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International Economics

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POLITICS AND FINANCE IN TAIWAN

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PAG 208/1-D

28 June 1984

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POLITICS AND FINANCE IN TAIWAN

Taiwan presents two faces to the world: a stolid, bureaucratic, mainlander, Kuomintang, official face, and an entrepreneurial, dynamic, fragmented, Taiwanese, private sector face. The mainlanders mainly run the government, and they run it in their bureaucratic, conservative fashion. The Taiwanese run the economy, and they run it in their family-oriented, entrepreneurial fashion. Despite all the intermingling of Taiwanese and mainlanders that has occurred, every aspect of Taiwan presents both of these faces.

This is also true of the financial sector. When analyzing sovereign risk, one is dealing with the government sector and therefore with stolid, capable, experienced bureaucrats who manage the country's finances as if they were managing the world's most conservative bank. Unlike virtually every other country in the non-Communist world, Taiwan's foreign assets exceed its foreign liabilities. The government personalities one deals with change little from the personalities of a decade ago, and then mainly because a few people have died in the meantime. Policies change only at a glacial rate. Institutions are solid but not very dynamic.

When one looks at the market and at the credit risk of individual firms, one is dealing with the other face. The market is extraordinarily fragmented, especially as compared with Japan and Korea. The market grows like a yeast but any particular component of it may thrive for a few years and disappear. The domestic market is ruthless, fractured, risky, and pre-modern in its organization and finances.

The result of this Janus quality of Taiwan is that sovereign risk presents virtually no constraints on the expansion of business, but the fragmentation of the market and its pre-modern financial and organizational patterns severely constrain the range of strategies with which a foreign bank can be successful.

The Government

Leadership

Taiwan's leadership is extraordinarily experienced and capable. The government is run by elderly mainlanders, and the economy for the most part by Japanese-era Taiwanese. It is not uncommon for a cabinet minister to have held half a dozen cabinet-level posts. The senior leaders know each other and know each other's jobs. Every cabinet ministry is run with a banker's caution, taking only one small step at a time and thoroughly assessing the results before taking another step. But the government also has the wisdom to allow the domestic economy sufficient freedom to generate dynamic economic growth.

The new cabinet installed in the spring of 1984 possesses all the advantages and disadvantages of such a pattern. For the most part the ministers are elderly and extraordinarily experienced. Prime Minister Yu Kuo-Hwa is 71 years old and has held a large proportion of the senior positions his government has to offer. The cabinet, always highly competent

in economic management, displays even greater emphasis on economics and less on politics than in the past. Appropriately, the new cabinet once again adds another Taiwanese to the leadership--continuing a pattern of doing what is necessary, but doing it very slowly so as not to rock the boat. The price paid for this competence and continuity is a substantial loss of opportunities and a considerable impatience on the part of Taiwanese businessmen and younger mainlanders.

Taiwan faces a major leadership succession in the very near future. The president and the prime minister are both extremely elderly men, and so are most members of the cabinet. The Legislative Yuan is dominated by elderly representatives of provinces on the mainland. The generation of potential leaders in their mid-forties through fifties is strikingly absent; the next generation of dynamic leaders is in the thirties and early forties and is strikingly different in its attitude toward change, in its view of Kuomintang ideology, in education, and in experience of the world outside Taiwan. The transition will also be the end of a dynasty. Chiang Kai-shek and his son have governed Taiwan ever since the Kuomintang defeat on the mainland in 1949. The transition of the top leadership will not only be from inside the family to outside the family, but also to some extent from mainlanders to Taiwanese. The vice president now is a Taiwanese, and, in contrast with the previous transition, the prime minister is in no position to overwhelm the succession.

Despite this, Taiwan has a tremendous reservoir of able leaders. The next generation's greater experience with the West, greater experience of contact between Taiwanese and mainlanders, greater familiarity with modern technology, and generally more liberal and democratic outlook is likely to be an advantage.

Ultimately the real succession of power will be decided within the Kuomintang Party. This is a crucial difference from South Korea, where the political parties are impotent, the formal rules governing succession have been ignored, and the real determinant of succession is a struggle within the military. South Korea has been run by personalities, but Taiwan has been run by institutions. This facilitates what will likely be an orderly succession to a more collective form of leadership, followed by the subsequent emergence of some dominant individual.

In short, the leadership is competent and the succession, although massive, presents no untoward risks.

Institutions

As suggested by the above, Taiwan's institutions are solid. Its political institutions are better established than those of South Korea and of most Third World countries. Its ministries are capable, coordinated, and staffed to great depth by experienced and well-trained individuals. To an extent that is not true in South Korea, they are overstaffed and have a penchant for red tape, but in comparison with the Third World norm they are extraordinarily able.

The private sector also possesses great institutional strength. Taiwan's ruthless domestic competition has created an economy of firms that are lean, fast on their feet, and competitive. As will be discussed in greater detail below, Taiwan's firms are smaller and more specialized than the giant conglomerates of Japan and South Korea. In a world economic downturn, this serves them well, because each firm is managed by people who understand every detail of their business and hence are able to make quick adjustments. When the world economy is booming, they lack South Korea's economies of scale, but this has never prevented the economy from growing 10 percent per year when world conditions were appropriate.

The real bases of political power in Taiwan are the Kuomintang Party apparatus, the Kuomintang Party secretariat, and the security forces (which consist of the police, the Taiwan Garrison Command, and the Investigation Bureau under the coordination of the National Security Council). Although the security apparatus has great influence, Taiwan has consistently been run by civilians. The risk of a slippage into military or quasi-military rule has been reduced by the purge in 1983 of Wang Sheng, an able general who occupied a position in the Taiwanese military similar to that which Chun Doo Hwan occupied in South Korea's military. Wang Sheng is now ambassador to Paraguay. Similarly, the Kuomintang has ensured that the most government ministers are pure technocrats who lack their own political bases. They are planners and managers who serve at the pleasure of the Kuomintang. This means that real power, including power over the transition, remains with the political party.

The Social Base and Taiwanization

Taiwan's greatest strength and greatest weakness has been the division between the mainlanders and the Taiwanese. The roughly three million people who came over from the mainland were socialist-minded bureaucrats and political leaders devoted to the idea of reunifying and governing all of China. In contrast, the vast majority of the population (which now totals 18 million) were predominantly spirited capitalist entrepreneurs. For a generation, there was a clear division of labor between the ideological, socialist, bureaucratic mainlanders who maintained order, created governing institutions, built an infrastructure, instituted a land reform, and smoothed the income distribution, and the vigorous, ideologically apathetic, anti-bureaucratic, Taiwanese peasants, workers, and industrialists who generated extraordinary growth rates. The combination of a socialist income distribution and capitalist growth rate was Taiwan's magic formula.

At the same time, the Taiwanese resented Kuomintang ideology, resented being ruled by outsiders, and generally believed that the economy could grow much faster if they could just get rid of the "outside" interference. In the early days of Kuomintang rule, before the formula of growth and equity became firmly established, there was a Taiwanese revolt in which some 10,000 people were killed. The mainlanders imposed a rigid police state controlled by the Kuomintang (a Bolshevik-style socialist party organized under the guidance of the Russian communist Bukharin). That kind of control has become gradually less necessary as prosperity and equity became widely recognized.

Within the last five years there have nonetheless been outbreaks of tension. Shortly after the United States derecognized Taiwan, massive riots broke out in the southern industrial city of Kaohsiung. The Kuomintang, which had communicated to the population that it had U.S. government support, suffered a tremendous loss of credibility when derecognition occurred, and pent up pro-Taiwanese and pro-human rights frustrations broke out into the open. The Kuomintang allowed the riots to occur then used them as an excuse to round up virtually the entire opposition leadership. The Kuomintang's point was established, and the economic dynamism continued, so the problem has not recurred. In 1981, there was a further period of tension when a U.S.-based dissident professor, Chen Wan-chen, died under circumstances which led opposition elements to blame the government. The government continues to permit only one serious political party, to harass individual oppositionists, to suppress magazines and newspapers which get too far out of line, and in general to run a fairly tight political ship.

At the same time, in historical perspective, there has been extraordinary liberalization decade by decade. In recent years, the balance has swung sharply in the direction of liberalization. The December 1983 elections to the Legislative Yuan were extremely free, and the strong Kuomintang victory in those elections strengthened moderate members of the Kuomintang Party who argued that Kuomintang hegemony could survive liberalization. As noted earlier, the principal security-oriented conservative political force, General Wang Sheng, was exiled to Paraguay. A noted advocate of liberalization became the new Minister of Education in June 1984, and a reorganization of the Kuomintang in the Spring of 1984 promoted moderate figures. This liberalization has eased tension and enhanced stability.

Along with the economic successes, another trend which has made liberalization possible is Taiwanization. 20 percent of Taiwan's marriages are intermarriages. 55 percent of the people have an intermarriage in the family. The post-1949 generation of Taiwanese and mainlanders has grown up working with one another. The new generation of Taiwanese has money, high status, and education. As a consequence, whereas previously one heard only mainland dialects spoken at important gatherings, now people speak Taiwanese on all occasions.

The government under Chang Ching-kuo has moved slowly but quite steadily to integrate Taiwanese into the government. The Vice President, Minister of Education, and the Minister of Justice, among other crucial roles, are filled by Taiwanese. The government is even moving to cope with its constitutional crisis: for a generation the Legislative Yuan has been dominated by elderly ex-mainlanders who allegedly represented mainland provinces. The government has now announced that, as these elderly mainlanders die off, they will not be replaced in the Legislative Yuan. Hence, Taiwan's legislature will come to be dominated by people from Taiwan itself. Due to the economic successes and of this gradual but steady admission of Taiwanese into the governing elite, tension between mainlanders and Taiwanese has remained quite manageable despite intense Taiwanese impatience with the mainlanders' ideology and red tape.

An ironic consequence of this political success has been the emergence of a significant group of discontented mainlanders for the first time. The first generation of mainlanders became political leaders, bureaucrats, and soldiers.

When the soldiers retired, they received sinecures in government-supported construction companies and the like. The bureaucrats and politicians solved their problems by simply not retiring. . The second generation of mainlanders, however, finds that the government is already overstuffed and that, in a society where entrepreneurship and business success are increasingly dominant values, they have no capital, no economic skills, and the wrong values for success. There are, therefore, suffering a vast relative decline in status. For the time being, however, their discontent is confined to relatively small groups and is poorly organized, so their complaints can be viewed as an acceptable side-effect of the regimes political economic success.

In sum, the government faces opposition of four kinds. First, much of the population resents a government that was imposed from the outside. Second, idealistic democrats, especially intellectuals and editors, resent the lack of freedom and human rights. Third, there are local factions which oppose the factions with which the Kuomintang has allied itself. Fourth, there is the new generation of alienated ex-mainlanders. But the government has a steady affirmative action program and has made Taiwan a land of opportunity, so opposition is manageable.

Politics and the Structure of the Market

Financial Management

The Kuomintang's conservative approach to financial manangement has been mentioned above, but it should be underlined. In 1948, China suffered one of the worst inflations in modern history. The results were so damaging economically, politically, and socially, that the resulting scars can only be compared with events like the Jewish experience of the holocaust. China's memories of the horrors of hyperinflation are much more vivid than Germans' memories of their inflation in the Weimar years. This is reflected in the PRC's hyperconservative financial management, in the vigor of the Hong Kong taxi drivers' strike when their costs were raised earlier this year, and also in Taiwan's hyperconservative financial management. Taiwan's foreign exchange reserves exceed its debts. Its current account surpluses are substantial. Although it has not been completely immune to inflation, in the last generation its inflation has been far less than that of Western countries. The government for many years had a fetish of balancing its budget.

These are bankers' virtues. At the same time, however, these virtues can become economic vices. Reserves are now so large that they threaten to cause inflation. The government has been very cautious about changing over from direct government control of the nation's finances to market mechanisms. As a result, the entire financial system is primitive compared with the sophisticated technology and management of the real economy.

The Fragmented Market

In sharp contrast with South Korea and Japan, where a few giant firms dominate the domestic economy and even more strongly dominate the nation's exports, Taiwan's economy is fragmented into a multitude of family firms.

Taiwan has more than 500,000 registered export-import firms, of which the largest has a turnover of less than \$200 million. The reasons for this are political and cultural. First, Chinese culture places such a central emphasis on the family that the growth of impersonal firms on the model of Sumitomo and Hyundai has been inhibited. Second, the mainland government has deliberately discouraged the rise of huge firms, because, in line with the island's division of labor, such firms would inevitably be run by Taiwanese and would inevitably acquire great political leverage. In the past this could potentially have threatened the stability of Kuomintang rule. Third, the Kuomintang socialist ideology finds monopolistic huge concentrations of market power unacceptable. Socialist principles seem to most of Taiwan's senior government figures to require not only that income but also that ownership and control be widely distributed. Thus there has been active discouragement of the rise of huge conglomerates, and there has been a lack of the special government accorded privileges (subsidized interest rates, special access to imports, and effective government guarantee of all honestly acquired foreign financial obligations) by which South Korea has encourage the rise of giant conglomerates.

The resulting fragmented structure has numerous important consequences. Taiwan's firms are smaller and more specialized, and therefore can frequently adapt more quickly to adverse conditions than South Korea's. They lack economies of scale, so they cannot compete with South Korea's for huge contracts in the Middle East. Because they are specialized, they grow quickly and many go out of business quickly. Their management tends to be extremely informal. Their accounting practices tend to be even more informal: all carry one set of books to the government (showing that they have almost no assets) and another set of books for the banks (showing that they have enormous assets), but few have the ability to analyze their true assets, liabilities, and cost structure in a sophisticated manner.

This structure has very important implications for Bankers Trust: Even in one of the world's most dynamic economies, with some of the highest technology in the Third World and a financial management philosophy so conservative that it almost eliminates sovereign risk, the markets are so fragmented and the accounting systems so primitive as to make credit analysis a formidable difficulty and to make a philosophy of origination- and-distribution extraordinarily difficult to implement.

Security and Red Tape

Security concerns lead Taiwan to impose a high degree of regulation on certain kinds of international economic and financial activity. Faced with the determination of the PRC to incorporate Taiwan into a Communist-run China, the military greatly fears any kind of communications link which could facilitate large-scale flows of information between Taiwan and mainland Chinese cities. Similarly, the military does not want to allow free flows of capital, and some government economic managers fear that, in a security crisis, capital flight could endanger economic stability; hence the government controls communications and capital flows. The government maintains a monopoly on the installation of important communications equipment, usually will not permit use of the most modern equipment, completely prohibits

equipment which could for instance simultaneously send simultaneous voice and data flows, and insists that firms with large-scale international communication capabilities pay for security personnel to monitor their transmissions.

Superimposed on these security concerns are the legacies of the old socialist bureaucracy. In other words, on top of its legitimate problems, Taiwan also has a plain Third World red tape problem.

The Next Phase

The government recognizes that the primary barriers to its long-run economic development hopes are the institutional obstacles created by the above structural features. The government seeks to encourage a leap into high-tech industry, and has taken many impressive measures to encourage that leap, but the domestic market for the high-tech industry is constrained by immature financial institutions, security regulations, and unnecessary red tape. The government would like to obtain economies of scale in marketing and production, and has created incentives for larger-scale firms but for political reasons each of the measures is controversial and tends to get watered down. The government seeks to create modern domestic financial markets, but bureaucrats resist loss of control, protected firms resist exposure to additional competition, and thus progress is slow. The government would like to introduce sound accounting principles, especially because this would facilitate its ability to collect taxes. The government would like to capture some of the firms fleeing from Hong Kong, but those firms fear the Kuomintang's ideology, the government's regulation, and the prospect of facing a PRC threat again in a few years.

In all these areas, progress is steady. But, like the movement of the Taiwanese into high government positions, progress occurs by slow, almost invisible steps. There is an emerging struggle between the security forces on one hand and the economic planners on the other, and the economic planners are winning, but very slowly. According to the key economic planners, the major barriers to future growth are institutional: red tape, inadequate education, an obsolete legal code, and restrictions on communications and capital flows. Progress on all these fronts will be dramatic over the coming decade, but the deliberate speed of reform will be terribly frustrating over any one or two year period.

International Risks

Beijing is determined to incorporate Taiwan, and will turn its attention to Taiwan as soon as the Hong Kong issue is settled.

Long before Beijing suggested that Hong Kong become a special autonomous region, it offered Taiwan a similar arrangement. Under the Chinese offer, Taiwan would become an autonomous region of China, retaining its current economic system and government, but would initiate intercourse with the mainland and would have its top officials appointed simultaneously to senior

positions in Beijing.

The Kuomintang's first fear of such a deal is that it would be reinterpreted if the balance of power changed. Tibet was promised political, cultural, and economic autonomy under central leadership. As soon as Beijing's powers rose in comparison to Lhasa's, Beijing put the emphasis on "under central leadership" and eliminated all vestiges of real autonomy. Taiwan's situation is, however, different because of its economic success and high technology and its separation from the PRC by many miles of water. Taiwan could well calculate that the balance of power would be unlikely to change against it.

Nonetheless, Taiwan refuses even to discuss Beijing's proposals. The reason is domestic. Conversations between the Kuomintang and the Chinese Communist Party would terrify the indigenous Taiwanese. The Taiwanese simply want to be left alone to earn money. They fear the Kuomintang's obsession with Chinese unity and believe that the Kuomintang is capable of selling out Taiwan's economy in the interest of overall Chinese unity. Hence, serious negotiations between the parties in Beijing and Taipei would be likely to spark a bloody Taiwanese uprising.

In the face of this recalcitrance in Taipei, Beijing has limited levers. Any PRC attack on Taiwan would risk total destruction of the economic development plans upon which the current leadership in Beijing has staked its reputation in history. Currently, the areas of China opposite Taiwan are almost demilitarized; Taiwan faces only MIGs of 1950s vintages. Transfer of enough forces to Fukien to threaten Taiwan would denude the PRC military vis a vis the Soviet Union. The expense of war would by itself destroy economic development hopes for a considerable period. In addition, most PRC trade zones, the key to the future of Deng Xiaoping's development plans, are inside what would become the war zone. Threatening Taiwan would also threaten China's increasingly healthy economic ties with the United States and other Western countries.

Taiwan has some vulnerabilities. Its diplomatic role has been declining. It is totally dependent upon trade, which in 1983 amounted to \$45 billion as compared with a GNP of \$52 billion. President Reagan promised to not to increase the quality or quantity of arms sales to Taiwan so long as the Taiwan Straits remain peaceful, and this makes Taiwan vulnerable to a PRC change of attitude after a long period of inability to modernize adequately. Washington remains somewhat susceptible to the threats and siren songs of Beijing. Taiwan's own people are a bit skittish, as indicated by the fact that an overwhelming proportion of Kuomintang members of the Legislative Yuan hold U.S. green cards; most of them systematically invest in U.S. real estate and have children who, as U.S. citizens, can serve as conduits to move funds abroad.

Nonetheless, on balance, the cost to China's economic prospects of threatening Taiwan's trade are probably large enough to deter such threats. So long as Gary Hart does not become President, there is sufficient consensus in Washington on support of Taiwan's economic and political autonomy that no fatal concessions are likely to be made. And today there is little sign of the kinds of fear and capital flight that are plaguing Hong Kong. Hence, until conditions on the mainland change substantially, international threats to Taiwan's safety and creditworthiness are manageable.

Summary

Thus, Taiwan's politics create a context within which extraordinary economic growth leads to a rapidly expanding financial market. Taiwan's politics also lead to economic and financial policies which minimize financial risk. But Taiwan's politics also lead to a fragmentation of the marketplace and to a slow pace of modernization for Taiwan's financial institutions, and these create formidable obstacles for implementation of Bankers Trust's corporate strategy.