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DIRECTORATE OF INTELLIGENCE

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Taiwan: The Impact of the 10th Credit Scandal



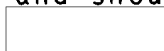
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Summary

The Yu Kuo-hua administration is still feeling the effects of the collapse of the 10th Credit Cooperative Bank in February. Two cabinet ministers have resigned and more officials suspected of malfeasance are expected to be dismissed. Meanwhile, the scandal has increased doubts about the government's ability to manage the economy and added to the island's mounting economic woes. We expect President Chiang to reorganize the cabinet and replace Premier Yu sometime after this fall's provincial elections an effort to restore public confidence in the government. Li Huan--a reformer--probably is the front runner to replace Yu, but the nod could go to another conservative. Indeed, Chiang's plans for ensuring a smooth presidential

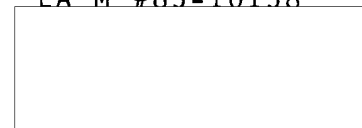
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succession, which he has kept to himself, are likely to influence his final choices for the next government as much as the state of the economy. [redacted]

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### Political Ramifications

The widening scandal surrounding the collapse last February of the 10th Credit Cooperative Bank has--in our view--dealt a crippling blow to the already badly tarnished administration of Premier Yu Kuo-hua's.<sup>1</sup> The unearthing of widespread official corruption has already forced the resignations of Kuomintang (KMT) Secretary-General Chiang Yen-shih and the Economic Affairs and Finance ministers. In addition, several lower level financial officials have been dismissed. [redacted]

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The government has tried to limit the damage by promising swift punishment for those involved. The authorities probably hoped that the resignations of two cabinet ministers and the highly publicized reprimands of other finance and banking officials would mollify the public and quickly close the books on the incident. But that is not likely. [redacted]

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[redacted] the Chairman of the KMT Provincial Headquarters and the Speaker of the Taiwan Provincial Assembly also may lose their jobs. Even Premier Yu, who until 1984 was Chairman of the Central Bank that regulates the banking system, is widely believed to have participated in an attempted coverup of the firm's financial difficulties. [redacted]

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### Economic Slowdown Compounds Problem

The collapse of the 10th Cooperative has had serious economic side effects, triggering runs on several other privately owned lending institutions.<sup>2</sup> Other larger banks in turn have adopted tighter credit policies after being reprimanded by the government for questionable lending practices. The net result is that many small-and medium-sized firms, accustomed to easy access to credit, are now going bankrupt. Even some large conglomerates are having financial difficulties. [redacted]

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<sup>1</sup> In addition to the 10th Credit, the Yu administration has come under fire for a series of mine disasters since last summer and official Taiwan involvement in the murder of Chinese-American writer Henry Lui last October. [redacted]

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<sup>2</sup> The 10th Cooperative collapsed after the public disclosure of illegal banking practices including massive unbacked loans.

The credit squeeze has contributed to a general slowdown in the economy caused in large part by factors beyond the government's control. The sluggish US economy has hit Taiwan's export industries particularly hard. Taiwan, moreover, is facing stiffer competition from countries whose cheaper labor costs allow them to undercut the prices of Taiwan's exports. [redacted]

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The faltering economy has focused even more unfavorable public attention on the Yu government. Indeed, its failure to adopt more stringent financial controls to prevent the kind of abuses exemplified by the 10th Cooperative scandal is symptomatic of Yu's weak leadership in dealing with deeper systemic problems in the economy. The government for example, has been slow to consider tax reforms that would encourage Taiwan's export sector to invest in more technology-intensive industries. Taipei has also been very reluctant to open the island to foreign investors, even those willing to transfer technologies and contribute to R & D expenditures. [redacted]

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To restore business confidence in its policies the cabinet has recently cut taxes, loosened controls on foreign exchange and lowered electricity prices for major firms. At the premier's initiative, the government also has established an Economic Reform Committee, which includes a number of highly respected Taiwanese businessmen. These steps, however, are widely regarded as stop gap measures and have done little to defuse criticism of the government's failure to initiate much needed economic reforms. [redacted] local businessmen are now publicly deriding the Premier, characterizing him as a "Typhoid Mary" who damages everything he touches. [redacted]

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### Looking to the Fall Elections

We believe opposition forces will try to capitalize on the economic slump, the scandal and other setbacks to the government to chip away at the Kuomintang's dominant position in the provincial elections scheduled for November and December. The KMT seems resigned to losing some seats, but party officials remain confident that the KMT will still garner close to 75 percent of the popular vote. The opposition remains fractured and without a strong core of leaders who can launch an effective campaign against the extensive resources of the KMT. As a result we believe many voters probably will remain convinced that despite the Yu government's poor performance, only the KMT is capable of turning the economy around. [redacted]

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### And Beyond

Once the elections are over, President Chiang is likely in our view to remove the hapless Yu and reorganize the cabinet--

perhaps after the next KMT plenum expected to be held in December or January. Chiang is unlikely to move sooner because of the embarrassment the removal of Yu--an old family adviser--would cause the KMT and Yu personally. Moreover, Chiang probably will want to wait and see who else is implicated in the 10th Cooperative scandal before naming a new cabinet. [redacted]

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Several senior officials have been rumored to be in the running to replace Yu. These include Minister of Education Li Huan, Chairman of the Council of Economic Planning and Development Chao Yao-tung, and Secretary General of the Presidential Office, Shen Chang-huan. Li Huan, who is popular within the party and with economic technocrats, seems to be the odds on favorite at present. We believe the Taiwan business community would support either Li or Chao, who are known to favor reform. By contrast, Shen shares many of Yu's flaws. A conservative on both political and economic issues, we doubt that he would be willing to take the steps needed to improve the economy. [redacted]

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President Chiang, however, may have more confidence in Shen to carry on the policies he favors. Over the past 18 months, for example, Chiang has virtually delegated authority over foreign policy to Shen. Shen's hand has been particularly visible in Taiwan's decisions to:

- seek greater official status in the United States;
- refuse to use the "Olympic formula" to resolve Taiwan's status in the Asian Development Bank;
- revert to an inflexible policy toward Beijing's reunification overtures. [redacted]

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We also suspect--but are not certain--that Chiang is closer to Shen than Li Huan in favoring a very gradualist approach to political reform and Taiwanization of the KMT. In any event, we believe Chiang's calculations for ensuring that power is in the "right hands" after his death will influence his decision on the next government as much as--or perhaps even more than--his concerns over the present state of the economy. Thus, even if Chiang picks Li to succeed Yu, the President will continue to rely heavily on Shen, who represents the conservative wing of the KMT, to ensure a "balance" within the collegial leadership likely to take over after he dies or retires. [redacted]

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