

**Banking Transformations in Taiwan:
Perspectives from New Institutional Economics (NIE)**

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1. Introduction

During the last decade, Taiwan has transitioned from a planned economy to market economy and experienced a rapid political transition. As one of the competitive transitional economies, Taiwan has been ranked no.1 regarding its growth competitiveness in Asia and top five among the 102 economics in the world during the year 2001 to 2004¹. However, the development of financial system in Taiwan has been lagged behind despite the nation's great potential competitiveness. In order to enhance the international competitiveness of the financial industry, Taiwan's government has implemented financial reform in 2000. Nevertheless, the soundness of Taiwan's banking system is showing no sign of improvement and the system has remained fragmented.

Using the concept of New Institutional Economics (NIE), this paper centralised on the idea that the dynamics of institutional linkage between the state and society during the development processes would influence the institutional structure of an industrial system, and that the degree of comprehension of the financial system and its related regulations will alter the level of transaction costs, which further affects Taiwan's financial development and the performance of its financial reform.

¹ The Global Competitiveness Report conducted by World Economic Forum (WEF) publishes annually since 1989. It provides ranking and assessment of the comparative strengths and weaknesses of over 100 national economies. Taiwan was ranked 10th regarding its growth competitiveness in 2000 and 7th, 3rd, 5th, 4th between 2001 to 2004.

2. Background of Financial Industry in Taiwan

2.1 Historic Background

Taiwan, an island that was colonised by the Netherlands between 1624-1662 and Japan between 1895-1943 was returned to the governance of Republic of China (ROC) namely Kuomintang (the nationalist party, thereafter KMT) which was lead by Chiang Kai-Shek in 1945.

Since then, Taiwan remains under the one-party governance KMT and the economy has developed uninterruptedly, from the policy of "using agriculture to support industry" to the record of exports, the liberalization and internationalization of the 1980s, and the burgeoning IT industry of the 1990s.

In 2000, Chen Shui-Bian of Democratic Progressive Party (thereafter DPP) was elected president, ending 50 years of KMT rule. The role of the government has been significant for Taiwan's economic and financial development. However, Taiwan is now an emerging market economy in transformation from a planned economy towards a capitalist market based system and the government will need to readjust its role in the new operating environment.

2.2 Evolution of Financial Industry

1960-1980: Deregulation of Interest rates and foreign exchange rates

Back in the 1960s, the Taiwanese government had adopted repression policies to control interest rate and direct credit programs by

allocating funds to specific industries and economic activities which creates the comparative advantage for Taiwan. During this time, the Taiwanese authorities had frequently intervened into financial system either formally or informally. This system in the early years has a positive effect in improving the efficiency of financial systems and increasing economic growth by correcting market failure. In the 1980s, the process of financial market modernisation in terms of liberalisation and internationalisation has been undertaken. By 1989, the pass of New Banking Law ended the history of interest rate control and fixed foreign exchange rate system in Taiwan.

1990s: From a public banking system to a private banking system

Before the 1990s, all banks in Taiwan were either owned or partially owned by the government. In the provincial government, three large commercial banks played a significant role in promoting industrial development, and many local financial institutions had assisted the farmers' and the small businesses' development a great deal.

Meanwhile, in the central government, many banks had played a key role in promoting economic development. In order to liberalise the financial market in Taiwan, Private Bank Act was passed in 1991 and 15 new private commercial banks were also established in the same year. Hence, the year of 1991 had become a turning point for the shift of market dominance from the government-owned banking to the private banking system. As a result of the expansion in business scope from private banks, the number of domestic bank's branches

increases 219% for the past decade. However, their performance was actually falling due to the increasing operation cost from the excessive competition.

2000s: Financial reform

Together with external pressure i.e. East Asian financial crisis and internal pressures namely the worsen quality of banks' assets, the problems caused by the political parties' rotation and the lack of a comprehensive regulatory framework for financial system, Taiwan's financial system was pushed to reform in early 2000s. As many important financial laws and regulations became effective in 2001, this year was announced by the government as the first year of Taiwan's financial reform. The aim of the financial reform is to make financial institutions stronger and healthier through expansion by mergers and acquisitions, universal banking, and globalization, thereby enhancing their international competitiveness

3. Literature Review-New Institutional Economics (NIE)

The New Institutional Economics is a generic term introduced by Oliver Williamson (1975) and further developed by North (1990). The concept of New Institutional Economics is that transaction cost is the cost incurred during operation of institutions and the main function of institutions is to save transaction cost. In other words, institutional economics views markets as broad institutional structures and arrangements that support and govern the process of exchange with

the aim of minimising transaction costs in order to enhance economic performance.

According to North (1993a) institutions consist of formal rules, informal constraints (e.g., culture, norm of behaviour, and self-imposed codes of conduct) and the enforcement characteristics of both. It is these institutions which allow for economic forces to operate efficiently and effectively. It is noted that efficiency can only be fully achieved when the institutional framework is conducive to productivity, that is, private property rights are well defined.

Accordingly North (1994) proposed that "institutions form the incentive structure of a society, and political and economic institutions, in consequence, are the underling determinants of economic performance."

4. Research Framework

For any capitalist state that is promoting economic growth, it is important to consider the environment of the industry and its surrounding social and political contexts (Friedman 1988, Haggard and Kaufman, 1992) in order to appreciate the role of institution for a long run economic growth.

In the view of New Institutional Economics (NIE), North (1990) argues that an appropriate institutional environment and governance structure should be developed in order to reduce uncertainties and

transaction costs, which are capable of specifying property rights and enforcing contracts, he further pointed out the institutional structure of markets must evolve with minimum transformation cost to facilitate the process of market expansion and deepening. Therefore, the dynamics of linkages between the involving agents during the development processes would influence the institutional structure of an industrial system, and that the degree of comprehension of the financial system and its related regulations will alter the level and nature of transaction costs, which further affects the performance and willingness for banks to carryout M&A.

5. Research Methodology

In the first part of studies, the concept of New Institutional Economics (NIE) will be used to investigate the impact of formal institutions and informal institutions on financial evolution in Taiwan. The level of institutional observation is useful in clarifying the underlying reasons for dynamic change of the financial industry because in many ways, the institutional arrangements affect the activities of the financial industry. The analysis of institutional change will follow 4 steps: (1) the agent of change i.e. decision markers in organizations. (2) the source of change i.e. the opportunities perceived by decision markers (3) the process of change (4) the path of Institutional change i.e. the direction of change. (North 1993a)

In the second part of the filed work, a combination of institutional

factors will be studied in order to identify the ones which have significant influence on banking systems' soundness.

6. Expected Results

As financial consolidation trend and opening of the Chinese market will be the main issues for the further financial development in Taiwan. Therefore, this paper intends to draw out the following implications:

- (1) A need for further liberalisation and internationalisation of regulations. This includes taxation reduction towards foreign financial institutions and product development which is necessary to support quality banking with best practices.
- (2) Bank failure resolution procedures: The larger the bank becomes, the more serious damage and risk will involve if the bank's function has problems. Government should work out emergency measures in the case of banks failure. In addition, it is necessary to set a proper exit mechanism.
- (3) Opening of China's market: China has great market opportunities but Taiwanese financial companies have been facing the difficulties to operate in China or form the cooperation relationship with them due to political issue. Consequently, it is urgent for the government to draw a plan regarding this issue. Otherwise Taiwanese financial industry might lose out the competitive

advantage in this Chinese-speaking market.

- (4) Informal Institutions: The implication is that Taiwanese government at this stage intends to transfer the formal institutions from successful Western countries but this not necessary works in Taiwan. As informal institutions (i.e. culture) play a fundamental role and they can only change slowly. As a result of this, it will make a difference for the performance outcome.

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