

# The Reluctant State Policy and the Development of the Futures Trading Industry in Taiwan

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Jinn-yuh Hsu\*

Pin-hsien Chen\*\*

National Taiwan University

*This research aims to tackle the issue of development of the futures trading industry in Taiwan. In spite of being praised as a model of the developmental state, the Taiwanese government was very conservative in its financial policy, and usually put a high priority on stable growth in its decision making. As a result, it took an ambivalent attitude toward the opening of the futures market, which was believed to be highly speculative and subversive to the financial system. However, an underground futures market came into de facto existence and caused social concerns, and the state was forced to legalize the new industry. Even so, instead of following a big push model, the state adopted a gradualist approach and opened the trading market step by step. This led to creation of a market dominated by individual investors and little foreign capital participation. The market was characterized as decentralized and price sensitive to service charges, and at the same time, required brokers to bridge the knowledge gap for individual investors, rather than institutional ones, in complex financial transactions. Under such circumstances, it was the extent of social networks, rather than the sophistication of trading skills, that was critical in the business. In other words, reluctant state policies led to a decentralized market structure, which further shaped an under-developed professional community in Taiwan's futures trading industry.*

**Key words:** *Financial geography, financial services, futures trading, globalization, developmental state, information and communications technology (ICT), Taiwan*

The financial industry has become dominant in the capitalist economic system since the breakdown of the Breton Woods agreement in the 1970s. The innovation of financial commodities, in combination with the new information and communication technologies, has been stirring up the market structure and dramatically reshaping financial landscapes. Martin (1999) pointed out that three penetrating and cross-enhancing processes characterize the current global financial system: deregula-

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\* Department of Geography, National Taiwan University, 1 Roosevelt Road, Section 4 Taipei 106, TAIWAN. E-mail: jinnyuh@ntu.edu.tw

\*\* Center for Environment, University of Oxford, South Parks Road, Oxford OX1 3QY, UK. E-mail: pin-hsien.chen@ouce.ox.ac.uk.

tion, technological innovation and globalization. Deregulation or liberalization of financial markets opens up new geographical markets, and provides new financial products. Under the current system, some key financial transactions occur in a few global cities, while others disperse to the lower-tier financial centers connected by electronic networks. Thanks to the development of information and communication technologies (ICT), it is argued that the amount of transactions has become virtualized and even blind to location (O'Brien, 1992). Among the innovations in ICT, a wide new array of financial instruments has appeared on the scene that facilitates greater spreading of risk (Boden, 2000).

The most important product innovation since the mid-1980s has been the phenomenal growth of the derivatives market. The goals of the markets are to enable investors to manage risk by offsetting the effects of volatility, and to allow them to gain profits by arbitraging the gap of information. However, as argued by Tickell (2000), the derivatives not only allow institutions to offset risk, but have also been implicated in a series of high profile losses which have undermined the financial viability of companies, banks and government entities (also see Pryke and Allen, 2000). So, how to survive and even leverage the futures markets has become a key issue for financial institutions to grow in a turbulent world market.

However, even as abstract as the derivatives product is, it is still regulated and affected, to some degree, by embedded institutions (Agnes, 2000). Divergent modes of financial development in various national systems have been becoming similar in the era of neo-liberalist hegemony. Of critical importance is the difference in regulatory environments, which are under attack from the forces of deregulation but still affect financial activities and monetary networks in/across divergent national systems, for financial systems are regulatory spaces (Martin, 1994). But why is the state willing to deregulate financial control?

This issue is particularly relevant in the case of East Asian developmental states such as South Korea and Taiwan. A number of researchers claim that the miraculous development of East Asia's Newly Industrializing Economies (NIEs) should be understood as a process in which the states played a strategic role in taming domestic and international market forces and harnessing them to national ends (Wade, 1990; Amsden, 1989, 2001; Evans, 1995). Fundamental to these miracles is an insistence on industrialization, rather than on following current comparative advantage. In other words, market allocation rationality is subjected to the priority of industrialization, which usually means employing new technologies to increase capital accumulation (Storper and Walker, 1989). Key to the process of industrialization is that the state lends directional thrust to the operations of the market mechanism.

Among the protagonists of developmental state theory, Wade (1990) carefully distinguishes state leadership from market leadership in order to allow theorization of the complexity of state-market interactions. Based on an empirical study of Taiwan's industrialization process before 1980, Wade concentrates on the synergetic relationships between state activities and market allocation in each industrial sec-

tor. He provides a vivid example of how state intervention, under certain historical conditions, can help start up industrialization and create economic space in which the market mechanism can function. In other words, the state in the Asian NIEs is not a passive administration that takes price signals for granted and takes charge of a sound regulatory environment only. In contrast, the developmental state is an interventionist one, and plays an active role in targeting industrial development (Pempel, 1997).

However, the key to the developmental state leveraging its capability to realize its goals is the financial pocket (Skocpol et al., 1985). As the leading figure of the concept, Johnson (1987) argued that state control of finance was the most important, if not the defining, aspect of the developmental state, followed by other aspects such as labor relations, autonomy of the economic bureaucracy, and the combination of incentives and command structures. In fact, states still play an important role in setting key parameters of national monetary activities and modes of integrating with the international system (Thrift and Leyshon, 1997). They can exploit their administrative powers to discriminate one sort of financial institution from another by limiting the range of financial products and markets in which different types of institutions may trade. Finance is the tie that binds the state to the industrialists in the developmental state. The state takes advantage of the monopoly of financial resources, and maneuvers to allocate financial credits to promote those industrial sectors which the state targets for some reasons. By doing so, the state can exert influence over the investment pattern and guide sectoral mobility, since in such a financial structure, firms mainly rely on bank credits for raising finances beyond retained earnings and respond quickly to the state's policy, as expressed in interest rates and other financial policies (Zysman, 1983). As a result, finance itself is conceived as an effective conduit of industrial policy, rather than a sector which can become the propelling one in the developmental state. The top concern for the developmental bureaucracy in financial development is the stability of the system--anything but the competitiveness of the financial sector. Students of the developmental state believe that the model can work well for the NIEs to catch up and give birth to miraculous growth, as demonstrated by the East Asian case (Wade, 1990).

In contrast, the phenomenon of financial repression, or the intervention in the financial market by the developmental state, has been targeted as the key area to be deregulated by neoclassic economists (McKinnon, 1989). The neo-liberalist rhetoric argues that "external" intervention will distort the optimal operation of the market mechanism, and lead to financial dualism, the co-existence of legal and underground financial systems. Meanwhile, if it continues, the financial resources will be misallocated, and rent seekers will emerge in the market (McKinnon, 1989). In the neo-liberalist prescription, the government would be better keeping away from resource allocation and loosening financial control to let prices return to the right track.

The debate raises an interesting issue: why would the developmental state engage in deregulation policy since controlling finances has been the lifeblood for it to

survive and even prosper? Why did these states dismantle the institutions that gave them the power to control financial resources, thereby surrendering much of that power to the market? As illustrated above, two explanations stand out. One privilege the role of market forces and the other underscores the importance of policy decisions influenced by the scheme of domestic business groups and international hegemonic institutions, particularly the U.S. government. The former tends to explain financial liberalization and deregulation as a relentless transformative process driven by the development of new technologies, particularly new information and communication technologies, and more sophisticated financial instruments. As a result, the state cannot but accept the rule of the market and loosen its control as responses. In contrast, the latter focuses on the politics of the alliance of local and extra-local economic forces in affecting policy making. This leads to the erosion of state autonomy and the decline of state capacity in the political struggle; thus the state is forced to withdraw from the policy of financial repression.

These two reviews are usually mobilized to explain the different cases respectively (Loriaux, 1997). Even though they hold contradictory viewpoints on the causes and effects of financial liberalization, they ironically share an unpredictable consensus that market forces and state bureaucracy could work well, respectively, if they do not interfere and attack each other. However, it is widely agreed that the developmental states have to embed themselves in the market to make policies (Evans, 1995), and at the same time, the de-regulated market needs re-regulation from the state to operate smoothly at different geographical scales, from local, regional to global levels (Weiss, 1998; Martin and Sunley, 1997). Such an either-or thinking as markets oppose states is a deadlock for further theoretical development (Boyer and Drache, 1996). In fact, the wisdom of recent institutionalism demonstrates that both markets and states will encounter issues of information incompleteness, coordination and governance, and thereby fail to function well consequently. Moreover, the institutions carry their own lives, and constitute barriers to engage in radical change (Amin, 1999; Scott, 1995; Nelson and Winter, 1982).

In light of the institutional analysis, a number of intermediary institutions could allow richer historical study of the industrial development in a particular locality (Piore and Sabel, 1984; Saxenian, 1994). Among these meso-level institutions, the community is usually referred to as the alternative but complementary mode of organization, and mediates between the seemingly polarized position between state regulation and market rule. As argued by Storper (2004), the particular local and national forms of social organization in which social actors' daily lives are embedded underpin the supposedly transparent and anonymous forces of markets and state in modern society. In turn, the latter two forces shape the particularity of the social organization and interaction within the community.

In the case of financial services, the formation of the community will be heavily affected by the state action and market shaping, and vice versa. In a late-developing country such as Taiwan, the financial market was strictly regulated in the early stage

and has been forced to loosen the controls gradually. What are the forces behind the liberalization process? Furthermore, what kinds of institutions will play a role to work with the state and market to govern the new system? Moreover, as technology transfer literature has demonstrated the particularity of the latecomer context in industrial development (Amsden, 1989), does the late development situation apply to the financial industry in the construction of the market? If so, are there any differences for the development of the professional community in the local context? All of these questions will be tackled in this research, based on a case study of the creation of Taiwan's futures trading sector.

In the next section, a methodology will be provided first. Following that will be a section to briefly discuss the relation between the developmental state and financial repression before the liberalization policy in the late 1980s. Then, we will detail the development of the futures market in Taiwan. A number of particularities will be raised to illustrate the role of the state in the shaping of the market and the professional community. After the historical review, the social networks and product innovation of the community will be discussed. It will focus on the three domains of social networks in the decoding of financial information in the context of Taiwan's futures market. Finally, a short conclusion relates the Taiwan example with current financial geography literature that will conclude the paper.

## METHODOLOGY

This paper is based on the findings of a research project, which started in May, 2004. The project examined the social and professional networks of the futures trading industry. In the research process, we conducted interviews with general managers of all twenty-eight futures trading companies in Taiwan, selected from a member list of the Taiwan Futures Company Association, the major industrial association. In addition, representatives of key government agencies, business organizations and other social groups in the futures industry and related financial sectors such as securities and banking were also consulted. In the beginning of the research, we proposed a temporary hypothesis about the relation between state policy and the evolution of the futures trading community in Taiwan's newly emerging market. Under that framework, we developed a semi-structured set of questions for our interviews (see Appendix). The interim framework allowed us to focus on the research topic, and at the same time, to expose us to feedback on our original hypotheses from the empirical world. As we gathered more information, we sharpened our points and raised more critical issues in the interviews. In the corporate interviews, in particular, we were cautious to double-check each interview's results with cross-references. These interviews typically lasted at least one hour. After each interview, we discussed the findings, encoded the information, and tried to challenge each other's viewpoints.

In addition to in-depth interviews, government publications, business surveys

and journal reports provided materials for this research. However, in order to avoid turning the research into a collection of business anecdotes, we have been particularly careful in drawing conclusions from these reports. We double-checked with the relevant people or agencies before we made final judgments.

## FROM FINANCIAL DEPRESSION TO FINANCIAL DEREGULATION?

In the developmental state of Taiwan, the then ruling party, the KMT (Kuomintang), manipulated the financial resources as a key tool to leverage strategic industries. Financial policy was very conservative under KMT rule due to its failed experience in Mainland China before it was defeated by the Communist Party in 1949. Because of attributing the failure partly to financial disorder, the KMT tightly controlled the development of financial activities in Taiwan (Cheng, 1990). Three points, particularly relevant to the futures trading industry, characterized the financial repression in Taiwan before the liberalization policy began in the late 1980s.

First, financial activities played an ambivalent role for economic development since the state started industrialization in the 1960s. On the one hand, the state used financial resources to target key industrial sectors, as the developmental state theory demonstrated. Finance played a supporting role for national industrial policy. On the other hand, the state had to tame the financial beast to weaken its subverting potential by controlling its full fluidity. Private companies were not allowed to get foreign loans directly, and had to consult with the state-owned banks. The penetration of foreign capital was strictly limited within some financial areas, and foreign exchange rates were set and manipulated by the government (Wang, 1996).

Second, the banking system controlling credit allocation was the pillar in Taiwan's financial system before the late 1980s. State-owned banks picked their clients not based on the level of interest rates, but on policy discretion. More importantly, as securities and foreign exchange markets were strictly manipulated not to disturb financial stability, most of the funding for the private sectors came from banking loans, rather than from the capital market (Chu, 1999; Wu, 1993).

Finally, the weakness of the capital market led households to choose bank savings as the most convenient channel to invest, even though the official interest rates were undervalued (Wu, 1993). As the banking system could not absorb the amount of capital accumulated in the process of economic development, a number of illegal financial mechanisms were created to "solve" the problem of over-accumulation.

However, things changed gradually after the economic liberalization policy in the late 1980s (Selya, 1993). On the one hand, economic restructuring started to push the majority of Taiwanese labor-intensive sectors, such as plastics, footwear, and textile industries, to move out of Taiwan to search for cheaper labor. Information Technology (IT) industries became the propelling sector, and started to take advantage of the boom in domestic savings in the capital market to raise their funding.

Prices on the stock market skyrocketed, and overheated in the 1990s. On the other hand, pressure from the U.S. government to open markets in the financial sector forced Taiwan to change its policies on foreign exchange and regulation. In addition, the pressure of deregulation in the 1980s also came from key business groups, which were excluded from setting up commercial banks and gradually grew up to penetrate the financial sector in the late 1980s (Lin, 2001).

In 1994, the state proposed a major project, for an "Asian Pacific Operation Center", in response to pressures from both domestic and international sides. A Financial Center plan was included in the Project. It aimed to loosen regulations of the banking system to allow the emergence of big private banks, and promoted the operation of a "sound" capital market to channel capital into profitable investment. In particular, the core issue for the financial center project was to transform the old banking-dominated system to a capital-market dominated one, and focused on the development of derivatives, foreign exchange, and stock markets (Yeh, 1997). Financial deregulation in the early 1990s led to a boom in the capital market. Around mid-1997, Taiwan's stock market ranked sixth in average trading volume and fifteenth in terms of overall capitalization in the world (Yang, 1999).

In appearance the change was quite dramatic and raises the following questions. How did the developmental state let its major tool, credit allocation through the banking system, break down without protection? In fact, in response to the neo-liberal challenge, the state chose a sequence of financial liberalization that put priority on deregulating the domestic capital market over foreign participation. Despite the trend toward global financial integration, the state has been cautious to permit the full internationalization of local currency, and controlled the volatility of cross-border movement of short-term capital (Chu, 1998). Even the QFIIs (Qualified Foreign Institutional Investors) were allowed to enter the local capital market, only in an incremental way. The state put a ceiling on the percent of stock held by the QFIIs in each local company's capital value from 5 percent in 1991 to 15 percent in 1998. QFIIs were not allowed to purchase more than 50 percent of any local company's value by local capital until late 1999. In the adjustment process, small increments were usually increased by the state on the ceiling every two months. The process of financial deregulation in Taiwan was characterized by Chu (1998) as "dragged and incremental".

The reasons behind the conservative policy came from the contradiction between financial stability and financial liberalization. The state tried to balance the two contradictory demands and led to a catch-22 situation. Concerns for stability have become keen as Taiwan is diplomatically isolated from the international community, and in a situation of political and military confrontation with mainland China. These concerns caused the government to watch the capital flows warily, since "unlike Thailand, South Korea, Indonesia and the rest of the reckless tigers, Taiwan knew that it could not afford to go bust. As a diplomatic pariah, it was banished from virtually all important international organizations, including the IMF. If it got

into trouble, it could not hope for a bail-out. Indeed, it worried that in the event of a domestic economic crisis, China might just invade it.” (Anderson, 1998)

In other words, the state's long-standing policy guideline for financial management since the KMT regime retreated to Taiwan in 1949 has been characterized by its overriding concern for financial stability. However, the attitude of the financial sector has shifted from being a willing tool for the goals of industrialization in the era of the developmental state before the 1980s, to liberalizing the sector to grow in response to neo-liberal hegemony. The contradiction between the institutional dependency path for stability and the institutional change for growth constituted the core issue in the emergence of the capital market. Without doubt, the dilemma also appeared in the decision to establish the futures trading industry, the highly risky and abstract capital market.

## RELUCTANT STATE AND DECENTRALIZED MARKET

### *Offshore first, then inshore*

The burgeoning of Taiwan's futures market could be tracked to the “underground” futures trades undertaken by a number of business groups from Hong Kong in the early 1970s (Lin, 1991). It was not legal at that time, as the government regarded it as gambling and did not allow it to disturb financial stability. Cumulated household savings aggravated the money game and stimulated the growth of the underground market in the late 1980s. The underground dealing companies were generally criticized as bucket shops, not sending clients' orders to foreign exchange, parcelling clients' money, and running away in case they lost money (Li, 1982). The Taiwan government had twice (1983 and 1996) raided these futures companies, but failed to wipe them out. Even though the legal FCM (Futures Commission Merchants) or IB (Introducing Brokers) are widespread today, the underground futures companies reportedly never perished, as reported in (Yang, 2003). There were over 350 underground traders and more than NT\$ 40 billion per day trade volume at the peak (Lin, 1988). It was not until the early 1990s that the government decided to legalize the futures trading industry (FTI).

A legislative decision for a futures market was proposed to deal with staple commodities price instability caused by international currency fluctuations, and futures trade was suggested by several key commodity exporters to hedge the risk in the late 1980s. Moreover, from then on, Taiwan's economy faced the pressure of industrial restructuring, and the service industry, including financial services, has become critical for economic development. In addition, the trading volume of the stock market continuously expanded and sometimes fluctuated fiercely, which implied the increasing needs of investment diversification and hedging. Finally the government passed the law in 1993, and the first futures brokerage company, Grand Cathay



Futures Corp, was established in 1994.

However, the legacy of the underground companies for the futures industry was unexpectedly significant in two perspectives. On the one hand, these underground companies served as a training school for many of the key managers of the “legal” trading companies in later stages. Most of the “underground” ex-employees accumulated their brokerage experiences and mastered the skills, as well as languages, of operation at that time. Once the industry was institutionalized, they were recruited as the first seed employees, and soon were promoted to the manager ranks. In a sense, the underground companies trained the troops and paved the way for the later legal ones.

On the other hand, the fraudulent practices of the underground period left a scar in the minds of the general public, and impinged on the government’s policy making. In fact, in 2005 underground traders still existed in Taiwan, as they took advantage of low brokerage fees and margins. To avoid fueling the money game, the government adopts a gradualist approach to financial deregulation. Rather than pushing the market growth hard, the government loosened financial control step by step. It basically reacted to solve the issue of underground futures as a social problem, without a clear intention to take the futures market as a key piece in constructing a sound financial system. Under such circumstances, the futures markets were legalized in two steps: at first, offshore futures contracts, such as those launched by the Chicago and Singapore markets, were permitted to be traded by passing the “Offshore Futures Transaction Law” in 1994. After three years, an inshore trading market, the Taiwan Futures Exchange Corp. (TAIFEX) was established in 1997, and eventually in July, 1998 the first local futures contract designed by TAIFEX was launched.

The legislative process was not without debate. Establishing the FTI was taken as part of the project of setting up the regional financial center in Taipei. A hot debate about the sequence of opening either offshore or domestic markets first occurred in the legislative process. The government finally opened the offshore transactions first as the underground traders had engaged in such business for a long time and it would be easier to legalize such transactions. If the policy were to prioritize the domestic market, which would be beneficial for a long-term, sound financial system, it would take a longer time to pass the law and might trigger speculation (Zan, 1993). To obtain permission for the offshore transactions, the capital requirement for establishing a brokerage house was set at NT\$200 million (equivalent to US\$7 million), much higher than required in the U.S., which requires only US\$250 thousand. This was the logic behind the government’s reluctant internationalization policy: to control the volatility of cross-border movement of short-term capital and hinder the full penetration of local financial activities by foreign capital.

However, the initiatives were challenged by lawmakers who represented a number of key business groups. Among the disputes, the issue of whether to allow the same business group to engage in both stock dealing and futures dealing was raised.

According to the government's plan, the two were not permitted to merge together in order to avoid the growth of securities houses beyond governmental control. But, as the securities business groups gathered together to fight, the government made slight adjustments in the initiatives to allow the securities houses to spin off formally independent futures shops. "By doing so, a firewall could be raised to prevent illegal dealings to occur for the financial business" argued Lin Zong-yong, the then Vice-Chair of the Committee of Securities Management, who was in charge of establishment of the FTI. The government was indeed cautious towards the opening of the seemingly speculative business, and tried setting up barriers to the merging of financial businesses to avoid the prospect of disturbing financial order.

In addition to the restrictions on market area and starting capital, the law also closely regulated the kinds of transactions and contracting procedures. Only those clearly stated in the law would be allowed; otherwise, a penalty would be imposed. In the words of Mr. W, the Chair of the Futures Association, "the aim of the government in the futures trade law is to prevent abuse, rather than to promote the industry. The bureaucrats do not take the industry as a necessary element for the capital market to grow healthily, but as a trap of speculation. Even as they are forced to open the market, they hesitate to comply with the liberalization doctrine."

No matter to what extent the policy design came true, two positive effects were certain for the development of the futures trading market in Taiwan. One effect was the change of the public image of futures trading; at least, it was no longer exclusively illegal or fraudulent and could be a normal channel of investment. Among others, those newly established trading companies were especially hard to do propaganda. The other effect was the creation of a professional association, the Taipei Futures Trader Industrial Association, for the futures industry. In order to control industrial development, it was stipulated that all of the futures houses had to join the association. It represents the collective interest and engages in promotion of the industry.

Nevertheless, the most significant development in the futures market has been the establishment and growth of the local exchange market. After permitting the foreign futures transactions, the government started to draft the law to set up a local trade market. Meanwhile, two events pushed the government to speed up the legislative process. First, that CME (Chicago Mercantile Exchange) and SIMEX (Singapore International Monetary Exchange) was planning to launch a Taiwan Stock Index Futures in late 1996 caused Taiwan authorities' concerns that local exchange might lose the supposedly advantaged local product. Secondly, an idea for a "Pacific Asian Regional Operation Center" was proposed by the government to situate Taiwan in the global economic system. It argued that in order to attract foreign investment and push the domestic financial market and institutions to be international, the government should head toward deregulation and liberalization. A local futures market was seen as one of the symbols of a competitive financial system. Besides, the newly founded Futures Traders Association lobbied heavily with the opposition party legislators, and forced the government to accelerate the legislative process. Under these

circumstances, the Futures Trading Law, which mainly covered the establishment of the local futures exchange market, was passed in 1998. Under the law, a locally launched product, the Taiwan Securities Exchange Capitalization Weighted Index (TAIEX), became a major target in the local market.

After the opening of the local market, the trading volume at the Taiwan Futures Exchange has risen exponentially (Figure 1); the leap is mainly attributed to the TAIEX options contract as well as the TAIEX futures contract. As a result of such growth, the Taiwan Futures Exchange joined the top 20 world derivatives exchanges by volume for the first time in the first quarter of 2004 (DeGrandis, 2004). Among all kinds of products, over 99 percent of trading volume comes from stock-related items though two interest-based products have been issued in 2004 (Table 1). Such domination of stock-based products reflects one of the major characteristics of Taiwan's economy: in contrast with restrained exchange and inactive interest market, the bustling stock market makes stock indexes be the most viable and potentially profitable underlying assets of derivatives.

Table 1: Trading volume of each contract in TAIFEX.

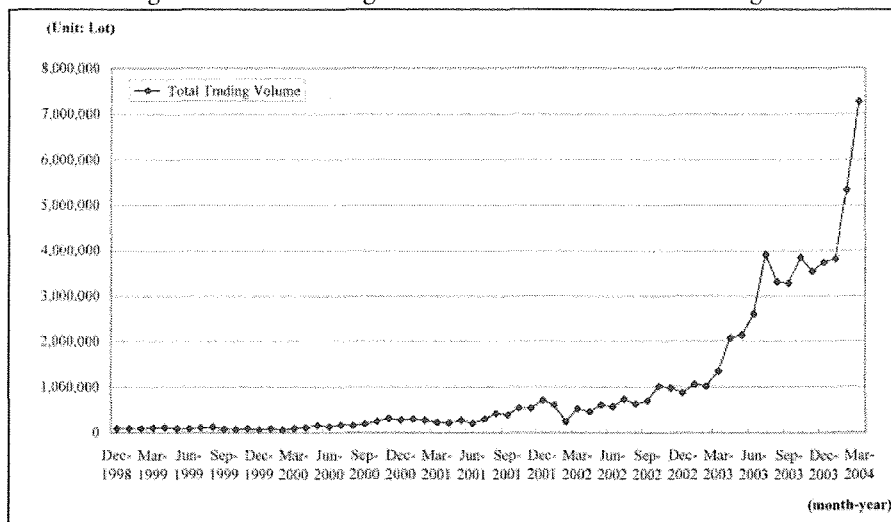
Total Trading Volume (Lot)	1999	2000	2001	2002	2003	2004
<b>Futures Contracts</b>						
TAIEX Futures (TX)	971,578	1,339,908	2,844,709	4,132,040	6,514,691	8,861,278
Taiwan Stock Exchange Electronic Sector Index Futures (TE)	87,156	409,706	684,862	834,920	990,752	1,568,391
Taiwan Stock Exchange Banking and Insurance Sector Index Futures (TF)	18,938	177,175	389,538	366,790	1,126,895	2,255,478
Mini-TAIEX Futures (MTX)	NA	NA	427,144	1,044,058	1,316,712	1,943,269
Taiwan 50 Futures (T5F)	NA	NA	NA	NA	4,068	6,157
10 Year Government Bond Futures (GBF)	NA	NA	NA	NA	NA	67,705
Commercial Paper Futures (CPF)	NA	NA	NA	NA	NA	209,561
TAIEX Options (TXO)	NA	NA	5,137	1,566,446	21,720,083	43,824,511
Equity Options (STO)	NA	NA	NA	NA	201,733	410,026
Total	1,077,672	1,926,728	4,351,390	7,944,254	31,874,934	59,146,376

Source: TAIFEX, [http://www.taifex.com.tw/eng/eng\\_home.htm](http://www.taifex.com.tw/eng/eng_home.htm).

\*NA: No data, because contract was not launched yet in that year).

\*\*The underlying index of both TX and MTX is Taiwan Stock Exchange Capitalization Weighted Stock Index (TAIEX). The TX is 4 times the contract size of the MTX.

Figure 1: Total trading volume at Taiwan futures exchange.



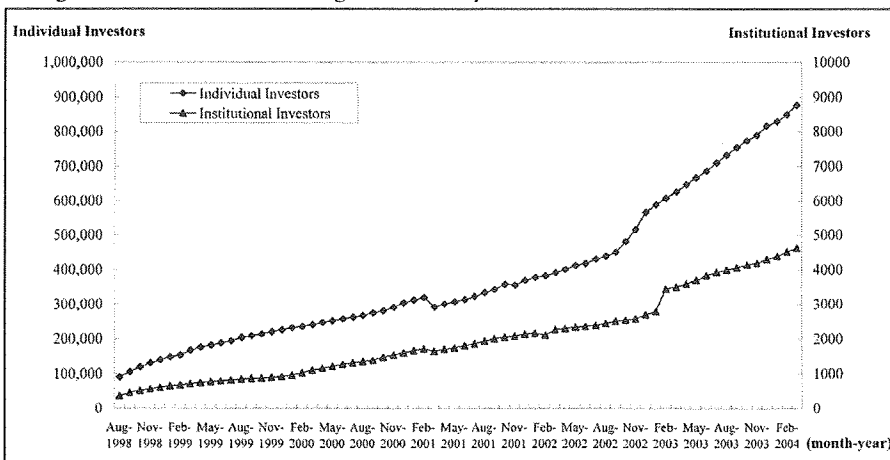
Source: Securities and Futures Bureau, <http://www.sfb.gov.tw/11.htm>.

Consideration of the vigorous stock market influenced the planning and launching of the sequence of derivatives; for the government avoided fueling the overheating stock market by promoting the futures market too hard (Zou, 2002). Taiwan stock market has drawn considerable quantities of individual investors and fund to plunge in; thus the turnover and volatility of local stock market are extremely high in comparison with other countries (Yang, 1999). Furthermore, the authorities may do anything to retrieve stock quakes, for example, by means of tightening daily price fluctuation limits, exempting capital gains from tax, purchasing stocks by governmental fund, etc.; so that discontent among voters and local fractions who possess stocks can be mollified (Wang, 1996). The Securities and Futures Commission was set up to manage the development of these two industries in 1997. The Commission vigilantly launched new commodities and little by little loosened the control of foreign capital's penetration into the local market. As complained by Mr. L1, the president of S Futures, the third largest house in Taiwan, as well as a senior veteran in the industry, "the government never gave the futures industry an equal footing with securities, and took neither of these two industries as symbiotic. The key concern for the Securities and Futures Commission has always been targeted on the development of the stock market, and the futures market next. Every time the Commission decided to launch new commodities in the latter, the first question would be if these would disturb the former."

### Market facts

In light of the wisdom of institutionalism, the market was embedded in the social and political structures; in other words, state policies would shape the organization and practice of market. As shown above, strict rules on institutional investors characterized Taiwan futures trading, so that the state could tame the organized investors safely to repress their pervasive potential. Moreover, once the local futures exchange beginning to work, the main source of trading has quickly come from individual investors who are eager for new investment outlets, which was just like the earlier Taiwan stock market. Up to now individual investors has always accounted for over 50 percent of total trading volume (Figures 2 and 3).

Figure 2: Volume of trading accounts by individual vs. institutional investors.

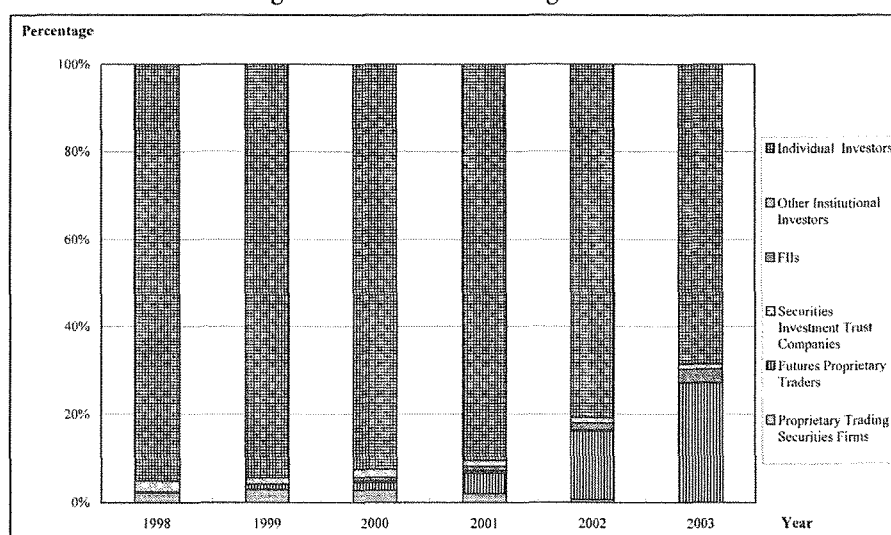


Source: Securities and Futures Bureau, <http://www.sfb.gov.tw/11.htm>.

A market dominated by individual investors heavily influenced the activities and strategies of the futures dealers. Most of the individual investors carried less analytic capability and decision-making power in the market, and usually relied overwhelmingly on the judgments of experts. As argued by Leyshon et al. (1998), the perennial problem which faces all producers of financial services is information asymmetry, that is, providers and consumers of financial products have unequal amounts of information (and knowledge) about whether or not customers have the wherewithal to make them 'capable' purchasers. In the increasingly complex financial world, individual investors are usually regarded as seriously information-handicapped investors, in comparison with the institutional investors who usually carry research and analyst teams that sometimes have it over even futures traders. Additionally, individual investors are also quite sensitive to price, and care most about the cost

of brokerage fees and transaction taxes. As a result, price competition rules over the futures market in Taiwan. In other words, the major group of customers of Taiwan's futures market is short of expertise knowledge and susceptible to price. Therefore, two effects are produced in the individual investors dominated market. Firstly, the futures traders exploit the ICT (information and communication technology), which is often claimed to render financial texts readable and empower individual investors in decision making, to cost down their business operation. As a result, the digitalization of financial services is in vogue in Taiwan. Designing a humanlike trade platform becomes one of the major advantages in Taiwan's futures market. Second, in spite of the ICT being widely utilized in market promotion, "traditional" interpersonal relations still matter in the individual investor dominated market. The trust engendered in the process of other financial transactions, particularly securities and banking, can be helpful for the futures traders to expand their customer bases. Consequently, the IBs (Introducing Brokers), who work in the branches of securities houses but engage in futures dealings with their frequent customers, still play a key but declining role in Taiwan's futures industry.

Figure 3: Sources of trading accounts.



Source: Securities and Futures Bureau, <http://www.sfb.gov.tw/11.htm>

The other characteristic of Taiwan's futures market is that foreign capital plays a relatively insignificant role (Figure 3). The government hesitates to remove the restrictions on the entry of foreign capital: not until October 1999, QFIIs were allowed to invest futures. Further, invest derivatives as QFIIs (Qualified Foreign Institutional Investors) could, they were allowed only to short futures as hedge,

which means they must buy stocks first and then could sell futures. The attitude of xenophobia illustrates the concerns of the government in buffering the local financial market from the incursion of skillful "players" who might jeopardize the stability of the stock and futures markets. Not until very recently (2004) did the Taiwan government approve the newly amended regulations on foreign investors in futures trading.

The ambivalent policies on foreign capital to some extent dissuade foreign investors from embracing Taiwan's market. Even though foreign traders take high interest in the booming market, few of them set up offices in Taiwan. Most of the transactions are conducted by their offices in Hong Kong, ordering contracts through the channels of some specific traders, such as Capital and Grand Cathay. It is generally conceded that the foreign traders, based on their long time accumulated experience, possess better trading skills than the local ones. The expatriate communities formed by the managers and professionals employed in the foreign companies could constitute a key channel of technology transfer to the host society in the financial centers, as shown by Beaverstock and Bostock (2000). As most foreign dealings are conducted "at a distance", the story basically does not apply to the case of Taipei, with the exception that foreign traders sometimes have to dispatch their staff to Taipei for the "market feel". The skilled transient international migrants constitute a small group in the futures trading communities in Taiwan.

## AN UNDER-DEVELOPED COMMUNITY OF PROFESSIONALS

Another key feature, besides the market structure, shaped by state policy has been the communities of futures dealers. So far, three major groups have been identified in the managing cohorts in Taiwan's futures trading industry. The first group is composed of those managers who worked in the underground shops at the early stage and were recruited to the newly established futures houses. Most of them accumulated trading skills from the bucket shops starting with nothing, let alone having degrees in related disciplines. Learning by doing was the key channel of mastering trading skills. "In the beginning, I, as a graduate from agriculture studies, knew nothing about futures. As an underground company, it could not offer the formal course to train new employees. My then boss, who was from Hong Kong and has been in the business for more than 10 years, took me directly to the trading place just after a short course. I spent time in accumulating trading experiences and interacted closely with my customers and supervisor. It took me two years to master the variety of skills in handling different positions." Mr. L, the president of H Futures, recalled his early experience. As first movers, they were mostly promoted to high ranking positions in the newly legalized futures trading companies.

The second group came from those who participated in other financial service industries, particularly securities, before they transferred to the futures sector. These

experienced financial operators usually took advantage of the combination of varieties of financial tools in running the futures business. Most of them were employed by the newly established financial holding companies, and could utilize their social relations to persuade customers from other financial fields to join the futures market. They built up their competitive edge in the business by exploiting their widespread social networks within the futures industry and extending to other financial business at the entry stage. Accumulating knowledge about the stock market, they were usually quick to get particularly familiar with the trading skills in futures options. Based on existent skills, they had to be sensitive about the differences between these two seemingly overlapping businesses. As stressed by Mr. C, the president of W Futures, "The requirement of professionalism is higher in the futures industry than in securities. When I was in the latter, what I needed to do was to establish relations with my customers, but in the futures business, I have to do research in trade model building and strategy setting. Otherwise, I will be eliminated through competition."

Besides the top managers, the makeup of the operating group was mainly the salespersons in the front counter, or the IBs in the securities houses. The securities sector has been better developed in Taiwan, and has penetrated each household economy. It serves as the capillary attraction of capital flow, and constitutes one of the major channels of managing household finance. Most of the key financial groups have their securities branches around the island. For the futures sector in the same group, these amount to the could-not-be-better sales points. As an example, take the case of company F group, the current number four market sharer. The F Securities possessed sixty-four branches, in contrast to only one of the F Futures. Thus, the latter provided a series of on-the-job training, and incentive mechanisms to mobilize the salespersons of the former to expand its market share. According to Mr. J, the president of F Futures, "The interpersonal trust fabricated between the IBs and their customers from the securities business could be transferred to the futures business."

The third group, relatively small, comprised the ex-employees of the foreign companies in Taiwan or abroad. Among them, Chair W of the Futures Industry Association and Mr. L1 of S Futures were exemplar. Mr. L1 worked in Merrill Lynch (Taiwan) before hopping to local companies, and Mr. W was a long-time futures brokerage manager in Chicago before being recruited back to run the local company, and become the Chair of the Futures Association. Since the activities of foreign capital were confined, these veterans of foreign companies were the key channels for transferring new products and operation techniques, such as hedging skills, back to Taiwan.

The institutionalization of the communities was the formation of the Taiwan Futures Company Association. As the membership was obligatory by law, the Association became the key agent of collective interest and identity. Through the participation of the social and professional activities sponsored by the association, these three groups of managers maintained and enhanced dense social networks.



More important, the monthly meeting provided a forum for members to settle disputes and reach consensus. The association could play the role of collective agent to lobby for favorable policies in the legislative process (Liu, 1996).

Overall, the communities of professionals in Taiwan's futures industry were dominated by locally trained groups spun off from other financial businesses, mainly securities, with a few returnees equipped with foreign experience and skills. As most of the transactions were based on cost considerations, the expertise of the futures dealers was to master techniques borrowed from other countries, such as South Korea, and to exploit the advantages of networking extending from other financial businesses. Under these circumstances, it was the extent of social networks, rather than the sophistication of trading skills, that was critical in the business. In other words, reluctant state policies led to a decentralized market structure, which further shaped an under-developed professional community in Taiwan's futures trading industry.

## CONCLUSION

While financial liberalization is praised by neo-liberalists and criticized by political economists, its process has not been thoroughly examined in most studies. The establishment of Taiwan's futures market provided a case to show how a developmental state adopted policies to meet the liberalization challenge, and at the same time, maneuvered to maintain stability. Against the neo-liberalist argument that the liberalization policy demonstrated the death of the state in managing financial flow, Taiwan's case argued that the state could arrange the sequence of liberalization to balance the deregulation mandate and financial order. The case also refuted the discourse of the developmental state which identified the bureaucratic plan as the key drive behind the financial transformation, since dragged and reactive responses characterized the main theme of the state policy. In the process of forced liberalization, a market dominated by individual investors and little foreign capital participation was created. The market was characterized as decentralized and price sensitive to service charges, and at the same time, required brokers to bridge the knowledge gap for individual investors, rather than institutional ones, in complex financial transactions. Under such circumstances, it was the extent of social networks, rather than the sophistication of trading skills, that was critical in the business. In other words, reluctant state policies led to a decentralized market structure, which further shaped an under-developed professional community in Taiwan's futures trading industry.

As Storper (1997) argued, institutions consist of persistent and connected sets of rules, formal and informal, that prescribe behavioral roles, constrain activities and shape expectations. Institutions provide a cognitive structure to legitimize collective action, and tend to evolve incrementally in a self-reproducing and continuity-preserving way (North, 1990). At the same time, institutions are the products of

historically-situated interactions, conflicts, and negotiations among different socio-economic actors and groups (Martin, 2000). Thus, institutional breakthrough could occur in the course of political struggle among the asymmetrically powerful agents.

The dialectic of path dependency and path breakthrough indicates ways to disentangle the deadlock of state-market antitheses. Following the theoretical thread, the liberalization of the financial system in the developmental state can be understood as a process of the state's will to adjust in the new historical conjuncture set by neo-liberalist hegemony. Simultaneously, it wants to keep policy priority on control of financial resources to avoid damage caused by the abrupt de-regulation process. It is a process of institutional learning, as well as institutional resistance.

Moreover, institutional evolution unfolds in different ways at various geographical scales, and constitutes the pillar of the particularity of each locality (MacLeod, 2001). Martin (2000) added that the evolution of particular institutional architectures would give rise to distinctive local, regional and nationally instituted "configurations of capitalism". Hayter (2004) furthermore argued that path dependent sectoral, regional or corporate trajectories were neither predetermined nor 'random walks'. Institutional evolution matters in different ways in different places. To claim financial liberalization as universalism, in a sense, is misplaced. In contrast, identifying and scrutinizing the social agents which interact with each other and their situated institutional endowments in the process of financial deregulation in specific cases could be stimulating in the study of financial geography (Clark et al., 2002).

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## NOTES

1. "Community" is widely referred to as the networks of social interaction among social agents with specific identities or collective emotion (Bauman 2001). They are bound by relations of common interest, purpose, or passion, and held together by routines and varying degrees of mutuality.
2. Interview with Mr. W, July 21, 2004
3. Interview with Mr. J.1, July 9, 2004.
4. Interview with Mr. L, July 9, 2004
5. Interview with Mr. C, July 14, 2004

6. Interview with Mr. J, July 15, 2004.

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## APPENDIX: INTERVIEW QUESTIONS

### *Personal background*

1. Please describe your education level, and explain why you choose the futures industry as your job.
2. What kind of business you are engaging in now? Please specify any special organizational configurations of futures companies you have worked for in your career.

### *Industry environment and business characteristics*

1. What kinds of product innovation or modification are of the most significance?

Please describe the importance of the innovation for the companies you worked for.

2. How do you search for and contact with the clients, and then evaluate and control the potential risks? How does your company differentiate from others in the risk-avoiding strategies?
3. What measures do you adopt to coordinate the operations between the main office and the branch offices? Do you have set branch office to satisfy the special demands of different customers? If yes, please specify it.
4. In your company, how many employees have overseas working experience or have worked for foreign companies?
5. Does your company engage in collaborative projects, such as collective training program, cooperative product development, or the development of new transaction platform, with other, local and foreign, companies?
6. Does your company regularly consult with other supporting companies, such as software companies? How often?
7. How does your company recruit the employees? How high is the turnover rate? How do you respond to it?
8. What institutions involve in the process of new product development? What roles played by the governing bodies, such as the public agencies and the industrial associations?
9. Please assess the impact of the legalization of the futures business on the development of your company in particular and the business in general.
10. Does your company subscribe to any professional magazine or database? Please specify them.
11. Please assess the strength and weakness of the development of the futures industries in Taiwan.