that powerful forces for change applied across borders can overwhelm institutional inertia (Thatcher 2004).

How do we explain these different processes of development? The developmental model, which used to be an engine of growth in the past, is blamed as the main cause of the crisis. However, some argue that democratization limited the state’s role of promoting financial reform and new industrial policies, and made the East Asian economic structure vulnerable to external shocks. Though less academic attention has been given to the developmental model since the Asian crisis in 1997, the debate on the state’s role continues. Thus, the transformation of developmental states provides an interesting case in examining how internal and external pressures for change can be reconciled and how democracy can become public goods for development in some states, and public bads in others. The analysis of developmental states may also give us some clues regarding the issue of conversion versus diversion of the capitalist system.¹

The relationship between democracy and economic development has been a perennial question for policy makers as well as scholars. Is democratization a panacea or a

¹ Some argue that modes of capitalism would converge along with globalization. But, according to the “varieties of capitalism” argument, different modes of coordination across states exist despite having the same system of capitalism. Coordinated market economies (CME) such as Germany show many differences as compared to liberal market economies (LME) such as the United States. As one comes to understand capitalism’s diverse modes of coordination, the argument of convergence to Anglo-American capitalism after recent globalization may be seen as somewhat hasty. Hall and Soskice (2001); Lim (2007).
problem for reform? Are democratization and economic reform mutually supportive processes or in tension with each other? Both Korea and Taiwan face the daunting task of accomplishing democratic consolidation with economic growth, a task made all the more difficult—and important—by the economic crisis that began in late 2008. The introduction of democracy, however, can sometimes present obstacles for economic and political reform, and many new democracies tend to be fragile. The first objective of this study is to explore whether democratization in Korea and Taiwan has led to economic reform, focusing on the financial sector. The sustainable development of an economy can only be achieved through economic reform. The study of whether democratization is compatible with economic reform is therefore worthwhile.

Another very important point of interest is that, as noted above, the transformation processes in Korea and Taiwan have been considerably different. Why does democratization’s effect on the transformation process vary across countries, and across sectors within a country? How can we explain that the changes in developmental states sometimes follow the pattern of continuity, and sometimes do not? According to Przeworski (1993), it may be because political institutions do matter for development. Focusing on regimes, however, does not seem to capture the relevant differences among developmental states. The paths taken by countries with different levels of political-economic development vary across countries. East Asian developmental states have undergone substantial democratization largely as a consequence of rapid economic development. However, the path of democratization in one country is different from that in another, and the effects of democratization also vary. The second objective of this study is to explain why the reform process follows a “path-breaking” pattern in some developmental states, and a “path-dependent” and “non-reform” pattern in others.

This study focuses on the financial sector for two reasons. One is that significant reform in the financial sector has happened only recently, after the Asian crisis, in both countries. Thus it provides a good case study on how these new democratic systems respond to such massive external pressure for reform. The other is that the financial sector is the most rapidly expanding service sector. This paper extends the analysis to the recent development of the reform process in the newly expanding financial sector.²

This study may have three implications. First, it shows how forces for change such as globalization and democratization can be reconciled with political and economic reforms, and it explains why transformation processes vary across countries and sectors. Second, it provides a guideline on the management of the transformation process that can bring beneficial results and further development of East Asian countries, recognizing that modes

of governance must be changed as democratization proceeds. Third, this study suggests that the leaders of developing states seeking to emulate East Asian countries must first understand their own social and economic structures and choose appropriate processes of social and economic transformation.

This study first provides a theoretical framework to tackle both objectives of this study—whether democratization has led to economic reform in Korea and Taiwan, and why seemingly similar states may follow very different paths of reform. After briefly introducing previous discussions on the relationship between democratization and economic reform and suggesting some additional complementary factors to understand the relations, I attempt to provide a unified framework to explain the comprehensive process of reform. Comparative analysis of Korea and Taiwan will then be presented in Sections III and IV as case studies of the theoretical framework, emphasizing their financial reforms. In each section, the process of financial reform is described and interpreted with respect to the relation between democratization and reform process, in support of the arguments in Section II. Section V provides a brief summary of this study.

II. A Theoretical Framework

1. Democracy and Economic Reform

Previous studies on the relationship between democracy and economic reform have centered on whether both can be consolidated simultaneously, and if so, under what conditions and in which sequence. Analysts have also debated whether economic reforms are easier to implement in authoritarian or democratic regimes.

Some assert that democracies are at a disadvantage in achieving economic reform for two reasons. First, democracy can be seen as presenting obstacles to economic reform. Democracy increases citizen participation through various means, including elections. As the short-term net effect of reform on many citizens tends to be negative, people harmed or potentially harmed by reforms will oppose them by means of various opportunities in the democratic system. Politics trumps economics. Second, democratization results in decentralization of power within the government, and weakens the autonomy and efficiency of the government. In this sense, a democracy can undermine the successful implementation of economic reform.

Those who are skeptical of the capacity of a democracy to achieve economic reform often point to Chile, China, and Russia. Economic reform in Chile was successful under Pinochet’s authoritarian regime. China chose to undergo economic reform prior to political reform, and this plan has been considered a success. Unlike China, under Gorbachev’s leadership the Soviet Union implemented political liberalization (glasnost) more successfully than economic restructuring (perestroika), and experienced economic
collapse and political disintegration (Diamond 1995). These examples lead us to believe that successful economic reform is easier under an undemocratic government.

Some studies have extended and applied this analysis of the relationship between democratization and economic reform to East Asian countries. For example, Pei (1995) argued that East Asian countries achieved successful economic reform under autocratic and authoritarian rule, unlike most Latin American countries where democratic breakthroughs preceded wrenching economic reform. Economic restructuring occurred very gradually in East Asia, and economic reform was compatible with three other key developmental goals: high growth rates, poverty reduction, and shrinking socioeconomic inequality (Pei 1995, 114-5).

Skepticism toward democracy’s role in bringing about economic reform might seem persuasive, to a certain extent. However, such a vague connection is too simplistic and deterministic. There are many other factors that influence the reform process. As skeptics have stated, economic reform may indeed be more successful under authoritarian regimes. In the short run, the earlier stages of democratization can result in negative outcomes that are anathema to reform, such as money politics. The lack of a consensus mechanism among diverse interest groups, the lack of appropriate governance mechanisms to resolve bureaucratic conflict, and high money politics with increased costs of elections, will result in political instability and an impasse for economic reform. However, as democracy becomes more stable, its long term effect on reform will be positive. Consolidated democracy, such as the development of a political party system, could be a basis for resolving conflicts associated with economic reform.

Many studies have suggested that democracy is compatible with economic reform and structural adjustment. The success of economic reform is influenced by many institutional, historical, and political variables which are independent of regime type. Furthermore, democratic institutions, especially a well-developed political party system, can facilitate the resolution of social conflicts associated with economic reform (Diamond 1995). Democratic consolidation, such as establishment of the rule of law and accountability of the political system, can be compatible with economic reform. Successful economic reform requires the broad support of the public, which would be possible under a policy-based political party system.

2. A Theoretical Framework

Meaning of democracy and economic reform in this study

A theoretical framework should provide an explanation of the relationship between democracy and economic reform on two levels: whether democratization in Korea and Taiwan has led to the reform process in the financial sector and why the transformation process is a continuous pattern in some countries and a big-bang pattern in others.
Before framing the theory, let us first define the concept of democracy and economic reform. Democracy is usually characterized by competitive elections, protection of civil and political liberties, and a variety of channels for citizen participation. To examine the developmental process of East Asian countries, however, democratization should be understood as a “process” rather than a “result.” Most countries are regarded as democratic if they simply satisfy the minimum condition of the procedural meaning of democracy, which is holding competitive elections not substantial meaning of democracy, which promotes equality.

Korea and Taiwan began a long journey of democratization in the late 1980s, but they are still in the process of democratization in terms of consolidating and institutionalizing democratic norms and principles.

Economic reform often refers to all policies that promote marketization, privatization, and free trade, especially for countries that have experienced fast growth under authoritarian regimes. However, the content and direction of economic reform vary across time and regions. For example, the external economic shocks of the 1930s resulted in heterodox policy experiments, many of which expanded the role of the state in the economy. In contrast, in most cases new democratic governments are compelled to implement a more or less “orthodox” direction of reform, which includes liberalization by reducing the role of the state in the economy and expanding the role of the market. During the 1970s and 1980s, debt-burdened economies pursued stabilization and “structural adjustment” by converging on a set of principles of sound macroeconomic management. In the 1990s many Communist countries had to transform from socialism to capitalism, which is an even more daunting task. They had to privatize state enterprises, remove trade restrictions, and create capital markets and social insurance systems from scratch.

These various experiences suggest that the contents of economic reform vary across time, regions, countries, and even sectors, depending upon the causes of the reform. In this study, since we focus on the financial sector before and after the Asian financial crisis in Korea and Taiwan, economic reform basically means financial liberalization and financial reform with the aim of improving competitiveness and transparency in the financial sector. The reform process tries to improve its economy by transforming industrial structures and corporate governance.

Additional factors to be considered

To understand the relationship between democracy and economic reform, we need to have a broader perspective on this relationship and consider various factors that influence the reform process. For example, we need to discard the absolutist position that democracy is

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3 The procedural meaning of democracy is characterized as the regular election of president and politicians. Dahl (1971) suggests the concept of ‘polyarchy,’ constituted by two conditions such as political contestation and participation. Sorenson (1993) developed this procedural meaning of democracy into ‘democratic autonomy’ which includes a more substantial meaning of democracy, such as economic equality and social participation etc.
either positive or negative on economic reform. Democracy can be a positive and negative engine for economic liberalization and opening. Also, we should consider path-dependent dynamics of reform processes across countries and sectors; in short, past choices constrain choices for the future. The institutional legacy in each country will affect different challenges and tasks for reform. The sectoral characteristics, pattern of development, and historical legacy also affect the reform process. According to the theory of historical institutionalism, an institution offers a particular set of opportunities, and actors are expected to gravitate toward certain behaviors that take advantage of these opportunities. Since institutional structures influence actors’ behaviors, the process of democratization is conditioned by institutions and can be different in different countries; therefore the transformation process of developmental states under globalization and democratization can show path-dependent characteristics (Hall and Soskice 2001; Thelen 1992).

In addition, we need to include coalitional factors in understanding variant outcomes across countries and sectors. The choices and outcomes of reform will also be influenced by the support or opposition of coalition groups. The effects of reform will highlight winners and losers, therefore the support from embedded interest groups or shifting coalition group would be followed according to the contents and direction of reform. The contents of economic reform could include deregulation such as liberalization, and re-regulation such as improvement of transparency, accountability, and so forth. The interests of various societal groups will be hurt or benefited by various polices of economic reform. When we take these factors into account in attempting to understand the relationship between democracy and economic reform, the comparative analysis will be more comprehensive and balanced.

The framework

Partly borrowing from Lim’s (1998) coalition theory of industrial transformation and considering various factors mentioned above, we suggest the following theoretical framework. First, economic reform can be achieved under both democracy and authoritarianism. However, a threshold must be overcome. Threshold conditions include a close collaboration among industrial sectors, political leaders, and bureaucrats (Lim 1998, Ch.2) and the capacity of a given industry group to implement a reform process. Basic environmental factors such as market development, institutional quality, and governance may also be included in the threshold conditions, but these can be endogenously provided as the reform proceeds.

In order for reform to move forward, coalition groups should have a mutual interest in and a motive to reform. For example, the political regime may desire a certain reform in order to weaken the power of an existing group and to strengthen a new leadership. A business group may also require the reform to strengthen its competitiveness for survival in a new environment. And bureaucrats may want the reform because sometimes they stand to regain power through the reform process. In such a situation, the collaboration threshold can be overcome. However, collaboration is not the only requirement—the ability to
achieve the given reform is essential. An economic reform requires not only a strong will and mutual interest but also business groups and perhaps bureaucrats who have the capacity to implement it.

Korea’s experience transforming its industrial base from light industry to heavy-chemical industry (HCI) provides an example of an economic reform under authoritarian regime. The new political regime and the newly rising large enterprises (LEs) both showed very strong interest in the basic change of the economic structure, and the government provided strong support to implement reform through industrial policy. Likewise, informatization and the information technology (IT) transformation in Korea and Taiwan are examples of economic reform achieved under democratic regimes. Both the governments and business groups showed much interest in the transformation in order to establish a new growth engine, the existing large enterprises had capital and developed technology to enable it.

<Figure 1> Theoretical Framework

As a country democratizes, pressures from various groups increase and it is difficult for the political regime to ignore such pressures, especially when they are strong.
Since a reform produces winners and losers, sometimes opposition from the presumed losers can be very strong and the reform can be blocked. Also, this kind of political pressure can undermine the autonomy and ability of bureaucrats to implement the reform. Thus, we also suggest that in a democratic regime, a reform is more likely to proceed in a sector where the negative effect on a specific group is not salient.

For example, most people benefited from reform of the IT sector in Korea and Japan, and no specific group was negatively impacted. Thus, IT reform proceeded without much resistance in both countries. In contrast, financial reform had the potential to negatively affect both existing business groups and bureaucrats. Financial liberalization and opening could also negatively affect the poor and widen the income gap, a result of the negative impact of globalization. Thus, financial reform was often delayed, which led to increasing problems in that sector. When these problems erupted in a crisis as in Korea or when the market pressure was too strong as in Taiwan, financial reform was imperative and could no longer be put off, so the threshold conditions were met. Since financial reform requires a break from past practices, it usually follows a path-breaking and big-bang pattern.4

Table 1 shows a summary of some applications of the above framework to the experiences of Korea and Taiwan. According to this table, financial reform in Korea basically failed before the crisis, and was path-breaking after the crisis while it is still hard to see a noticeable process of financial reform in Taiwan. In the next two sections, we will compare financial reform processes in Korea and Taiwan and explain why their reform processes are classified as in Table 1.

<table>
<thead>
<tr>
<th>Table 1&gt; Patterns of Reforms</th>
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<td>Country</td>
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<td>Taiwan</td>
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Note 1: HCI, IT, and Finance respectively mean industrial transformation from light to heavy-chemical in the manufacturing sector, informatization and IT industry development, and financial reform.

Note 2: Finance 1 and Finance 2 respectively mean before and after the crisis.

Source: Classified using Lim (1998; 2007)

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4 A big-bang pattern can be characterized by huge changes in industrial and governance structures within a short time (as opposed to gradual reforms); the reforms enacted by the Thatcher government in the UK are an example of big-bang reforms.
III. Democratization and Financial Reform in Korea

1. Financial Liberalization and Financial Reform: Delayed and Forced Reform

Financial systems in early periods: developmental banking

It is well known that the Korean government pursued export-oriented industrialization beginning in the 1960s. The government targeted strategic industrial sectors over time: light manufacturing in the 1960s; HClIs (heavy and chemical industries) in the 1970s; technology industries in the 1980s; and IT (information technology) since the 1990s. The government intervened in the economy by providing large corporations in these sectors with incentives such as import protection, fiscal preferences, and, most importantly, preferential access to subsidized credit (so-called policy loans\(^5\)). The government also influenced the sectoral allocation of credit through the appointment of bank management and credit controls. These policies resulted in a tightly-controlled, government-administered financial system, which is characterized by chronic demand for credit.

The Korean financial system consists of three main types of institutions: commercial banks, specialized and development banks, and nonbank financial institutions (NBFIs). Before the 1997 financial crisis, commercial banks accounted for over half the assets of the financial system. Specialized and development banks were partly or wholly owned by the government, which used to provide credit for strategic sectors. NBFIs also played a big role in the financial system and were owned mainly by the chaebols (large business conglomerates). Most of the thirty merchant banks in 1997 were owned by the chaebols, and some were partly owned by foreign banks. Securities companies were also owned by the chaebols and acted as dealers for their own accounts.

Commercial banks were nationalized in the early 1960s, when the top eight banks accounted for two-thirds of commercial bank assets. Five of these had been providing government-directed policy loans over a long period. To reduce the reliance of large corporations on bank loans, in the mid-1970s the government began to impose a credit control system and develop capital markets. The gradual and partial reform in financial system began in the 1980s.

Financial liberalization and reform before the crisis

Financial liberalization refers to deregulation, whereas financial reform includes re-regulation as well as restructuring, although both terms are often used interchangeably. It is widely believed that the main cause of the financial crisis in 1997 was a mismatch between too much financial liberalization and too little financial reform (Chang 1998; Weiss and Hobson 2000; Lew 2005). To understand this, we need to go back to the 1980s and

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\(^5\) The borrowing cost differential between protected and unprotected industries was about 2-3 percentage points. Lim 1998. Ch. 4.; Balino and Ubide 1999.
examine how financial liberalization started in Korea. Woo-Cummings (1997) argues that financial liberalization in Korea was triggered by a much larger global process, world capitalism, and external pressure from the United States. The story of the 1980s is less a story of Korea “reforming” after behaving badly in the past than of adjusting to new realities in Washington (Woo-Cummings 1997, 91). Korea might be the case in which external factors could explain the process of liberalization and post-crisis reform.

However, overemphasis on the external factor should not overshadow the importance of domestic political reform as an important variable in Korea’s financial reform, especially when we compare Korea with Taiwan. We cannot but ask why the two countries responded differently under similar external pressures and in similar environments. Because of differences in domestic politics, the external environment is filtered and may have a different effect on different countries. But this does not explain away the important role of the external environment as a structural constraint. The complementary perspective and more sophisticated job of fleshing out the important domestic variable should be done first.

The period of financial liberalization and reform in Korea can be divided into three phases. First, the 1980s can be seen as an era of “delayed reform.” Second, the period of the Kim Young-sam government (1993-1998) can be considered one of unregulated liberalization which sowed the seeds of the 1997 financial crisis. Third, the period following the crisis can be regarded as a period of “forced reform.” The characteristics of each period in terms of speed, content, and direction of financial liberalization and reform in Korea are explained below.

After the death of President Park Chung-hee in 1979, economic reform was largely in the area of macroeconomic policies. The agenda known as the “Washington Consensus” consisted of a reduction of government deficit, a tight monetary policy, privatization of commercial banks, relaxing control over foreign investment, and phasing out of subsidies. These reform measures were seen as successful but they did not completely overhaul the financial sector.⁶

The first priority of the Chun Doo-hwan regime, which came to power in 1980, was to stabilize the overheated economy. To achieve economic stabilization, the authoritarian Chun government pushed for a financial liberalization plan consisting of privatization of banks, reduction of policy loans, deregulation of bank entry barriers, and interest rate liberalization. Some of these policies were implemented—for example, as commercial banks were privatized and entry into commercial banking was liberalized, six new commercial banks were established between 1980 and 1992, increasing the number of

⁶ Reform during the Chun Doo-hwan government was prepared by Kim Jae Ik, who was a neo-liberal economist trained at Stanford University. Reforms during this period, however, did not change other important areas such as corporate governance, reduction of state intervention, etc. Lee et al. 2005, p. 13.
commercial banks from 7 in 1985 to 13 in 1992. Entry barriers for NBFIs were also lowered. Interest rates were partially liberalized, and in 1987 many preferential lending rates were abolished. However, the reform of the financial system during the 1980s was partial (Balino and Ubide 1999). Most of the reform goals such as interest rate liberalization, reduction of policy loans, and foreign exchange liberalization were postponed. The developmental characteristics of the state and the cozy relationship between the government and the financial sectors continued during the 1980s.

Lew (2005) argues that the nature of reform in the 1980s was “delayed reform.” On the other hand, Jang (2003) considers the reform in the 1980s as a positive development, or “gradual” liberalization. These two interpretations do not necessarily conflict with one another: there was indeed both gradual liberalization and delayed reform during the 1980s. However, under the Kim Young-sam government of the 1990s, this process was shifted into speedy financial liberalization without the parallel financial reform.

From the early 1990s, the Korean government started to significantly relax its control over the financial sector, accelerating financial liberalization. (Chang et al 1998). The Kim government announced a five-year financial liberalization plan aimed at interest rate deregulation, abolition of policy loans, more managerial autonomy for banks, reduction of entry barriers to financial activities, and, most importantly, capital account liberalization which Korea’s previous plans for financial liberalization had failed to include (Chang et al 1998). Foreign borrowing, which traditionally had been very tightly controlled by the government, was also liberalized, and the number of merchant banks increased from six in 1994 to 15 in July 1996. But the Kim government relaxed controls on foreign borrowing more than was needed, and, more importantly, the government failed to exercise adequate supervision of this borrowing. The merchant banks took full advantage of this absence of supervision, and created a severe mismatch in the maturity structure between their borrowings (64 percent of the $20 billion total were short term) and lendings (85 percent of them long term).

The Kim government also abandoned the traditional approach to exchange rate management. The current account surplus of $0.4 billion in 1993 turned into a deficit of $4.5 billion in 1994, to $8.9 billion in 1995, and grew to a record $23.7 billion in 1996.8 There were other incidents such as the collapse of the price of memory chips, a major export item for the country. The failure to take timely action to adjust currency overvaluation proved fatal when the Japanese yen and Chinese yuan massively depreciated beginning 1994.

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7 For example, during 1981-1987, 12 investment banks, 1 investment trust company, and 57 of mutual credit organizations were established. Lew 2005, p. 174.
8 The Korean government has traditionally taken quick action against currency overvaluation to maintain export competitiveness. The shift of policy had to do with the increasing dominance of the monetarist idea in the Korean and in the international policy making circles. The Korean government feared that significant depreciation would make the foreign debt repayment burden unbearable. Chang. 1998, p.1558.
Further, the Kim government abandoned an important tool for developmental states: industrial policy, particularly the coordination of investment. The planning ministry, the Economic Planning Board (EPB), merged with the Ministry of Finance (MOF), creating the super-sized Ministry of Finance and Economy (MOFE), which symbolized the demise of “planning” in Korea. This rationalization policy resulted from the rise of a pro-market ideology and the loss of legitimacy of centralized coordination (Chang 1998, p.1558). There were many examples of the Kim government abandoning the role of investment coordination. The government refused to coordinate investments in the petrochemical industry despite evidence of massive overcapacity, for example. However, it is well known that the government inconsistently allowed Samsung to enter the auto market due to political reasons despite evidence of overcapacity. Critics have argued that the Kim Young-sam government produced a full-blown “crony capitalism.”

**Financial reform after the crisis**

The long history of government intervention in bank lending decisions had hindered the development of a sound banking system. The Korean economy was dominated by large corporations which were highly dependent on borrowing mainly from the banking system. The government stood behind the banking system, and it was believed that large corporations were too big to fail. This cozy relationship among the government, banks, and large corporations was one cause of the crisis. During the 1990s, banks and NBFIs increased borrowing in the international financial markets. Weak regulatory and supervisory arrangements allowed banks and NBFIs to take excessive risks without building a capital base to withstand shocks.

Financed by this lending from banks and NBFIs (especially NBFIs), Korean corporations greatly increased investment in new industries between 1994 and 1996. A large portion of borrowing was undertaken through overseas subsidiaries and foreign branches, especially focusing on short-term capital inflows. Domestic banks channeled short-term borrowing to finance domestic corporations with long-term loans.

These investments turned out to be unsustainable. The sharp fall in the semiconductor market and a decline in foreign demand resulted in substantial losses in the exports sector, and the “carry trade” exposed Korea to the risk of a bank crisis. The collapse of the Thai baht peg in July 1997 and the subsequent spread of the contagion to other countries in the region also sent shock waves to Korea. Short-term creditors began to

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9 Of course, there existed many cases of huge scandals before this period. As Amsden argues, one of the reasons why East Asian countries performed well had to do with the existence of both subsidy and criteria of export performance. It prevented Asian countries from degenerating into predatory states like Latin American and African countries. Amsden 1989; Lee. 2005.

10 Short-term foreign borrowing rates were lower than long-term rates and short-term foreign funds could be easily raised by international money markets. Balino and Ubide. 1999. pp. 23-25. This ‘carry trade’ exposed the country to a risk of bank crisis, for banks would be able to liquidate assets rapidly in case foreign short term creditors became concerned about growing trouble in the Korean bank system.
withdraw their credit lines, leading Korea to the brink of collapse.

Korea could not but ask the IMF for help and commit to a program of macroeconomic adjustment and structural reform through a stand-by arrangement of SDR 15.5 billion (roughly US$21 billion) from the Fund. The prescribed program of structural reform included three goals: to restructure the banking system; to increase the market orientation of the financial system and to strengthen the supervision and management to prevent a similar crisis from occurring again; and to start a program of corporate restructuring, especially to resolve problems of the major chaebols, which is closely related with restructuring of the financial sector (Balino and Ubide 1999). As an interim measure, the government consolidated all financial sector supervision under a single Financial Supervisory Commission (FSC). The government also revised the Bank of Korea Act to guarantee the central bank’s independence and allow it to focus on price stability.

A year after the restructuring process began, the Korean banking sector became more consolidated. Since December 1997, 16 of the 33 commercial banks and 897 of 2070 NBFIs have either closed or merged (Table 2). In particular, 29 out of 30 merchant banks which were heavily blamed for their high exposure to currency and maturity risk have closed, and only two, including one new entry, are currently operating. A considerable amount of public funds were provided in the process of financial restructuring; the most important reform measure was to strengthen the banking environment, including improving bank supervision and prudent regulations.

The Korean government almost completely opened its financial market to foreigners while simultaneously restructuring the financial sector. As foreigners bought distressed Korean financial companies at fire sale prices, most big Korean banks were handed over to foreign companies. Among the seven biggest commercial banks in Korea, six are owned by foreigners (on average, foreigners’ share is over 80 percent); Woori Bank is the only remaining large commercial bank that is majority Korean-owned (Table 3).

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11 Before the crisis, commercial banks were under the direct authority of the Monetary Board (the governing body of the Bank of Korea) and the Office of Banking Supervision (OBS), while specialized banks and NBFIs were under the authority of Ministry of Finance and Economy. This lack of unified system of supervision and regulation created the conditions for regulatory arbitrage and the development of risky practices among commercial banks’ trust business and merchant banks. ibid. p. 16.
<Table 2> Financial Restructuring after the Crisis
(unit: number)

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<td>New entry</td>
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<td>617</td>
<td>59</td>
</tr>
<tr>
<td>Total</td>
<td>2,103</td>
<td>631</td>
<td>60</td>
</tr>
</tbody>
</table>

Note: Restructuring means the number additionally reduced by M&A, closures, etc. since the previous period.
Source: Annual Report of Public Fund Oversight, Korea Public Fund Oversight Committee

<Table 3> Foreigners’ Share of Commercial Banks
(unit: %)

<table>
<thead>
<tr>
<th>Name</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
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<td>Kookmin</td>
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<td>50.5</td>
<td>58.2</td>
<td>71.1</td>
<td>70.2</td>
<td>73.6</td>
<td>76.1</td>
<td>85.4</td>
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<tr>
<td>Jootaek</td>
<td>45.1</td>
<td>66.4</td>
<td>66.4</td>
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<td></td>
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<tr>
<td>Woori</td>
<td>---</td>
<td>0.05</td>
<td>16.3</td>
<td>0.0</td>
<td>0.7</td>
<td>4.5</td>
<td>11.7</td>
<td>11.4</td>
</tr>
<tr>
<td>Shinhan</td>
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<td>34.2</td>
<td>40.4</td>
<td>48.6</td>
<td>49.0</td>
<td>40.4</td>
<td>62.8</td>
<td>57.1</td>
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<td>Chohung</td>
<td>5.8</td>
<td>0.4</td>
<td>0.2</td>
<td>0.3</td>
<td>3.1</td>
<td></td>
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<tr>
<td>Hana</td>
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<td>26.2</td>
<td>32.2</td>
<td>52.0</td>
<td></td>
<td></td>
<td></td>
<td>78.2</td>
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<tr>
<td>Seoul</td>
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<td>---</td>
<td>---</td>
<td>---</td>
<td>28.7</td>
<td>37.2</td>
<td>---</td>
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<tr>
<td>SCfirst</td>
<td>0.1</td>
<td>50.99</td>
<td>50.99</td>
<td>50.99</td>
<td>50.99</td>
<td>48.56</td>
<td>48.56</td>
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</tr>
<tr>
<td>KEB</td>
<td>34.9</td>
<td>23.0</td>
<td>34.2</td>
<td>34.1</td>
<td>27.9</td>
<td>71.0</td>
<td>72.0</td>
<td>74.2</td>
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<tr>
<td>Citibank</td>
<td>25.7</td>
<td>30.7</td>
<td>48.6</td>
<td>53.2</td>
<td>61.0</td>
<td>85.8</td>
<td>---</td>
<td>99.0</td>
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</tbody>
</table>

Source: KDI (2007)

Financial reform in Korea can therefore be characterized as delayed, but ultimately forced by the Asian financial crisis. The next section explains why the reform process took this pattern, how democratization affected the politics of reform, and what other factors also could have influenced the process of financial liberalization and reform in Korea.
2. Political Economy of the Reform Process

Democratization

As noted above, the idea of political democracy tends to spread into other areas of society, and the year 1987 was a turning point in terms of changing the political/economic landscape in Korea. The following year, the new Roh Tae-woo government (1988-1993) declared that democratization in other areas should go hand in hand with political democratization: In particular, the Roh government advocated that liberalization of the financial sector should be leveled with the trend of democratization. Roh promised a reduction of policy loans, independence for the Central Bank, and rationalization of the financial sector. Unfortunately, most of these pledges were postponed due to changes in economic conditions such as increasing inflation, the real estate bubble, and the stock market crash after 1990.

Political democratization began to have an effect on economic liberalization and reform during the Kim Young-sam government, beginning in 1993. The Kim government was the first “civilian” government since democratization and tried to push for broad and drastic reform in various areas including the military, economy, and politics. (Chang 2003). Financial liberalization was one of the most important areas for this drastic economic reform. The fast deregulation and liberalization under the Kim government reflected the pace of democratization in Korea. As the idea of political democratization spread into the economic area, economic democratization was somewhat understood as market liberalization and financial liberalization (Chang 2007). As a reaction to the past authoritarian rule, the democratization in the economic area meant the reduction of state intervention, deregulation, and liberalization in the financial sector as well.

Such democratization complicated governance in Korea. The autonomy and efficiency of technocratic bureaucrats was gradually weakened. As a plan of government administrative rationalization, the merger of the EPB with the MOF, creating the MOFE, reflected the demise of “central planning” and centralized coordination. Democratization reduced the willingness and capacity of the state to implement a coordinated investment policy.

Democratization increased various voices in the debate about reform in the legislature. In the late 1990s, the lack of consensus among parties in the legislature and the divided government (in the presidential system) led to the failure of many reform measures. The political structure at that time was unstable: Kim Dae-jung’s ruling

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12 Political democratization affected the democratization of the economic sector. However, economic democratization was understood as the primacy of the market, created by reducing the role of the state in the economy. Korea’s experienced with authoritarian governments created a belief that market primacy meant economic democratization. Chang, Ha Joon. 2007 Discussion in Pressian.

13 For example, the “big bang” plan in January 1997 was aborted due to political disputes. The moral authority of Kim Young-sam was lost due to a labor fiasco and the Hanbo scandal over corruption, etc. Lee. 2005. p. 28.
Millennium Democratic Party did not win a legislative majority in the April 2000 general election, and it was allied with Kim Jong-pil’s United Liberal Democrats against the big opposition party (the Grand National Party). This made it difficult to reach an agreement on reform. In addition, Korea’s limit of one five-year term for presidents created an early “lame-duck phenomenon” which could diminish reform efforts (Kim 2000, pp. 156-7). Korean party politics after democratization have been fluid and unstable. Political parties have been weak, divided along regional lines, and organized around cliques. Conflict between the legislature and the president has been frequent. This is typical of democratized developing countries, and political constraints on reform.

On the other hand, democratization strengthened the political and economic power of the chaebols. Due to the high cost of national election campaigns, politicians and political parties turned to the chaebols for funds. The government’s attitude and behavior toward the chaebols thus swung from one of confrontation to cooperation with impending elections, especially when the economy faltered in 1997. Democratization thus created an ambivalent relationship between the government and the corporations.

Coalitional factors

With democratization in the late 1980s, diverse interest groups such as NGOs, labor unions, intellectuals, and the media organized to pursue their parochial interests at the expense of the overall goal of growth. With the rise of these new groups, the power of the technocratic bureaucrats declined. Despite some liberalization in the 1980s, the government continued an overly cozy relationship with the banks and still influenced the banks through appointments of bank directors and personnel. With democratization, however, the chaebols became powerful enough to influence the direction of economic policy.

Democratization therefore affected domestic coalitional politics. It was not external pressure but internal conflict among various groups that determined the content and speed of financial liberalization during the 1980s. The slow and slouching process of reform during the 1980s had to do with the preferences of domestic interest groups.

Based on the interest centered perspective, there were two reasons for sluggish financial liberalization during the 1980s. First, the chaebols, despite the general preference for liberalization in the financial sector, were not ready to give up the privileges derived from the triangle relationship among the government, the financial sector, and the industry. In fact, the chaebols were of two minds on the issue of liberalization. On the one hand, they wanted to keep the protection and support of the government. Because the chaebols were fearful of the heavier burden of market-determined interest rates (which would probably be higher), they had reason to oppose financial liberalization (Lee et al. 2005, p.14). On the other hand, since the chaebols had begun to own their own NBFIs, they desired further

14 Regular election increased the election costs. This must be one of the reasons for the continuing connection between the government and corporations. Noble and Ravenhill. 2000, p. 100.
financial liberalization. The competing interests of the chaebols hindered the full implementation Chun Doo-hwan’s liberalization policy.

Second, the government could not relinquish its control of the financial sector, which could have been an important vehicle for industrial restructuring. There existed a conflict of interest between neo-liberals and developmental bureaucrats, which was one of the causes of the partial and delayed reform (Lew 2005). Developmental bureaucrats opposed reform for fear of losing their discretionary power, whereas neo-liberals supported reform to propel liberalization forward. The financial liberalization during the 1980s was therefore slow, slouching, and fragmented and the financial system remained tightly controlled until the early 1990s.

Why did the pace of liberalization accelerate during the 1990s? During the 1990s, the chaebols wanted much progress in interest-rate deregulation as they saw an advantage in having free NBFIs and thus freer access to credit. Short-term interest rates such as the rates on commercial paper available to NBFIs were deregulated first, in a speedy manner, while the deposit rates of commercial banks remained under government control. Also there was pressure for liberalization from foreign capitals that saw profitable opportunities in investing in Korea’s booming economy. In the 1990s, therefore, the power of the chaebols further increased whereas that of the government further decreased.

Despite the drag that this institutional realignment had on reform, the financial crisis of 1997 was a catalyst for comprehensive reform on all fronts—financial, corporate, and labor. In dealing with the crisis, the Kim Dae-jung government (1998-2003) followed a neoliberal program. Pressure from the U.S. and the IMF were conditionally used as a legitimate demand for sacrifice in all sectors of Korea. There was support among various sectors for coalesional reasons. The conservative sectors could not but support the reform package which would put Korea on the conservative and neoliberal track of economic adjustment, despite the deep mistrust of Kim Dae-jung for his progressive ideology. President Kim and the labor sector were close to each other in terms of ideology, so he was able to overcome the labor sector’s resistance to the neoliberal program. Due to a profound sense of a national crisis, Kim Dae-jung escaped criticism from various sectors for his reform policies. In addition, the state bureaucracy recognized that the financial crisis would empower it to restructure banks and corporations, and therefore supported the measures. Also, a huge inflow of foreign capital aided in implementing the reform, complementing the role of old financial institutions devastated by the crisis. The post-crisis reform led to a V-shaped recovery and was regarded as successful during the Kim Dae-jung

15 All restrictions on interest rates for NBFIs’ commercial papers and the amount they could issue were removed while restrictions on interest rates on commercial banks loans remained. Lee et al 2005, p.14.
16 Neoliberal economic reform often refers to all policies that promote marketization, privatization, and free trade under the general ambit of the Washington Consensus.
17 A poll by Gallup Korea reported a public approval rating of 70.7 percent for Kim Dae-jung’s performance in office in April 1998, an increase of 17.3 percent points from January - despite the layoff of half a million workers since January. Lee et al 2005. p. 18.
government, although it is still debatable whether the original goals were accomplished.

In sum, democratization affected the spread of ideas of liberalization in the financial sector, which eventually resulted in unregulated liberalization and the financial crisis in 1997. Democratization also led to bureaucratic restructuring, which was a signal of the demise of industrial policy and coordination. However, the state bureaucracy regained power in the middle of financial restructuring, whereas the crisis made the state weak in dealing with external actors such as the IMF.

Are there any effects of money politics on elections after democratization in Korea? The overly cozy relationship among the government, banks, and corporations had existed before democratization. This relationship began to change and became ambivalent after democratization. The chaebols became more powerful after they began to own NBFIs in the 1980s. Globalization opened a way for the chaebols to finance their business ventures by directly borrowing from abroad and to escape from government regulation. Financial reform often reflected chaebols’ interests before the crisis. However, the crisis resulted in a structural reform in the financial sector without big objections, although the severity and magnitude of the reform costs were huge. The crisis was a catalyst for change, which provided Korea with both opportunities and challenges.

IV. Democratization and Financial Reform in Taiwan

1. Financial Liberalization and Financial Reform: Slow Liberalization and Stalemated Reform

The financial system in the early period: bureaucratic banking

The financial system in Taiwan is regarded as underdeveloped, compared to other sectors in that country. As The Economist described the situation in 1995, “The island’s economy is state-of-the-art, the politics is turned from totalitarian to liberal. However, Taiwan’s banking system is still medieval” (The Economist 1995). Many state-owned banks were often used by local politicians as vote-buying machines (Sato 2002), and the banking system was in need of repair.

The arrested development of the financial system is attributable to the historical legacy of the Taiwanese state. Taiwan’s small and open economy made it vulnerable to instability and manipulation by its much larger neighbor, mainland China. Taiwan’s diplomatic isolation meant that it could not expect help from the IMF or the U.S. The ruling party (the Kuomintang, or KMT) also feared inflation and financial impropriety which had destroyed its political base during the civil war in the 1940s. This legacy of Taiwan history led to a strong policy priority for macroeconomic stability. The KMT sacrificed growth in favor of stability in the period of the oil-shocks and tried to control inflation (Noble and
Ravenhill 2000, p.102). Taiwan also placed restrictions on the overseas activities of local financial institutions. As the Asian financial crisis approached, these regulations on and supervision of financial institutions’ overseas investments made Taiwan less vulnerable to the financial crisis than was the case in Korea.

The ruling KMT was very well organized and autonomous. The KMT of the authoritarian period can be referred to as a “quasi-Leninist” party. Taiwan had virtually no national elections until the 1990s, whereas Korea has held national elections since the Korean War. Taiwan used party-owned enterprises to supervise local politicians and factions. In a sense, the KMT was stronger domestically than were the ruling parties in Korea. The features of the Taiwanese financial system could be characterized as follows: extensive government and KMT ownership of financial institutions; and heavy-handed government regulation of the banking system in terms of entry, pricing, product offerings, and financial dualism (Bruck and Sun 2007). As a result of KMT interference in the formal financial system, informal financial institutions thrived and provided significant amounts of capital to small- and medium-sized enterprises.

In order to manage its financial sector, Taiwan developed the autonomous Central Bank of Republic of China (CBC). Central regulators such as the CBC and Ministry of Finance (MOF) were widely respected and immune from political pressures. Taiwan’s central and provincial governments provided prudent oversight, and, unlike in Korea, banks were not aggressive. However, local financial institutions, especially community and agricultural credit cooperatives, had been plagued by endemic problems of inefficiency, incompetence, and politicization (Noble and Ravenhill 2000, p.96). Despite these problems, in general, the rigidities in the financial system of Taiwan provided structural support for economic development from 1956 to 1980. High interest rates and a strictly controlled banking sector served to augment national savings rates, which allowed rapid growth without foreign borrowing. But the oligopolistic nature of the banking sector contained dangerous inefficiencies. For example, the 1986 relaxation of currency convertibility restrictions and surplus export earnings during the 1980s resulted in the speculation bubble and stock market crash in early 1990. A series of financial instabilities and crises led the government to seriously consider financial liberalization and reform.

Financial liberalization and reform since the late 1980s

In the late 1980s, Taiwan faced a series of macroeconomic crises. The New Taiwan dollar had appreciated sharply, severely harming export competitiveness. The supply of labor was tightening, causing a debilitating rise in wages and rents. (The typical response was to relocate industries off the island, a trend which intensified between 1988 and 1990.) A speculative bubble developed between 1986 and 1989, fueled by high liquidity, low interest rates, and a lack of incentives to invest productively (Green 1998). The government tried to

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18 During the 1956-80 period, gross domestic capital formation averaged 28.4 percent of GNP while in the 1970s, and net savings to net national product ratios ran at average 30.5 percent. Green 1998, p.8.
respond by tightening credit, reforming the financial sector, and adhering to a tight supply-side monetary policy. However, this attempt at reform was impeded by a bureaucratic conflict between the MOF and the CBC. The MOF pushed for free-market and financial liberalization, but the central bank was committed to low-inflation and pursued a policy of deterring speculation. Also, the MOF plan for reform also was resisted by the Provincial Assembly.\footnote[19]{In 1991, the MOF unilaterally cut its stake in the banks, but the Provincial Assembly resisted reform. As the primary shareholder, the Provincial Assembly regarded the banks not only as a source of income but also a lever for patronage. Green ibid, p. 9.}

The “Big Bang” of 1991 was a result of deregulation and liberalization, which were the catchwords of the day. In 1989 the government began to liberalize the financial sector by relaxing restrictions and approving the entry of 15 private commercial banks into the market in 1991. The original plan was to issue 6 new bank licenses, but the government was forced to issue 15 due to the influence of large businesses (Green 1998). This reform increased competition among the struggling banks (Kao 2003).

During the 1990s, the Taiwanese financial system became very unstable under the weight of an increasing number of overdue loans.\footnote[20]{Overdue loans are a category of non-performing loans (NPLs). Taiwanese financial authorities define them as loans having nonpayment of interest for six months and nonpayment of principal for three months. Sato 2002, p.229.} There existed two reasons for this increasing trend of overdue loans. First, many firms tried to diversify investment to overcome a slow economy that had been the result of changes in the industrial sector in the late 1980s, but these efforts resulted in many non-performing loans (NPLs). The second, and related, reason was the inappropriate lending practices on the part of the financial institutions; loans to the real estate industry and loans for speculation in stocks were especially problematic.

Financial reform after the crisis

Despite this instability in the financial system, Taiwan was insulated from the 1997-1998 financial crisis and emerged unscathed. The CBC attributed this to the fact that Taiwan had not recklessly liberalized its financial system—as other Asian countries had—and tried to turn back the clock by going backward in the process of liberalization and reform. Most notably, the central bank and the Financial Supervisory Commission adopted a series of measures to slow down the growth of foreign-owned businesses in Taiwan (Taiwan Business Topics 2007 July, p.6).

The fact that Taiwan was able to weather the Asian crisis may indicate that the Taiwanese financial system performed comparatively well before the crisis. This success could be attributed to seemingly superior banking regulation and supervision practices. Also, the slow pace of liberalization since the late 1980s seemed to have been a good choice. However, problems in the financial sector began to emerge in the late 1990s.
Industrial relocation to China, falling domestic stock and real estate markets, and falling export demand reduced growth and led to rising unemployment and NPL ratios. However, since Taiwan suffered less than its neighbors during the financial crisis itself, the necessity of financial reform was felt less urgent. It is believed that Korea’s financial sector gained a new life since the Korean government implemented a series of drastic measures under the supervision of the IMF. The fortune which made Taiwan escape from the crisis, however, became a constraint for future reform. Soon, Taiwan would be hit by the aftershocks of the Asian financial crisis, and a wave of bankruptcies extended to the financial sector.

After the crisis, Taiwan’s financial sector began to show symptoms similar to those in Korea and Japan during the 1990s. For example, as the MOF recognized, the overall NPL ratio climbed from 3 percent in 1995 to 8.78 percent in March 2002, representing an increase in bad debt of NT$351.5 billion to $1.4 trillion. The major offenders were the grassroots credit cooperatives such as farmers’ and fishermen’s associations which had nonperforming loans at 18.5 percent in 2001. In 2001, Taiwan’s economic growth rate dropped from the previous year’s 5.0 percent to 2.18 percent, marking the slowest growth in a decade (Kao 2003). One reason for this high NPL ratio is that there were too many banks, and the cutthroat competition impaired their ability to increase profits. In 2001, Taiwan had 53 banks, more than 30 insurance companies, and more than 300 other types of financial institutions (see Table 4 and Figure 2, below). One of the principle causes of the overcrowding was the numerous regulations that prevented banks from diversifying or becoming too large.

With impetus from the market, the restructuring of the banking sector became the top priority of the government in 2000. As local companies grew in size, financial institutions followed suit. In 2001, a package of six financial laws had passed in the Legislative Yuan (LY), such as the Financial Holding Company Law (FHCL), the Finance Bills Supervisory Law, and the Resolution Trust Corporation (RTC) Statute for setting up and managing a NT$140 billion Financial Reconstruction Fund which was designed to clean up bad loans in the grassroots financial organizations. After the FHCL, banks, insurance companies, and securities companies were permitted to operate under one roof. Tax breaks also encouraged companies engaged in different financial services to consolidate. Since then, 14 financial holding companies have been established. The FHCL allowed foreign holding companies to invest in local financial institutions up to 100 percent of their own operations (Chung 2003). This seemed to contribute to positive development in sound supervision. However, Taiwan’s holding companies were still in the early stages of development and size did not guarantee competitiveness. The MOF expected that local banks could reduce their NPL ratio to below 5 percent and raise their capital-adequacy ratio to meet the minimum Bank of International Settlements’ standard of 8 percent within two years.

Most banks held less than 2-3 percent of market share and their margins were shrinking dramatically over the past few years. Pao 2001.
In 2004, Taiwan was still regarded as Asia’s most over-banked market (Table 4), with 49 domestic banks, 14 financial holding companies, and over 300 rural credit cooperatives to serve a population of just 23 million. As banks’ average return on equity went down to around 8 percent, the lowest rate in Asia, bank reform began to gain momentum. One of the goals was to create a handful of large financial groups that could compete regionally and globally by changing regulations that made hostile takeovers and mergers difficult. In 2004, President Chen Shui-bian launched a second round of financial reform. He sought to speed reform by outlining an ambitious agenda to cut the number of state banks by half to six by the end of 2004 and eventually to create three institutions with market shares of at least 10 percent, and to reduce the number of financial holding companies to seven by the end of 2006.  

Table 4 Number of Financial Institutions in Taiwan  
(unit: number)

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<tr>
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<td>Local Branches of Foreign Banks</td>
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<td>36</td>
<td>32</td>
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<td>Credit Cooperatives</td>
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<td>287</td>
<td>253</td>
<td>261</td>
</tr>
<tr>
<td>Fisherman’s Association</td>
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<td>25</td>
<td>25</td>
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<tr>
<td>Trust and Investment Companies</td>
<td>6</td>
<td>4</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Bills Finance Companies</td>
<td>3</td>
<td>16</td>
<td>14</td>
<td>12</td>
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<tr>
<td>Postal Savings System</td>
<td>1</td>
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<td>1</td>
</tr>
</tbody>
</table>

Source: Financial Statistics Monthly, Central Bank of Republic of China (Taiwan)

Figure 2 Number of Bank Branches per 10,000 people (2003)

The top five lenders account for 35 percent of the market, versus 60-80 percent in most developed countries. The Economist 2005.

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CNAPS Visiting Fellow Working Paper
This initiative failed, for several reasons. First, the government tried to insist on controlling every aspect of consolidation rather than allow the market to decide the number and timing of deals. The government set numerical targets for bank mergers, which led inevitably to bad mergers. The government also banned new branch openings and demanded the closing of financial holding companies even though most were healthy. Second, the government was weak and failed to persuade the public, the bank unions, and the legislature of the need for reform. Due to union pressures and huge protests, the government halted the takeover of the ailing state-owned Taiwan Business Bank. Also, the government overpriced its shares for fear of accusations of selling state assets too cheaply, but the resulting high prices deterred foreigners from buying Taiwanese banks (The Economist 2005).

In the second half of 2005, Taiwan experienced an unsecure lending crisis (resulting from overuse of personal credit and debit cards by consumers), called a “twin card” crisis. Bank losses from the twin card debt crisis reached almost $3 billion in 2006, with hundreds of thousands of Taiwanese people unable to pay off their debts. It was much easier for banks to engage in consumer financing was much easier than corporate financing: the loans were smaller, the risk was lower, and the interest rate was higher, which made it easier to reap profits in the short term. As a result, the scale of the credit card and cash card business grew by a factor of four in six years. The FSC worked with the Bankers

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*In a highly fragmented market (around 50 banks issue credit cards and 25 issue cash cards), the only way for banks to operate on economies of scale was to issue as many cards as possible. As a result, card debt became highest in Q3 2005 and cardholders began defaulting on their debts. www.lafferty.com.*
Association to create a system for the banks to negotiate with problematic card holders on a repayment schedule. Some legislators and financial specialists suggested that Taiwan should establish a mechanism for personal bankruptcy (Taiwan Business Topics 2006 July, p.50).

Even in 2007, Taiwan was still over-banked, with 39 domestic banks and 14 locally registered foreign lenders. The number of domestic banks decreased from the peak of 53 in 2001, but is still far more per capita than in most major economies. Korea, with just over twice Taiwan’s population, has brought down the number of banks to 18 since the 1997-1998 crisis, and there are but a handful of banks in Canada, Australia, and Singapore. More important than the number of domestic banks is the lack of differentiation among these banks. Most banks go after the same hot market segment, from corporate loans to credit cards and cash cards to wealth management to residential mortgage lending. This trend-following indicates a risk of speculative fervor and the development of a bubble, which created the credit card crisis. The plan of creating a small number of powerful, privately-run lenders has not been successful yet, as most domestic banks are unlikely to sell to larger domestic or foreign rivals.\(^{24}\) Mergers between larger private banks or acquisitions of state-run lenders by private banks remain impracticable for political reasons. Many private banks are affiliated with either the Democratic Progressive Party (DPP) or the KMT. Mergers between banks with different political affiliations sometimes occurs, but it does not stop political infighting. Also, the continued recalcitrance of unions, fearful of job losses, has been one of the biggest obstacles to establishing innovative private banks to take over state-run banks in Taiwan.

2. Political Economy of the Reform Process

Democratization

The success of the East Asian newly industrialized countries (NICs) could be attributed to politically insulated, powerful bureaucracies that steer industrial policy and developmental strategy. The KMT insulated the mechanism for bureaucratic planning and budgeting for economic development from legislative politics. However, democratization weakened the KMT’s dominance in the Legislative Yuan (LY) and eroded the autonomy of the bureaucracy managing the economy. First, democratization increased the LY’s power of oversight of the bureaucracy. In the post-Asian crisis period, the DPP, the New Party, and the KMT emerged as the three major legislative forces, which determined legislative outcomes. For example, the New Party cast a decisive swing vote on the passage of a sweeping Financial Disclosure Law, which reflected the importance of coalitional politics in the LY (Tan 2000).

Second, like in Korea, democratization increased the pressure of interest groups on

\(^{24}\) Leahy (2007) makes the argument that family owners are reluctant to sell as they want to own their bank and see their name on the building.
the bureaucracy. Regular elections increased the necessity of financing elections by the politicians, which resulted in the development of extensive electoral networks between politicians and business groups or special interest groups. With Taiwan’s prosperity and its transition to democracy, the new problem of money politics emerged. As a new party without an endowment, the DPP initiated an aggressive campaign to raise money for elections. Sometimes this was done by illegal means. For example, in one local election, 100 candidates were charged with illegal vote-buying (Pye 1997, 223). Money politics seemed to be rampant at the national level as well. As in all democratic politics, competitive elections require money and votes to succeed. Democratization weakened the KMT’s control of the electoral process and changed the nature of the traditional patron-client relationship in Taiwan politics. With increasing wealth and autonomy, local politicians, factional leaders, and powerful clans emerged as political brokers from whom the political parties asked for financial support and votes. Former clients became “equal partners” in interactions with their former patrons. Since the 1991 National Assembly election, the influence of factions and money politics worsened. A dysfunctional bureaucracy had been captured by business, crippled by electoral competition and corruption, and became inefficient in planning. In this case, politicians reigned, but business ruled (Green 1998, p.4).

Democratization also increased the voice of various societal groups, further reducing the autonomy of the bureaucracy. The ability to steer economic development has been challenged by increasing grassroots participation in the political process. A six-year plan to develop an economy sustainable for long-term growth also failed to get public support and the endorsement of elected local legislators. Many lawmakers and public activists criticized the plan for its lack of transparency, low cost-effectiveness, and poor implementation. Facing strong public opposition and inadequacy of planning, the Council for Economic Planning and Development (CEPD) had to scale back its original six-year plan in 1993 (Tan 2000).

The short-term effect of democratization on financial reform was negative in that lack of consensus among parties in the LY, divided government, and money politics foiled several reform efforts in the financial sector. However, the LY has taken steps to reform itself, changing the electoral system from large multiseat-districts to single member districts and downsizing itself through the January 2008 election. (Taiwan Business Topics 2006, Feb). The most important foundation for successful economic reform may be the political reform, and reform in LY should be an important development for further financial reform in Taiwan. The long-term effect of democratization in Taiwan, however, remains to be seen and its effect on the reform process should be reexamined in the future.

Coalitional factors

25 For example, legislator Oung Da-ming, a business tycoon, was charged in Oct. 1994 with stock market manipulation. It was widely reported that other legislators either had received political contributions from Oung or had entrusted money to him in stock transactions. Kau 1996, pp.300-303.
Democratization increased the opportunities for diverse societal groups to support or oppose certain reform policies. Despite the general consensus on the need for reform, not everyone is ready to swallow the bitter medicine. In November 2002, farmers and fisherman, worried about the possibility of cutting off their primary sources of credit, protested against the MOF’s plan to reform their local credit unions, especially the introduction of oversight mechanisms to reduce high NPL ratios. An agricultural finance bill was postponed due to domestic protest (Kao 2003), and the government suspended its measures and vowed to devise a more feasible approach.

One of Taiwan’s most serious obstacles to financial reform is the entrenched position of the state-owned banks, which account for about half of the market share in terms of assets (Figure 3, below). The long monopoly by inefficient state-owned banks has had a negative effect on the economy. One of the reforms proposed in the financial sector was to privatize the state-owned banks. However, the reform was not easy, partly because of domestic opposition from labor unions. The labor unions have fought to resist privatization and their efforts successfully blocked an attempted divestiture of the Taiwan Business Bank, as noted above (Taiwan Business Topics 2007, April 22). Other factors also discouraged the process of privatization including public discomfort over the growing concentration of wealth in the hands of a few business group, and the intense and unending conflict between the pan-green and the pan-blue camps. The issue of privatization has become so sensitive that each side criticizes and accuses the other of political favoritism; it is therefore especially costly for politicians to push privatization during the election campaigns. As a result, the government has backed off from the original plans of reducing the numbers of financial groups and state-owned banks. Instead the FSC has shifted emphasis to the improvement of corporate governance in various industries.

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26 The government imposed a three-tier risk-control measure to prohibit credit unions with an NPL ratio 10 percent from accepting deposits from non-members. It also banned lenders with NPL ratios of between 15 percent and 25 percent from granting loans of more than NT $3 million to sponsoring members who are not farmers or fishermen. Also, the government instructed 10 state-run banks to take over 36 debt-ridden associations between August and October in 2001. Her. 2003.

But democratization not only increases the voice of the opponents of reform, it also gives voice to supporters. The variables of democratization and coalitional politics are somewhat necessarily related. However, these two variables are different in terms of explaining the final policy outcome. Democratization cannot predict specific outcomes of reform policies. Inclusion of an interest-centered variable into this analysis will improve our complete understanding of the specific policy outcome. The case of the 2001 Financial Holding Company Law (FHCL) could explain this aspect well. According to Bruck and Sun (2007), the FHCL was passed despite a deadlock between the DPP executive and the pan-blue dominated LY. There existed voices from civil society and mass media arguing that the interests of the Taiwanese people would not be served if the FHCL was not passed. The pan-blue legislators feared that their opposition to the DPP government’s initiative might negatively affect their electoral prospects. Eventually, therefore, legislators in the LY, whether they belonged to DPP, KMT, People First Party, or New Party, came to view the

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28 Initially, it seemed that the pan-blue camp would exploit its leverage and deny the DPP passage of the FHCK. However, they were worried about their long-term reputation on future elections. Bruck and Sun 2007.
FHCL positively and thought that it would aid troubled local banks. Taiwan’s executive and financial bureaucrats also favored the FHCL, which they believed promised better banking and economic transparency and would upgrade regulatory capabilities. Finally, private business groups were strongly in favor of banking deregulation, and consumers could benefit by decreasing transaction costs. The case of the FHCL, therefore, illustrates how the interest-centered analysis helps us to understand why democratization can have a beneficial effect on the politics of financial reform. The divided government and a lack of consensus among political parties could be overcome by the role of civil society, media, and rational politicians. The increasing potential for involvement of interest groups in policy-making process can be labeled as “benign capture” of the state (Bruck and Sun 2007, 678).

Although partial financial reform has been achieved, progress in this area in Taiwan is regarded as slow and stalemated, compared to the reform process in other countries such as Korea.

V. Conclusion: Summary and Implications

This study analyzes the impact of democracy on financial reform in Korea and Taiwan. It is often argued that democratic systems are at a disadvantage in achieving economic reform, and the contrasting experiences of China and Russia are often cited as proof that economic reform requires an involved and autocratic regime. But experience indicates that economic reform is not easy under either an authoritarian or a democratic regime. Indeed, reform processes are affected by many variables such as the role of technocrats, institutional legacies, and coalitional politics, as well as democratization. Some argue that East Asian developmental states succeeded in economic reform under the authoritarian regimes, but this is inaccurate. In fact, Korea and Taiwan began the process of economic reform after democratization and, in particular, after the financial crisis in 1997.

Korea and Taiwan have shared many common characteristics such as the experience of economic growth under an authoritarian regime and democratic transition after economic development. Despite their similarities, we find that their responses to globalization and the 1997-1998 financial crisis are saliently different and that they have taken different paths of reform, which resulted in different outcomes in their financial reform efforts.

The pattern of financial liberalization and reform can be categorized as “fast liberalization, delayed reform, and forced reform” in Korea. The political power of the chaebols in Korea was strengthened immediately following democratization because political parties needed financial support due to the increased costs of elections. In contrast, democratization decreased the autonomy and efficiency of the bureaucracy because the legitimacy of centralized coordination was weakened. The beginning of financial
liberalization in the 1980s reflected the influence of the chaebols. Entry barriers for nonbank financial institutions (NBFIs) were lowered in the 1980s and the chaebols became more influential in the financial sector by controlling their own NBFIs. However, the chaebols showed ambivalence towards financial liberalization and reform. The chaebols wanted financial liberalization in order to create easy access to credit through their NBFIs and to reduce dependence on the government. While calling for fast deregulation, the chaebols at the same time wanted to retain the protection and support from the government that benefitted them. Democratization gave business more leverage over the state by extending the web of money politics to opposition politicians. During the 1990s, cronyism became rampant. Democratization did not end money politics and the cozy relationship between politicians and businesses, making reform of the financial sector more difficult. The negative aspects of democratization on the reform process during the 1980s and 1990s precipitated the financial crisis in 1997.

After the crisis, Korea committed to a program of macroeconomic adjustment and structural reform. Within one year, 7 of the 26 commercial banks and 16 of the 30 merchant banks were either closed or merged. The crisis was a catalyst for change. The crisis empowered the bureaucracy to restructure banks and corporations. The Kim Dae-jung government steered away from the previous government’s pro-chaebol policy to accelerate economic reform. Conditions for drastic reform were favorable: the urgency of the reform, weakening veto power of both businesses and labor unions, change of political leadership, the people’s willingness to share the burden of the crisis, strong IMF pressure for reform, public association of the chaebols with the crisis, and a strengthened bureaucracy. A coalition of many sectors of state and society pushed the reform. The Korean case is a successful case of “path-breaking” reform (nature of discontinuity and big-bang change).

The nature and pattern of financial liberalization and reform in Taiwan, on the other hand, is characterized as “slow and gradual liberalization and stalemated reform.” Taiwan’s history and national identity provided the country with structural constraints which emphasized macroeconomic stability and led to conservative policies in financial institutions. Structural constraints allowed the Taiwanese authorities continue to closely regulate the financial system until the late 1980s, when democratization and economic development, as well as globalization, provided pressure for financial liberalization and reform in Taiwan. Slow liberalization began in the late 1980s and the Taiwanese banking system seemed to work well during the 1990s as Taiwan emerged unscathed from the Asian financial crisis in 1997.

However, this success, although it can be traced in part back to the seemingly rigid banking regulations, became an obstacle for financial reform. There was no sense of urgency, as there was in Korea. Furthermore, democratization increased the effect of money politics, increased the voices of domestic interest groups such as labor unions and local groups, and weakened bureaucratic autonomy and governance. These developments foiled attempts at reform in the public banking sector. The effect of democratization, in the short term, has been negative due to divided government, an unstable political party system,
and lack of consensus among parties in the Legislative Yuan. However, in the long run, as Taiwan’s democracy matures, democratization will have a positive effect on reforming the financial sector.
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