FLOWS

Chapter 17

Global finance and financial regulation in Malaysia and Taiwan[124]

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1. Introduction

Volatile cross-border flows of short-term credit and portfolio investment, and 'herd behaviour' of international investors have increased the risk of financial crises in late-industrialising countries. The regulatory authorities of these countries face new task of prudently regulating the domestic financial system and managing mobile cross-border capital flows to reduce the risk of financial destabilisation. Their capability to perform these tasks does however vary widely. The current chapter addressed these issues through a comparison of government regulation of the financial sectors in Malaysia and Taiwan.

Malaysia and Taiwan are small open economies with impressive growth rates. Both have had good macroeconomic performances for a long period of time with high economic growth rates, low rates of inflation, high saving rates and relatively equitable income distribution. Although it has been running substantial current account deficits, Malaysia has a proven record of servicing its debts in the long term. Financial reform was undertaken gradually in both countries since the 1980s, with more accelerated liberalisation measures in the first half of the 1990s.

Nevertheless, Malaysia was far more vulnerable than Taiwan to the contagion from the 1997 East Asian financial crisis. This is indicated in Table 1, which shows that Malaysia was experiencing a larger percentage loss of the currency value and stock market value after the 1997 financial crisis. And while Taiwan maintained a reasonable GDP growth rate in 1998, Malaysia experienced strong contraction.

[124] The present article elaborates on themes developed in a previous work co-authored with Chin Kok Fay (Chin and Nordhaug, 2002). I thank the GlobAsia group and Sjur Kasa for comments.

Table 1: Economic indices of Malaysia and Taiwan before and after the 1997 financial crisis

	Malaysia	Taiwan
GDP growth rate (%)		
1994	9.2	6.5
1995	9.8	6.0
1996	10.0	5.7
1997	7.5	6.8
1998	-7.5	4.7
1999	5.4	5.5
Cumulative exchange rate changes against US dollar (%) – From June 1997 to:		
Dec 97	-35.1	-14.7
Jun 98	-36.8	-20.1
Dec 98	-36.8	-16.3
Jun 99	-36.8	-17.5
Dec 99	-36.8	-13.7
Cumulative changes in major stock market indices (%) – From June 1997 to:		
Dec 97	-44.8	-9.3
Jun 98	-57.7	-16.4
Dec 98	-45.6	-28.9
Jun 99	-24.7	-6.2
Dec 99	-24.6	-6.4

Source: Lee (2001: 91)

In the present discussion I explain these differences in terms of the quality of government policies in the two countries. A theoretical framework about state capacity of financial regulation is developed in section 2. Sections 3 and 4 provide a description of financial regulation and their effects in Malaysia and Taiwan from the late 1980s on. Section 5 analyses the relationship between political systems and financial regulation in the two countries in terms of the theoretical framework outlined in section 2.

2. States and financial regulation

In the so-called 'developmental state approach' it is argued that successful, industrialisation policies in East Asia (mainly Japan, South Korea and Taiwan) have been based on a particular political-institutional setting. First, there was a strong commitment within the government to promote industrialisation and industrial upgrading. Second, there was a division of labour between 'reigning' and 'ruling', where a political executive was boosting the power of a centralised technocratic elite agency, providing it with the authority to co-ordinate economic planning and protecting it from interest group pressure through parliament or rival bureaucratic segments.[125]

East Asian 'developmental states' have been compared with other states with less outstanding, but still relatively good economic performances. Peter Evans has identified so-called intermediary states. One variety was found in Brazil. The state organisation was to a large extent based on non-bureaucratic, clientelist relations, which impeded effective policy management. Still there were also well-working industrial planning agencies. These 'developmental factions' depended on political protection, which periodically declined with subsequent setbacks. This led to inconsistent policies, and several economic policy failures, but also to some significant examples of highly successful economic development projects (Evans, 1995: 60-66).

The developmental state approach focuses on industrial policies. It investigates planning agencies and their power position vis-à-vis other government agencies, relationships between government and manufacturing enterprises and business organisations in terms of state autonomy, state control over strategic resources to business and co-operation government–business.[126] On the other hand, the present discussion is about financial regulation, the role of central banks, their power position vis-à-vis other state agencies, especially ministries of finance and their relationship with financial institutions. Effective financial regulation is seen as an outcome of strong central banks that are insulated from political influence through the protection by a political leadership strongly committed to financial stabilisation.

This focus on central banks may seem surprising. Central banks are often viewed as spearheads of neoliberalism, and central bank autonomy has been a frequent conditionality demand from the IFIs in structural adjustments. Central banks are indeed strong contenders of the

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[125] The distinction between 'ruling' and 'reigning' was coined by Chalmers Johnson in a discussion of Japan (Johnson, 1982: 316), and later applied to South Korea and Taiwan (Johnson, 1987: 152).

[126] Peter Evans (1995) and Linda Weiss (1998) have developed a 'second generation' developmental state theory which emphasises institutionalised co-operation between government and business in successful promotion of industrialisation. Evans has used the term embedded autonomy to characterise the combination of bureaucratic autonomy and institutionalised government–business co-operation. See the discussion in chapter four of this volume for further detail. My discussion of finance comes closer to the focus on 'autonomy without embeddedness' in the first generation of developmental state theory.

macroeconomic stabilisation policies advocated by the Washington institutions. However, their preferences for prudential financial regulation and stability may also go against the neoliberal agenda of promoting free cross-border capital flows and domestic financial liberalisation.[127]

Taiwan's relatively cautious financial liberalisation and capital account deregulation in the 1990s as compared with Malaysia would then be explained in terms of a more powerful central bank with backing from the political executive. Malaysia would be closer to Evans' Brazilian model of an intermediary state. A well-working central bank is constrained by less regulatory government sections and interest groups. The central bank's ability to undertake prudent regulation has been undercut by non-regulatory policy priorities within the political leadership, notably the use of financial deregulation to strengthen a Malay business class with close ties to the ruling party, The United Malays National Organisation (UMNO).

In the developmental state approach economic policies are oriented to long-term economic growth and industrial policies once the institutional and political prerequisites are in place. Critics have claimed that this focus exaggerates technocratic rationality theoretically and empirically as governments and political elites use economic policy-making to pursue objectives unrelated to national economic development (Moon and Prasad 1994). This objection is to some extent addressed by varieties of the developmental state approach which emphasise that security considerations have played a strong role in promoting a 'developmental orientation' within East Asian regimes (Weiss and Hobson 1995; Nordhaug 1998). Similarly, it will be argued here that the great concern about financial stability within Taiwan's political leadership had to do with Taiwan's fragile security situation. Financial stabilisation policies were strengthened by non-economic security concerns.

However, the critics also emphasise that the political rationality associated with domestic politics frequently works against the technocratic rationality posited in the developmental state approach. Economic policies are used to cultivate political constituencies, justify political rule, establish alliances and weaken political opponents in ways which may go against

[127] The argument by Karl Polanyi (1957: ch. 16) may usefully be employed here. According to him, late 19th century European central banking developed in 'double movement' fashion as a part of 'society's self protection' against the devastating consequences of the international gold standard. The amassing of foreign reserves by central banks was used to buffer national economies against the shocks caused by gold outflows and ensuing monetary contraction. Of course, current financial flows take place within a non-metallic international 'dollar standard' which is very different from the monetary regime analysed by Polanyi.

economic development objectives (Moon and Prasad, 1994). In the current discussion it will be emphasised that powerful ruling party elites and elite factions in both countries had an interest in promoting lax financial regulation in order to provide funds for election campaigns. Thus financial policies served as a means to build constituencies that compromised regulatory prudence, also in Taiwan.

3. Regulation of financial institutions

In the mid-1980s unregulated non-banking financial institutions in both Malaysia and Taiwan began to compete with banks for short-term deposits and moved into less safe investments to get a higher yield, specialising in short-term financing, portfolio investment and real estate speculation and (in Taiwan) illegal lending to affiliated business groups. The ensuing financial turbulence of the mid-to-late 1980s had a lasting impact. In both countries the authorities tried to strengthen and centralise the regulatory framework of the domestic financial system from 1989 on.

Malaysia – The 1989 Banking and Financial Institutions Act (BAFIA) gave extensive powers to central bank Bank Negara Malaysia (BNM) to regulate and supervise financial institutions, both deposit-taking institutions (i.e. banks) and non-banking institutions engaged in the provision of finance (Chin and Nordhaug, 2002: 84).

Still, some new regulatory weaknesses emerged in the mid-1990s. In anticipation of future liberalisation of financial services under the WTO's General Agreement on Trade in Services (GATS), Malaysian authorities introduced a two-tier regulatory system (TTRS) for commercial banks in December 1994. This should provide incentives for smaller banks to recapitalise and merge, and thus prepare for future competition with foreign financial institutions. To qualify for tier one status, an equity base of at least RM500 million was required.[128] The new system was subsequently extended to merchant banks and finance companies in 1996. The privileged first-tier banking institutions were allowed to engage in activities previously denied to all financial institutions, such as opening foreign currency accounts. In their efforts to meet the requirement of the TTRS, shareholders frequently resorted to heavy short-term borrowings to inject more capital into the banking institutions, exerting pressure on the management to generate the requisite

[128] The minimum shareholders' funds for commercial banks was subsequently increased to RM1,000 million in December 1998.

returns to service their loans (BNM, 1999: 209-210). Consequently, this new regulatory system led to a sharp increase in aggressive lending activities, which eventually resulted in poor asset quality. The TTRS was subsequently abandoned in April 1999.

BAFIA also provided the BNM with the authority to restrict lending for speculative purposes, but the BNM was moving slowly. There had been clear indications of the overheating of the stock market during 1996. On 25 February 1997 the Kuala Lumpur Stock Exchange Composite Index rose to its second highest peak, before it began to decline (BNM, 1999: 307). However, not until April 1997 did the government impose restrictions on bank lending for purchases of stocks and shares. These measures were 'too little too late'. In result, the Malaysian banking system struggled with large amounts of non-performing loans that had been invested in the plummeting stock market.

Taiwan – The 1989 bank regulations of Taiwan lifted the previous ban on the establishment of new banks. The capital requirement was set at the very high level of NT$ 10 billion (US$ 400 million) in order to accomplish high concentration within the banking sector without compromising loan quality (Chu, 1999: 196). Nevertheless, fifteen new banks were approved and several investment trust companies, medium-sized business banks and credit companies were transformed into deposit banks. The number of banks increased from sixteen in 1992 to forty-seven in 1999 (Satō, 2002: 241).

In the 1990s the new banks began to issue loans for stock purchases. They also moved into housing loans and granted loans of 90 percent in collateral value, while the old financial institutions had limited their loans to 70 percent. In result, the banking sector became more vulnerable to boom and bust patterns in the property and capital markets (Satō, 2002: 232).

Still, the monetary authority was checking bank lending for speculative asset purchases more determinedly than in Malaysia. A speculative real estate bubble developed in the late 1980s. In 1989 the Central Bank of China (CBC) responded by imposing a 20 percent ceiling on bank lending to the overheated real estate market, which was retained for almost six years. In 1992 a new insurance law lowered the ceiling on real estate investment by insurance companies from 33 to 19 percent (Chu, 1999: 196).

In other respects Taiwan's regulations were less comprehensive than the Malaysian. There were separate regulations for banks, credit cooperatives and credit departments of farmer associations and Postal Remittances and

Savings that weakened regulatory control. As for the Farmers' Associations credit departments, there was partly overlapping regulative authority between the Ministry of Finance, the Ministry of Interior and the Council of Agriculture. This multisystem allowed for lax regulation (Chang, 1998).

After the bank liberalisation credit cooperatives and farmers' association credit departments faced growing competition from new local banks that weakened their financial position. In 1995 there was a series of runs on credit cooperatives and farmer association credit departments. The non-performing loan ratio of community financial institutions increased from 4.02 percent in December 1995 to 8.53 percent in December 1997 (Bureau of Monetary Affairs).[129] However, these institutions only accounts for a limited proportion of Taiwan's financial system. The authorities managed to stem these runs through mergers and refinancing before they resulted in large-scale contamination, although deposits in the sector decreased NT$ 16 billion (US$ 470 million) from July 1995 to April 1996 (Chang, 1998).

Table 2 compares the non-performing loans in the overall banking systems of Malaysia and Taiwan. As would be expected there were large differences after the onset of the financial crisis, but the 1995 and 1996 figures indicate that the NPL ratios in the two countries were converging from a relatively high level in Malaysia and a relatively low level in Taiwan, so that Taiwan's NPL ratio actually surpassed that of Malaysia in 1996.[130]

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[129] It peaked at startling 18.19 percent in June 2002.

[130] Possible impacts of the differing definitions of NPLs in the two countries is left out from this definition.

Table 2: Non-performing loans as a persentage of total outstanding loans in Malaysia and Taiwan, end-of-year figures

Year	Malaysia[1]	Taiwan[2]
1994	7.8	—
1995	5.5	3.0
1996	3.7	4.2
1997	6.1[3]	4.2
1998	13.4[3]	4.9

1. Banks and finance companies. NPLs: Six months of non-payment.

2. Banks, trusts and investment corporations and community financial institutions. NPLs: Three months non-payment on principal, six months on interests.

3. The BNM changed its definition of NPLs in December 1997. 1997 and 1998 figures are tabulated according to the old definition by the author.

Sources: BNM 2003, table III.15; Bureau of Monetary Affairs.

To sum up, it does not appear that different performances of Malaysia and Taiwan during the crisis can be satisfactorily accounted for in terms of their regulation of domestic financial institutions. However, the banking system of Taiwan was better protected against downturns in asset markets than in Malaysia. I now turn to the regulation of cross-border capital flows and domestic capital markets.

4. Regulation of cross-border capital flows and capital markets

Regulation of foreign capital inflows in Malaysia and Taiwan prior to the 1997 crisis was strongly affected by events in the 1980s. In the Malaysian case the main regulatory lesson learnt was about macroeconomic balancing and the ensuing need to control and restrict foreign borrowing.

Malaysia – Under the Fourth Five-Year plan of 1981-85 the Malaysian government pursued a policy of costly public sector expansion which included a state-led heavy industry import-substitution development programme along with large-scale public construction programmes. This new economic strategy increased public sector expenditure, and enhanced imports, while contributing little to exports. Increased government expenditures were financed by foreign borrowing. The ringgit became increasingly overvalued due to the effects of foreign capital inflows.

Malaysian manufacturing exports faced declining terms of trade and stagnating markets abroad, and its competitiveness declined. A recession in 1985 went along with considerable capital outflows and a sharp devaluation of the ringgit (Jomo, 1993: 28-34).

These experiences prepared for Malaysia's policy shift during the late 1980s towards macroeconomic orthodoxy, privatisation policies and more favourable policies towards foreign investment. Restrictions on foreign borrowing along with reduced domestic interest rates led to low exposure to private bank borrowings from abroad. Instead, capital market flows, especially those into and out of the stock market, figured more prominently.

Table 3 shows that Malaysia's stock market registered more rapid growth than its counterpart in Taiwan during the first half of 1990s. In 1996 Malaysia had the highest level of stock market capitalisation among the countries listed by the International Financial Corporation. This strong growth of the Malaysian stock market was an outcome of deliberate government policies.

Table 3 Malaysia and Taiwan: Market capitalisation as percentage of GDP

Year	Malaysia	Taiwan
1988	67.2	98.0
1989	105.2	160.5
1990	113.6	63.2
1991	124.6	70.2
1992	163.2	48.4
1993	350.6	89.2
1994	281.6	103.9
1995	261.1	70.8
1996	309.6	97.9

Source: Chin and Nordhaug 2002: 86.

The Malaysian authorities' privatisation policies resulted in large-scale public offering of public enterprises that boosted activity on the Kuala Lumpur Stock Exchange. The government also stimulated the stock exchange through other measures. Already in 1985 the Finance Minister had given banks permission to give up to 100 per cent loan support for share purchases. He also directed government-controlled investment institutions, such as the Employees Provident Fund, to invest into stocks.

In the 1990s the government worked to attract foreign portfolio capital to Malaysia's stock market. The gradual liberalisation of the financial market provided the impetus for the unprecedented surge of portfolio investment inflows in the early 1990s into the bullish Malaysian stock market.

There were no significant entry barriers on portfolio investment, withholding taxes or bureaucratic bottlenecks of repatriation. Foreign institutional investors were attracted by allowing fund managers to buy more equity in Malaysian corporations and reducing the tax rate on their profits to 10 per cent. Large inflows of foreign portfolio investment accelerated the growth of Malaysia's stock market. In 1997 the percentage of foreign held stocks was 19 percent. In comparison it was below four per cent in Taiwan (Lee, 2001: Table 4.2). The impact of foreign funds was stronger than indicated by their market share. They tended to become market leaders as they were concentrated and had a greater turnover than domestic institutions. Thus, Malaysia was vulnerable to the volatility of foreign portfolio investment holdings. In early 1994, temporary controls aimed at limiting portfolio inflows were put into place, but they were removed by the end of the year.

Following Malaysia's liberalisation of its exchange control regime, an offshore ringgit market had developed, dealing not only in ringgit trading, but also in shares and derivatives on the ringgit as well as ringgit deposit-taking and loan extending activities outside Malaysia. The offshore ringgit activities mostly took place in Singapore, but also in other major international financial centres in London, New York and Hong Kong (BNM, 1999: 273). These speculative activities on the offshore market were undermining the effectiveness of the domestic monetary policy and resulting in excessive volatility in the exchange rate and stock market in 1997 and 1998.

Financial liberalisation that reduced effective prudential regulation and supervision ultimately caused vulnerability to crisis. The contagion from the Asian financial crisis – that began with the floating of the Thai baht on July 2 1997 – was soon spread to Malaysia. Currency speculators turned to other regional economies that like Thailand had quasi-pegs to the strong US dollar. After an attempt to defend the ringgit at the cost of nearly US$4 billion, the BNM gave up currency support operations in the third week of July (Jomo 2001: 5). The ringgit fell from a high of 2.47 to a US dollar in mid-July 1997 to the low of 4.88 in early January 1998. Currency depreciation triggered a steep decline in the Kuala Lumpur Stock Exchange. The composite index declined from about 1,080 in early July 1997 to around 500 in early January 1998.

Taiwan – Unlike Malaysia foreign debt was not a problem in Taiwan in the 1980s as the country was running huge current account surpluses. The monetary inflows from these surpluses were to some extent neutralised by outflows of long-term capital. However in 1986-87 outward capital flows were offset by large inflow of short-term capital while current account surpluses boomed. Consequently, Taiwan's foreign reserves increased by US$ 51.4 billion during these two years (SEACEN, 1999: 142). The capital inflows came after the government's announcement in 1986 that it would permit a gradual appreciation of the NT$ in response to US trade policy pressure (Yang, 1998: 115). The capital inflows largely went into the state-owned banking system. From the banks, the excess liquidity found its way into the stock and real estate market, feeding an asset bubble in Taiwan in the late 1980s. The stock index peaked at 12,495 in 1989 and fell to a low of 2,560 in 1990 (Yang, 1998: 116, 119). These experiences taught Taiwan regulatory authorities a lesson about the need to shield domestic financial markets from volatile foreign capital inflows.

In the 1990s Taiwan pursued a restrictive policy with regard to foreign portfolio inflows. Taiwan's withholding taxes on dividends from foreign investment were relatively high. It had a medium-level 25 percent ceiling on foreign investment. Its entry and exit barriers were more restrictive than in Malaysia and other East Asian industrializing countries (excepting China and Vietnam). There were requirements for authorisation of foreign investment and all inbound portfolio investments were required to stay in Taiwan for at least three months.

In 1991 a law was passed which authorised 'Qualified Foreign Institutional Investors' to invest directly in Taiwan's stock markets. An investment cap was imposed on inflows although negotiations with the United States about WTO accession and domestic pressure forced Taiwan authorities to raise the ceilings through the 1990s (Chu, 1999: 192).

Capital account deregulation went along with new regulation to discourage the investment of inbound portfolio inflows in asset markets. In 1989 Taiwan's companies had been allowed to issue bonds abroad. In 1993 Taiwan's enterprises were allowed to remit proceeds of overseas bond issues for domestic use, but this was followed by new regulations. The overseas foreign currency remittances should be invested in plant expansion, and there would be a roof on the total annual remittance of US$ 3 billion (Weiss, 2000: 32, 51, note 11).

Taiwan authorities were then far more restrictive than their Malaysian counterpart with regard to portfolio capital inflows, and capital account deregulation was followed up by re-regulation to restrict asset market speculation and promote productive investment.

Taiwan was not unaffected by the regional currency crisis. During July and August 1997 the Philippines, Malaysia and Indonesia were forced to abandon their currency pegs. In September speculators shifted their attention to Taiwan and Hong Kong despite their huge foreign reserves. After having spent more than US$7 billion dollar in defence of the currency, the CBC decided to float it on 17 October 1997. In result the NT Dollar depreciated moderately from about NT$28.6 to US$1 to 32.1 to 1US$ by December 1997 and remained at that level afterwards.

Furthermore, the stock market index fell by 18 percent from June 1997 to the end of the year. However, falling international stock prices and reduced profitability in the electronics sector may have been as important to this decline as regional contamination (Wang, 2000: 150).

5. The politics of financial regulation in Malaysia and Taiwan

The previous discussion has identified some important differences in financial regulation in Malaysia and Taiwan, especially with regard to capital account deregulation. In section 2 it was firstly argued that these differences should be explained in terms of a modified developmental state model. Successful regulation in Taiwan could then be seen as an outcome of central bank autonomy sustained by political leaders with a strong commitment to financial stabilisation which was reinforced by security concerns. No such security commitment existed in Malaysia, where financial liberalisation was seen as a way to promote the main policy objective of ethnic redistribution. In addition it was suggested that there were ruling-party interests in lax regulation for purposes that had to do with the funding of election campaigns. As will be argued below, this pressure was stronger at the central level of the party in Malaysia than in Taiwan, while concerns about electoral funding of local campaigns led to lax regulation of local financial institutions in Taiwan.

Malaysia – The BNM is a well-working and competent regulatory agency. Its powers are however restricted. For instance, there were episodes where it was unable to restrict bank lending for asset purchases. In 1985 the BNM was strongly opposed to the measures to expand bank lending for share purchases, but it was overruled by the Ministry of Finance (Khor, 1987: 101).

The 1989 Bank and Financial Regulation Act (BAFIA) strengthened the BNM's regulatory role, but did not ensure the high degree of power and independence enjoyed by the CBC. BAFIA authorised the BNM to restrict bank lending for purchases of assets and stocks. Nevertheless, the level of this lending as a proportion of total bank lending more or less remained at the same level in the 1990s as in the boom years of the 1980s (Jomo and Hamilton-Hart, 2001: 71). This indicates that the BNM was unable to use its formal authority to restrict the build up of asset bubbles. Its belated response to restrict bank lending for asset purchases in April 1997 may also have been an outcome of its limited powers, rather than regulatory neglect.

The weakness of the BNM should be related to non-regulatory policy priorities within the political leadership. Since 1971 there had been a constant concern about creating a Bumiputera[131] capitalist class through ethnic favouring, including legal requirements of Bumiputera part-ownership in Chinese and foreign enterprises, training of entrepreneurs in the running of public enterprises and a variety of support programmes for private entrepreneurs. With the economic problems of the mid-1980s government finances for these policies dried out. The government now targeted its support at a small group of Bumiputera capitalists (supplemented with a few Chinese and Indian capitalists) with strong ties to the ruling party UMNO. This group was favoured by privatisation of public enterprises, public contracts and protected import-substitution. It operated on the Malaysian stock exchange and invested heavily in company take-overs, mergers and acquisitions and inside trading in stocks and real estate (Gomez and Jomo, 1999).

A key player in Malaysia's financial deregulation was billionaire Daim Zainuddin, the patron of Malaysia's biggest party-business capitalists. Daim was probably also a main benefactor from this party-business activity, although he claimed that he had relinquished his business interests after he assumed office. Daim shifted between positions as Minister of Finance and Mahathir's personal advisor in economic affairs until his final fall from grace in 2001.

The government's commitment to financial deregulation was reinforced by the growing costs of funding election campaigns and client networks related to growing intra-party factionalism, as well as a strengthening of the opposition in some of the states. In addition, in the 1990s UMNO lost its institutional control of a party business empire that previously had been

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[131] Bumiputera refers to the 'indigenous' population of Malaysia, mainly comprising the Malays.

funding its election campaigns. The Malay-based party UMNO has been dominating a multi-ethnic coalition (Barisan Nasional) which has been governing Malaysia since independence. UMNO was controlling a huge business empire until the late 1980s. The party could therefore rely on its business arm, rather than private business in financing its campaigns. This reduced the influence of business elites on economic policies, including financial regulation.

In 1987 a major division occurred within UMNO. Prime Minister and UMNO President Mahathir Mohamad narrowly won the presidency at the UMNO General Assembly. Afterwards his rival filed a law suit which was supported in court. According to the court verdict the UMNO elections should be nullified due to irregularities, while UMNO's business holdings were to be taken over by the official assignee.

Mahathir responded by forming UMNO Baru (New UMNO) and denied his opponents membership in the new party, while a quasi-privatisation of UMNO's businesses protected them from claims by the expelled UMNO dissidents. A small group of party business men associated with Daim Zainuddin who had managed UMNO's business empire in the past were in control of UMNO's assets from about 1990 (Gomez and Jomo, 1999: 122-123). This semi-private business empire financed UMNO's election campaigns at rapidly increasing costs.

The previous party business empire was now linked with a group that developed into a faction of its own in the UMNO power play. In the 1990s Anwar Ibrahim emerged as the leader of a new UMNO faction with strong popular backing. In 1994 Anwar began to challenge the Daim group and its benefits from the privatisation process, and mobilised a new generation of Malay businessmen (Gomez and Jomo, 1999: 123-129).

The UMNO business cronies were pouring large amounts of money into campaigns and vote buying in state elections to defeat rivalling parties. The Sabah state election in 1994 is one example (Gomez and Jomo, 1999: 130-137). In addition, huge sums were spent in the factional rivalries for UMNO positions. The growing costs to finance campaigns and vote buying led to enhanced stock market activity and insider trading. Thus there was a strong vested interest in financial deregulation to promote the stock market boom as the party business interests who dominated this activity played a crucial role in electoral funding after the dissolving of the UMNO business empire.

Taiwan – The destabilising impact of large foreign capital inflows to Taiwan in the late 1980s reinforced the CBC's commitment to financial stability and the political backing of the CBC from the executive. Taiwan's tense relations with mainland China, its diplomatic isolation and historical experiences during the Chinese Civil War had led to a strong concern about financial and monetary stability within Taiwan's political leadership. Monetary collapse and hyperinflation in Nationalist China during 1948-9 was widely seen as a major cause of its defeat in the Chinese Civil War. It is frequently claimed that this traumatic experience led to a strong orientation to monetary stability by the Chinese Nationalist refugee government in Taiwan, including the vesting of strong authority in the CBC.

Financial stability is considered vital to withstand diplomatic shocks, military tension or economic sanctions from the PRC. Taiwan was excluded from the Bretton Woods institutions in 1979. The government was then prevented from drawing emergency funds from the IMF and the World Bank. This strengthened its commitment to macroeconomic, financial and monetary stability. Within this setting the CBC has been given wide-ranging authority.

The strong presidency in Taiwan has made the CBC the most prominent economic government agency. During 1961-1979 the CBC was directly responsible to the President, unlike the economic ministries that were part of the cabinet. In 1979 the CBC also formally became a part of the cabinet under the authority of the prime minister, but in practice it continued to be under the President's control. The CBC is the only economic government agency which is included in the national security apparatus, which is the responsibility of the President.

There are also close relations between the CBC and the Ministry of Finance in terms of recruitment, career patterns and co-operation (Chu, 1999: 189-191). The regulatory authorities of the two agencies sometimes overlap. The CBC has been willing to reverse decisions on financial deregulation and it has occasionally overruled the Ministry of Finance in order to tighten the regulatory framework. In February 1992 it embarrassed the Ministry of Finance as it intervened to temporarily halt the remittance of foreign investment in the stock market. It had then been disclosed that some of the authorised investment funds had been used for speculation in foreign exchange markets (Thurbon, 2001: 252). In 1995 the CBC closed Taiwan's foreign exchange market for one year when it discovered that a major share of the foreign inflow approved for equity investment once again had been used to speculate against the currency (Weiss, 2000: 50-note 10).

The CBC did also have a strong authority over the banking system. From 1945 until 1992 all domestic banks in Taiwan were state-owned. During most of this period the CBC had the final authority to decide on appointments of senior banking officials. Banking officials were public employees subject to criminal prosecution if bad loans should be attributed to corruption or negligence. This instilled a culture of risk aversion and adherence to central bank directives within the banking system (Chu, 1999: 189, 251-note 13). Bank privatisation evolved slowly and did not undermine the CBC's power in a strong sense. In 1995 banks controlled fully or partly by the government in Taiwan accounted for 10.92 trillion NT dollar, or 71.9 per cent of total banking assets. Government-controlled credit and financial institutions held 12.65 trillion NT$ in the overall credit and financial system out of a total of 20.34 trillion, or 62.2 per cent (Chang, 2000: 237-8).

The Taiwan Strait missile crisis from August 1995 to March 1996 created a strong downward pressure on the New Taiwan Dollar and Taiwan's stock markets. The power and centrality of the CBC were strengthened as it intervened to defend the currency. A stock market stabilisation fund was set up. Government-run investment funds were instructed to buy stocks and bonds. This served as an unintended rehearsal for the subsequent 1997-98 regional financial crisis (Chu, 1999: 192-193).

The CBC's political strength, regulatory capability and caution derive from Taiwan's fragile security situation. In Malaysia there was no comparable geopolitical situation which could strengthen the authority of the BNM. But Taiwan's finance and credit policies should also be understood in terms of domestic political rationality.

During the authoritarian period (1949-1986/7) politics in Taiwan was deeply influenced by the political division between mainlanders who came to Taiwan after 1945 and the native-born Taiwanese. State ownership of the larger banks was a way of strengthening the power of the mainlander central government. Central-government elections were suspended, but some limited democracy was permitted locally with direct elections at county, township, village and provincial levels. In these elections the ruling Kuomintang (KMT) had to rely on local Taiwanese factions. These party-based factions were allowed to operate local monopoly businesses, including local community financial institutions. The KMT government tried to control the factions by supporting more than one and playing them out against one another, and by limiting their geographical scope of power (Satō, 2002: 236).

This situation was also reflected in the 1989 regulations. As noted in section 3, credit cooperatives and the Farmers' Associations' credit departments faced problems due to lax regulation and unclear regulatory responsibility. An important explanation for this regulatory neglect was the

KMT's interest in using local credit institutions as cash cows for local elections. In result, loopholes were inserted into the regulation of community credit institutions (Chang 1998).

As the process of democratisation gained momentum from 1987 on, individual KMT representatives and factions became increasingly reliant on business funding for elections to the national representative bodies. Like UMNO, the KMT experienced strong factional struggle. This took place in the early 1990s between the so-called mainstream faction in support of Lee Teng-Hui and his 'non-mainstream' KMT opponents. In this struggle Lee strove to mobilise support from local faction leaders and became vulnerable to their demands. This led to greater liberalisation of the banking sectors than was first planned. While the financial authorities had originally planned to approve three to five new banks, fifteen banks were approved, most of them with participation of major business group and local factions. One outcome of this situation was illegal lending from the banks to the business groups and factions who controlled them, as has been disclosed in a number of banking scandals (Satō, 2002: 241-243).

Still, the influence of local KMT factions on central government policies was limited after the settling of the intra-party struggle. Like UMNO KMT controlled a huge party business empire. Unlike UMNO in the late 1980s, the struggles within the KMT was settled without any fragmentation of the KMT business empire. As the struggle was ended with the victory of the mainstream in 1992/3, a centralised KMT used its party business arm to finance its national election campaigns. Institutional funding ensured a high degree of autonomy of the KMT national leadership against local party factions and their business supporters, and helped the political leaders to insulate the technocrats in the CBC and the Ministry of Finance from external lobby pressure (Chu, 1999: 194-195).

Thus, political rationality in relation to domestic party politics weakened financial regulation in both countries. But the political rationality associated with Taiwan's fragile security situation promoted policies that protected its capital markets against the kind of unregulated transnational portfolio movements seen in Malaysia.

6. Conclusion

The previous discussion has developed a theoretical framework of financial regulatory capacity, while also qualifying this theory with the notion of non-economic political rationalities of economic-policy making. Based on this approach it has been argued that conditions of high regulatory capacity were present in Taiwan: An insulated regulatory agency was empowered by the political leadership for security reasons. Its policies helped to contain volatile cross-border capital flows, and did to some extent succeed in establishing firewalls between asset markets and the financial system. However, political rationalities related to electoral funding at the local level and coalition building during a period of strong intra-party divisions also led to lax regulation of local community financial institutions, and new banks in Taiwan. Malaysia may be seen as a case of intermediary regulatory capacity. It had a well-working central bank, and a better system of banking regulations than Taiwan. However, the Malaysian authorities' boosting of local security markets through capital account deregulation dovetailed with political objectives of ethnic redistribution and party business interests. In result the regulatory power of the central bank was weakened, leading to imprudent liberalisation of capital markets and the capital account.

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