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RESTORING INTERNATIONAL BALANCE: THE TAIWAN ECONOMY AND INTERNATIONAL TRADE

A STAFF STUDY

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NOVEMBER 2, 1987

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JOINT ECONOMIC COMMITTEE

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LETTER OF TRANSMITTAL

OCTOBER 30, 1987.

To the Members of the Joint Economic Committee:

I am pleased to transmit to you the first in a series of studies by Joint Economic Committee staff members which focus on the trade surplus phenomenon, and the problems which today's unprecedented trade surpluses pose for the world trading system and, over time, for the countries that hold them.

The decision to undertake these studies reflects the Committee's concern that the huge and growing imbalances in international trade flows today constitute a serious threat to the health of the world economy. Some countries, particularly the United States, are posting unprecedented trade and current account deficits. Others, notably Japan, West Germany, Taiwan and Korea, are running up trade and current account surpluses of comparable significance. Over the long run these imbalances cannot be sustained. The longer they continue, the greater the danger that markets will impose a correction in the form of a sharp and wrenching world recession.

Much of the discussion of world trade imbalances has focused on the adjustment tasks facing deficit countries. The Joint Economic Committee has contributed to the discussion, most recently with the August 1987 study, "The Legacy of Foreign Debt," and in a number of earlier studies and reports. As the world's largest debtor nation the United States has been the focus of much of this discussion, and it is clear that decisive changes are needed in the mix of U.S. policies to increase the ability of U.S. producers to compete abroad and to reduce the heavy flow of imports at home. This study is in no way intended to minimize the gravity of the U.S. trade deficit, or to minimize the complexity of the challenge we face in attempting to reduce the deficit.

However, the task of reducing global imbalances does not rest exclusively with the world's deficit countries. A more balanced international trading system will also require policy modifications on the part of countries with large trade and current account surpluses. While from the perspective of an individual country surpluses may seem desirable, the benefits will continue to accrue only in the short term. When large surpluses—and deficits—persist in the world trading system, they pose a serious threat to the functioning of the system itself. In the long term, it is on the successful functioning of this system that the prosperity of all trading nations depends.

This and future JEC studies of the world's major surplus economies are designed to explore the causes of surplus and the policy alternatives for addressing them. They start from a premise that sharp recession in any country is a costly and undesirable solution to the problem of imbalance, for surplus and deficit nations alike. Their purpose is to provide a better understanding of the surplus phenomenon and thereby contribute to a framework for international economic policymaking capable of assuring orderly reductions in world trading imbalances and minimizing the risk of world recession.

The sources of surplus are rooted in particular institutions and practices which vary from economy to economy, and therefore these studies are organized on a case-by-case basis. The first in the series focuses on Taiwan, the trading nation with the highest ratio of current account surplus to GNP. Subsequent studies will explore the other major surplus countries: West Germany, Japan and Korea. The series is a collaborative effort among the international economists of the Committee staff who extensively review each study prior to release. This first study was written by Dr. Stephen Quick, Chief Economist on the staff of the Joint Economic Committee, following a recent visit to Taiwan.

It is my hope that this and subsequent studies will prove useful to you in analyzing the changes taking place in the world economy.

Sincerely,

PAUL S. SARBANES,
Chairman.

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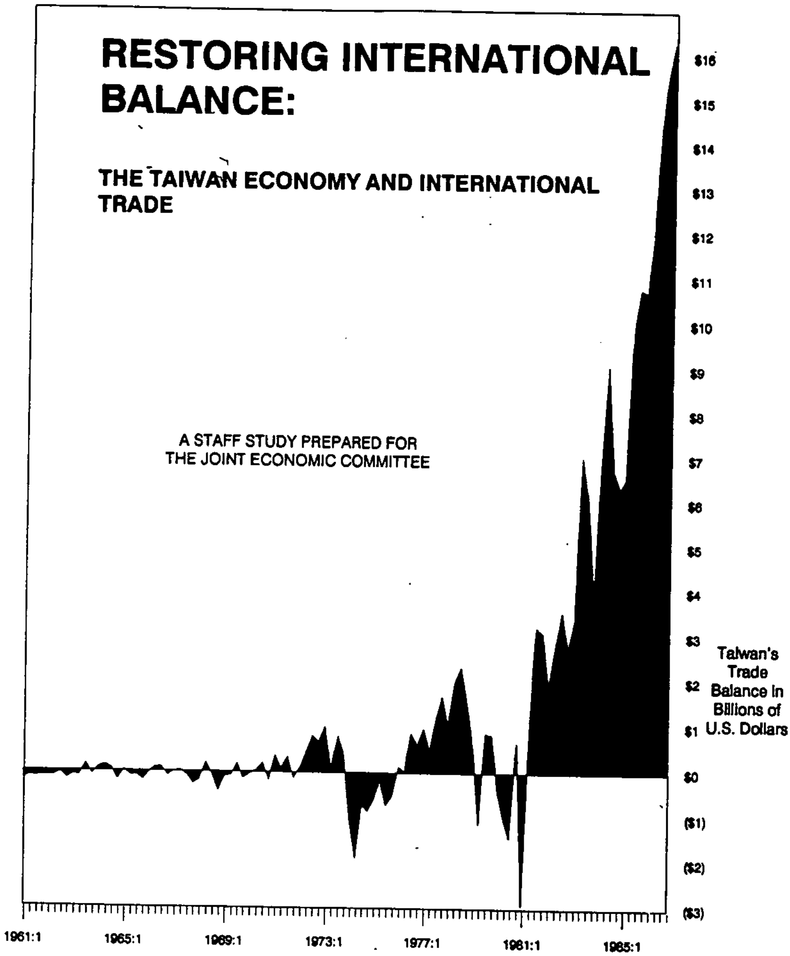


RESTORING INTERNATIONAL BALANCE: THE TAIWAN ECONOMY AND INTERNATIONAL TRADE

INTRODUCTION

Taiwan plays a role in the world economy far out of proportion to its geographic size and population. With only 19 million people, the island produces some $40 billion in exports each year, more than are produced by Mexico, Brazil, or India. It produces an annual current account surplus of over 20 percent of GNP, a ratio more than four times that of Japan and Germany, the other great surplus countries of the current era. Taiwan's central bank has the second largest foreign exchange reserves in the world, some 68 billion U.S. dollars.

This study will attempt to give an overview of the recent economic development of Taiwan, focusing particularly on the problems created by its recent success in generating export surpluses. These surpluses cannot be sustained indefinitely, and adjustment of the Taiwanese economy is inevitable.

This study will look at the adjustment problem facing Taiwan from two perspectives; first, the changes which will be necessary from Taiwan's perspective in order for the island to maintain growth while de-emphasizing export surpluses as a growth engine; second, the changes needed in Taiwanese policy in order to assure strong and positive U.S.-Taiwanese trade relations. Pursuit of these positive adjustment strategies should be a major goal of both Taiwanese policy and U.S. policy toward Taiwan.

THE ROOTS OF THE PROBLEM: TAIWAN'S DEVELOPMENT STRATEGY

The island of Taiwan, some 36,000 square kilometers in area, located only 90 miles from mainland China, was a remote agricultural province until 1895, when it became a colony of Japan. In 1949, some two million supporters of the nationalist Kuomintang party (KMT) came from the mainland after a civil war with the Communist Party. The KMT established governance over the six million "islanders" (Taiwanese) and the two million "mainlanders" and were faced with the task of creating a strong economic base to support the new regime.

The new rulers found that the island possessed a relatively poor, underdeveloped agricultural economy, few natural resources, and a large population of recent immigrants. Rapid modernization of this economy was seen as essential both to protect the KMT from mainland attack and to acquire the economic substructure which would enhance the viability of the island's economy.

National Security and National Development

In the early years, Taiwan's development strategy was dominated by concerns for national security. Military and economic assistance from the United States accounted for a large part of the government budget, and "import-substituting industrialization" was adopted to promote self-sufficiency in critical areas.

Given this national security orientation, the government played a critical role in the evolution of the Taiwanese economy. In part because of martial law, the state had virtually unlimited command powers over the economy, and the KMT was not hesitant to use its powers to shape the nation's economic future. Land reform was forced on a reluctant agricultural elite, high taxes were imposed to support the military, and a large number of government enterprises were established in critical sectors of the economy. Banks were government-owned or controlled, and the electric power and petroleum industries were government monopolies, as was the telecommunications system.

Exchange controls were also part of the national security/national development policy of the KMT. Fearful that the mainland would engage in "economic sabotage" through currency manipulation or counterfeit, the government pegged the value of the New Taiwan (NT) dollar to the U.S. dollar, and then created a set of exchange control regulations which effectively prohibited the use of conversion of the NT dollar off of the island. Under the exchange control regime, residents were allowed to earn foreign exchange, but not to hold it. All foreign currencies earned by Taiwanese residents were required to be converted into NT dollars, leaving the central bank in effective control of all foreign exchange assets on the island.

By the end of the 1950's, the KMT was secure enough to permit a lively debate on the island about the future course of the nation's economic development. Two schools of thought dominated this debate. The first urged Taiwan to follow the import-substituting heavy industrialization strategy being pursued in India and parts of Latin America. This strategy required substantial government trade protection for uncompetitive heavy industry, along with heavy government subsidies for capital formation. In the Taiwanese context, capital-intensive heavy industry was seen as a mechanism further strengthening the economic autonomy of the island and lessening the dangers of future blockade by the mainland.

The second school urged Taiwan to adopt a policy of export-oriented light industry to exploit Taiwan's comparative advantage in both the cost and quality of its labor. This strategy required Taiwanese industry to be more aware of international market opportunities and more responsive to international price signals, but also increased the risk of economic disruption should trade to the island be interrupted by hostile action.

Three factors helped persuade the KMT to adopt the export-promoting rather than import-substituting growth strategy. First, the limited size of the domestic Taiwanese market (15 million people in 1960) and the low level of per capita income presented some economic obstacles to a complete import-substitution strategy. Second, the local business community on Taiwan, unlike its counterparts in Latin America and India, was somewhat removed from the center of political power. Most businessmen were native Taiwanese, while most government officials were mainlanders. The natural constituency for government protection and subsidization was therefore less influential in the Taiwanese case. Third, geopolitical realities suggested that Taiwan's ultimate security depended more upon allies among the worlds major nations than on the ability of this small island to "go it alone." The sensitivity to foreign realities which was an essential element in an export-oriented strategy served the government's diplomatic and strategic needs better than an inward-turning policy of import substitution.

"Everything for Export"

Once the decision was made to orient the Taiwanese economy toward light industry and export, the KMT moved aggressively to pursue this objective. The NT dollar was pegged to the U.S. dollar at a rate of 40:1 in 1961, a highly competitive level which made Taiwanese exports very attractive to U.S. markets while limiting the range of goods which could profitably be imported to the island.

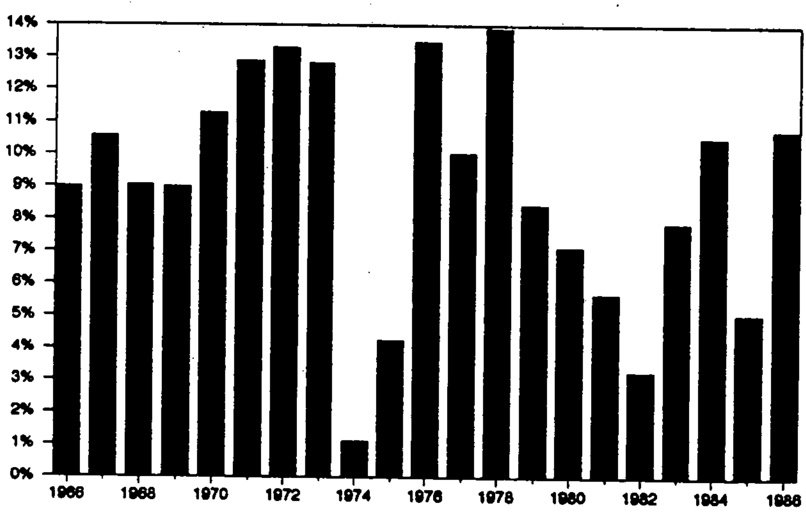
In addition to the exchange rate, the island's business community was provided with a generous set of incentives to shift their focus from domestic to export production. Government-controlled banks made loans readily available for export industries, tariff policy was used selectively to limit import of consumer goods while granting essentially duty-free status for machinery and intermediate goods to be used in export expansion, and the tax system was biased toward exporting industries. Government tax credits, subsidies, and preferential utility rates gave exporting firms assistance which totaled some 20–25 percent of total value added in export industries.

Exchange controls helped ensure an adequate pool of local savings, and the government undertook directly most of the domestic investment and infrastructure projects which were needed to build the domestic base for export expansion. The slogan that guided government policy during the 1960's and 1970's was "Everything for Export."

As Figure 1 demonstrates, "Everything for Export" turned out to be an effective development strategy for the island. Taiwan's GDP expanded by an average of 8.2 percent per year during the 1950's, 9.1 percent per year during the 1960's, and 10.1 percent per year during the 1970's. The overwhelming source of this strong growth was export demand. Since 1961, exports have grown at a rate more than four times faster than that of GDP, and in a number of recent years, export growth has accounted for more than 60 percent of total growth in the island's GDP.

FIGURE 1

ANNUAL GROWTH RATES FOR REAL GDP

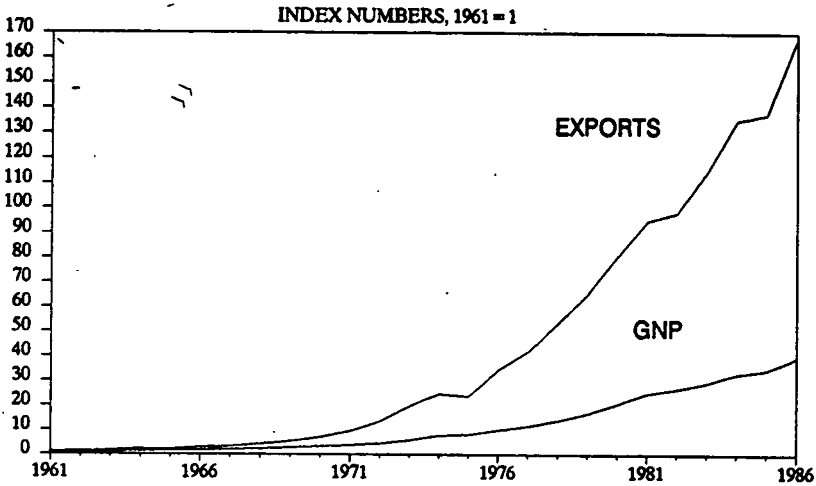


Furthermore, as Figure 2 suggests, this export orientation was not merely the product of an early stage of Taiwan's development. Exports as a share of GNP have continued to rise throughout the 1980's, and the island's economy is more dependent than ever on foreign trade to maintain its economic growth momentum.

FIGURE 2

GROWTH IN GNP AND EXPORTS

INDEX NUMBERS, 1961 = 1



Taiwan's external success has not been incompatible with rising domestic prosperity, a problem often encountered in other export-oriented economies. An important reason for this has been the government's commitment to domestic economic policies which mitigate economic disparities. While other export-oriented economies have been forced to contend with rising internal unrest, the Taiwanese political structure thus far has been remarkably stable. Edwin A. Winkler of Columbia University's East Asian Institute explains why:

> Taiwan has combined rapid economic growth with increasing economic equality, a widely noted exception to the general experience that distribution gets worse before it gets better in the course of development. "Basic needs" have long since been met. Not only current income but also asset ownership has been widely dispersed, at least until recently. By redistributing rural assets through land reform before 1965, and by creating urban employment through export promotion after 1965, Nationalist policy has greatly contributed to such equal outcomes. ("Statism and Familism on Taiwan," in George Lodge and Ezra Vogel, eds. *Ideology and National Competitiveness.* Harvard Business School Press, 1986, p. 193.)

A key element in this strategy had been a bold program for educating and training the Taiwanese work force. Between 1974 and 1984, for example, employees with an educational level below junior high school dropped from 68.7 percent to 46.7 percent, while those with a senior high school education rose from 4.7 percent to 11.5 percent. Upgrading the skills of workers has both helped fuel the island's export evolution into higher value-added products and helped increase the sense of well-being among workers.

The United States and Taiwan's Development

The enormous success of Taiwan's development strategy places the United States in a dilemma. The dilemma consists of traditional U.S. pride in the success of an economy shaped with U.S. aid, combined with more practical concerns about how it should adjust itself to the implications of that success in the form of large and growing Taiwanese trade surpluses with this country. The dilemma is real.

On the other hand, Americans are understandably impressed by Taiwan's progress. In many respects, its success owes a great deal to American ideas involving the role of the private sector and pursuit of open world markets. Appreciation of Taiwanese accomplishments is, if anything, deepened by personal ties between the two societies that were initially established when many of the island's leaders came to the United States for education and training. In fact, a good number of Taiwan's present leaders are graduates of American universities. U.S. assistance financed fully one-quarter of the island's total capital formation between 1951 and 1965, providing startup finance for a number of highly successful Taiwanese sectors, including fertilizer, dam construction, and agriculture. U.S. economic assistance also helped finance the bulk of Taiwan's imports, accounting for more than 40 percent of them before 1960.

U.S. support for Taiwan is also reflected in more general ways. For example, Taiwan derives significant benefits through membership in the Generalized System of Preferences (GSP). Launched in 1976, the GSP was designed to foster trade-driven growth in developing markets by extending duty-free treatment to approximately 3,000 products from 140 developing countries and territories. Under section 502 of the Trade Act of 1974, the President determines a recipient's eligibility based on a variety of considerations which are regularly reviewed and revised to reflect changing world economic realities.

Since the program's inception a decade ago, the value of U.S. imports receiving GSP treatment has risen from $3.2 billion to $13.3 billion in 1985. This growth is largely attributable to just five advanced developing countries (Brazil, Hong Kong, Mexico, South Korea, and Taiwan), who between them constitute nearly 65 percent of all GSP preferences. Taiwan has consistently been one of the top beneficiaries of GSP. In 1985 it ranked first, accounting for 24 percent of total imports coming into the United States under the program, followed by South Korea. Lopsided trade and current account surpluses generated by major recipients have made the GSP increasingly unpopular, and, in January 1987, the Reagan Administration announced completion of a two-year review of the program. As a result of the review, GSP-eligible exports from Taiwan and South Korea were reduced by 37.5 percent and 24 percent, respectively.

American Industry and the Taiwan Trade Surplus

The United States has also contributed to Taiwan's export success directly, through the operations of U.S. multinational firms. One frequently overlooked factor is to be found in the export activities of American multinational firms, which derive a large portion of their worldwide sales revenue from production facilities located outside of the United States.

Taiwan's low unit labor costs and high productivity have, not surprisingly, turned this island into one of those vital links in the chain of U.S. multinational production. American concerns come to Taiwan to seek out and send back to the United States, under American brand names, everything from shoes to consumer electronics. If the Taiwanese do not make something, the American companies help them get started. Many U.S. companies operate their own factories in Taiwan largely for the purpose of export, including substantial exports to the American market.

A case in point is electronics. Spurred on by Japanese competitors, a number of American electronics corporations went to Taiwan in 1964 in order to produce goods for the U.S. market. The result: within a few years, Taiwan became the capital of the U.S. electronics industry for a number of major television producers. By 1974, Taiwan had surpassed Japan in exports of televisions to the United States.

These arrangements are not foisted on the Taiwanese. On the contrary, the government allows virtually any kind of U.S. business investment—from partnerships with Taiwanese companies to wholly owned subsidiaries—which in turn has encouraged the growth of a large core of suppliers whose expertise in working with Americans tends to draw more U.S. investment.

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THE CONTEMPORARY STRUCTURE OF TAIWAN'S ECONOMY

Although the aggregate statistics would suggest that Taiwan's economy is strong and vital, past economic policies have helped shape an economy which is lopsided and imbalanced, and which may well have considerable problems adjusting to future changes in the world economy. Taiwan's export vitality is produced almost entirely by a private sector composed of very small and undercapitalized exporters, while the government remains responsible for managing and financing most of the capital-intensive businesses on the island. The financial system is unsophisticated by international standards, with the banks owned or controlled by the government, a very thin stock market, and a system of exchange controls which hampers the mobility of capital and investment in the economy.

GOVERNMENT'S ROLE IN THE ECONOMY

The government has always played a central role in the economic development of Taiwan, and that role shows little sign of diminishing as the economy grows. Originally, the national security orientation of the KMT dictated a command economy organized to serve the defense establishment. The government was the conduit for external aid, both financial and military, and this external aid accounted for a quarter of gross capital formation on the island between 1952 and 1960. Much of this investment was channeled through government enterprises, which were responsible for the development of roads, railroads, telecommunications, air transportation, electric power, petroleum, and agricultural irrigation. Government control of the financial system, through ownership of banks and strict exchange controls, was also seen as an essential national security ingredient.

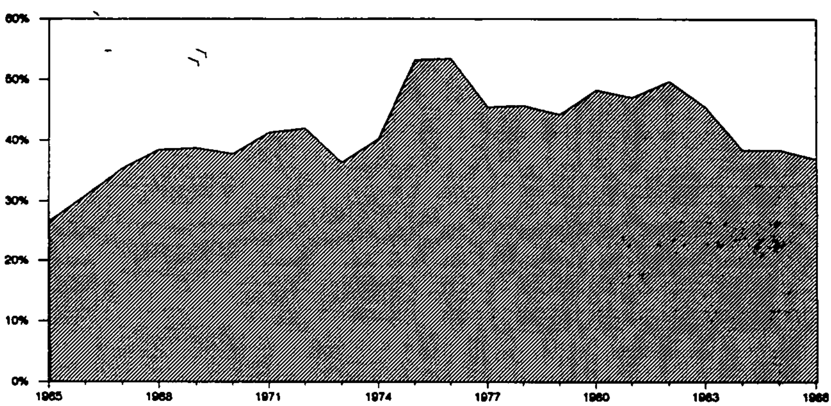
There were, however, other reasons for the dominant role played by government enterprise. The island's private sector was overwhelmingly controlled by Chinese who had immigrated to Taiwan between the 17th and 19th centuries. Newly arrived mainlanders, who controlled the government apparatus, were not very popular with the Taiwanese, and there were few avenues for either employment or entrepreneurship open to mainlanders. Government enterprises were an effective way of providing mainlanders with access to economic resources as well as political power. To this day, mainlanders account for a majority of employees in government enterprises, while the private sector continues to give preference to native Taiwanese.

As Figure 3 demonstrates, government remains a significant participant in the economic life of the island. While industrial production in public enterprises has fallen from 62 percent of total output in 1952 to 13 percent in 1984, government still plays a dominant role in total capital formation on the island.

When the choice was made to shift development strategy from import substitution to export promotion, government shifted its investment emphasis toward infrastructure (roads, railroads, ports, and electricity), agriculture (irrigation), and key industrial products (petroleum, chemicals) needed to support export promotion. The actual production of export commodities was left largely to the private sector.

FIGURE 3

GOVERNMENT'S SHARE OF TOTAL DOMESTIC CAPITAL FORMATION



As the export boom progressed, however, the government shifted its investment emphasis toward "backward integration" of the economy—building the necessary heavy industrial capacity to provide for the inputs needed by the light manufacturing export sector. Government investment built a shipyard, several petrochemical plants, a machinery works, and an integrated steel mill during the 1970's, and is now heavily involved in financing industrial parks and research facilities to enhance the nation's ability to compete in high-technology products.

Although difficult to determine from available data, on the surface it would appear that government enterprise on Taiwan has been relatively efficient and reasonably free from the negative stereotypes of "bureaucratic business" which plague public enterprise in much of the rest of the developing world. The one exception to this general picture of government efficiency is the financial sector, where government ownership or control of the major financial institutions has served to retard the evolution of the island's financial structure. The banks in Taiwan are notoriously conservative, lending to businesses on a short-term basis only (less than two years) and with heavy collateral requirements. This protects the banks from losses, but also deprives the economy of a financial infrastructure to support enterprise growth. Exchange controls and restrictions on foreign financial institutions in the country also restrict the diversification of the financial sector.

Government policy has also not favored the development of effective nonbank financial institutions in the private sector. The country has few mutual funds, virtually no "venture capital" firms, and a stock exchange which lists a mere 126 companies.

The Private Sector: "Better the Head of a Chicken Than the Tail of an Ox"

Taiwan's private sector is composed almost entirely of small, light industrial and trading firms which are thinly capitalized, with fewer than 50 employees and less than $1.5 million (U.S.) in annual sales. These businesses are largely self-financed, or financed through family networks. Because of the caution shown by major lenders, leverage is not high.

Although the island economy has boomed since the early 1960's, there has been relatively little consolidation of small firms into larger ones. Mergers are rare in Taiwan, as are bankruptcies, and there is a strong tendency for small firms to persist and grow modestly over time.

The most frequently cited reason for this pattern of enterprise is a Chinese cultural preference for small-scale business operations. In the words of a local proverb: "It is better to be the head of a chicken than the tail of an ox."

There are, however, two alternative explanations which help account for the persistence of small firm size in Taiwan's industrial structure. The first is financial. Since almost all firms are privately held, and very few offer stock to the public, there is much less opportunity for the kind of merger activity which has created large industrial firms in countries with broader and more extensive public securities markets.

A second potential explanation is political. The business community remains largely dominated by native Taiwanese, while the political system is still dominated by mainlanders or their descendants. Having a small business community of significant size gives those with ambition an opportunity for status and success outside the political system—the greater the number of businesses, the greater the possibilities for jobs as "chairman" or "president." The merger of smaller businesses into larger ones could potentially create a significant new center of economic power on the island, with some potential for spillover into increased political conflict. If this were indeed the case, then slowing the process of creating larger private businesses would help maintain the island's historic pattern of political stability.

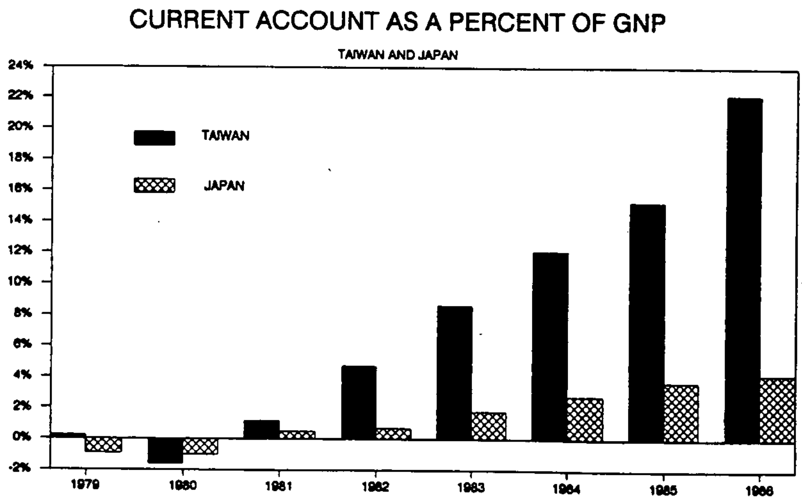
The predominance of small firms in the Taiwanese private sector has both advantages and disadvantages for the country. On the plus side, numerous small firms can adjust very quickly to changes in external demand for products. The Taiwanese textile and apparel industry, for example, has a strong international reputation for rapid adjustment of production to suit style changes.

But on the negative side, small firms have difficulty moving into lines of production which require substantial capital investment or which involve significant economies of scale in production. Yet these are likely to be the "industries of the future" for a rapid industrializing economy such as Taiwan. The government has attempted to mitigate this problem through subsidizing some of the overhead costs of capital-intensive, high technology production (through research subsidies and investments in high technology industrial parks), but it remains to be seen whether this sort of generalized government support can compensate for a private sector with a limited ability to mobilize significant blocks of capital on its own.

THE BURDENS OF SUCCESS: TAIWAN'S TRADE SURPLUS AS A PROBLEM FOR THE ECONOMY

Taiwan's mixed economy and its strong export orientation have produced impressive results both in overall growth and particularly in export growth. But as Figure 4 demonstrates, export success has ballooned out of proportion during the 1980's.

FIGURE 4



While this trade surplus creates a number of significant problems for the Taiwanese economy [see below], the main reason that the trade surplus is perceived as a "problem" in Taiwan is that it is disproportionately generated by trade with the United States. The United States accounts for over 80 percent of Taiwan's merchandise trade surplus, consuming 47 percent of the nation's exports while supplying only 22 percent of the island's imports.

Driven by the bilateral surplus with the United States, the Taiwanese economy during the 1980's has accumulated what can only be described as an "embarrassment of riches." This success creates four distinct but interrelated problems. The first of these is the problem of the surplus itself. Taiwan finds itself in the company of nations such as Japan and Germany in the aggregate size of its bilateral trade surplus with the United States, and in a class by itself with respect to the relative size of its current account surplus. The

U.S. bilateral deficit with Taiwan is this nation's third largest, trailing only Japan and Canada. Taiwan's current account surplus amounts to some 20 percent of GNP, more than four times larger in relative terms than the current account surplus of Japan and rivaling the OPEC surpluses of the late 1970's. Surpluses of this magnitude invite critical attention at a time when the United States is urgently seeking ways of reducing its own trade deficit.

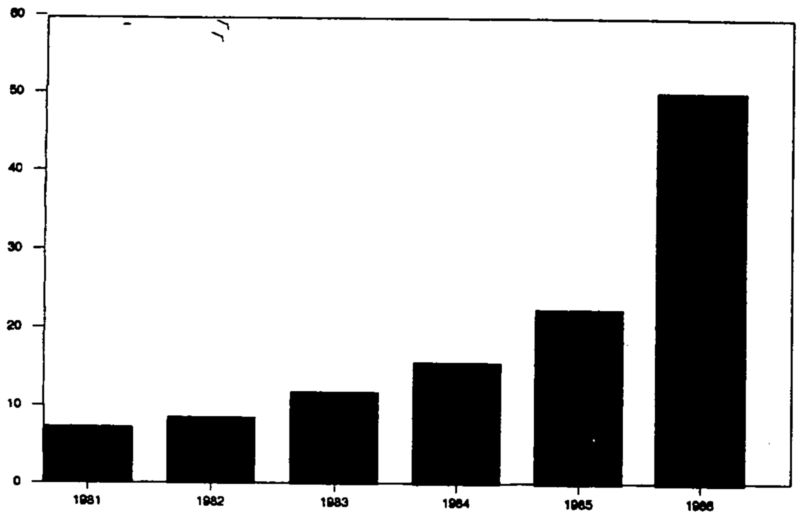
The second problem is the rapid buildup of currency reserves, which have resulted from current account surpluses combined with exchange controls. With little foreign debt and only a small amount of foreign investment, payments of interest or dividends to foreigners consume only a fraction of Taiwan's export earnings. The huge export surpluses of the 1980's therefore became current account surpluses of almost equivalent magnitude. Under the exchange control system, these current account surpluses were translated immediately into increased central bank reserves. By October 1987, the central bank has reserves of some $68 billion and most observers were predicting reserves of $70 billion by year-end. Such reserves are unprecedented in the world, and are sufficient to cover nearly three years' worth of imports, in contrast to the three-month coverage most major countries have as central bank reserves.

This huge accumulation of financial reserves in government hands both provokes criticism by the outside world and complicates the task of domestic economic management. Indicative of the foreign pressure which the reserves generate is the recent quote from U.S. Trade Representative Yeutter:

> Taiwan's reluctance to open its markets is particularly inexcusable since it maintains the second-largest foreign exchange reserve in the world . . . . (Business Week, April 13, 1987.)

FIGURE 5

CENTRAL BANK RESERVES
IN BILLIONS OF U.S. DOLLARS

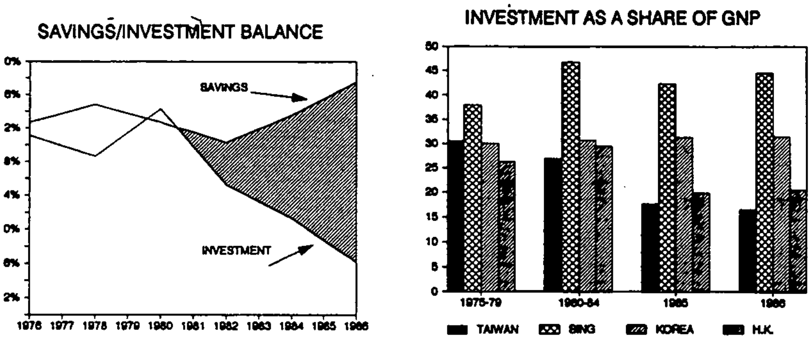


The principal domestic problem with these huge central bank reserves is a drastic expansion in the domestic money supply, since the exchange control regime requires the central bank to redeem all excess foreign exchange by issuing additional NT dollars. Thus far in 1987, the domestic money supply has grown at an annualized rate of more than 50 percent, leaving local capital markets awash in liquidity and heightening fears of inflation among government policymakers and private investors. According to KMT Legislator Eugene Chien: "The foreign exchange reserve has become a burden, not an asset." (Business Week, April 13, 1987.)

The third "burden of success" on the Taiwan economy is the effect which the trade and reserve surpluses have had on domestic investment. The island's traditionally high rate of domestic capital formation shrank noticeably during the 1980's, in tandem with the rise in the external surplus. Taiwan now has the lowest rate of investment (measured as a share of GDP) of any of the four Newly Industrializing Countries (NIC's) of Asia, and one of the largest gaps between savings and investment.

FIGURE 6

TAIWAN'S MACROECONOMIC IMBALANCES



The decline in investment has been induced by both political and economic factors. Politically, many of Taiwan's businessmen express considerable uncertainty about the future of their island in the international political system. They question whether the island will remain an autonomous political unit, and this uncertainty serves to increase the tendency for wealth-holders to keep assets in liquid and mobile form rather than committing them to fixed investment on the island. At the same time, Taiwanese industry has moved into many new areas where rapid technological change increases the riskiness of many new capital investment projects.

This sense of uncertainty about the future has been heightened by growing concern about protectionist reactions from major industrial countries to Taiwan's economic success. Although they are proud of their export success, most Taiwanese businessmen also are fearful that their lopsided trade surplus will be brought to an end through external political pressure, either through a forced closing of foreign markets or through a forced appreciation of the currency to levels where many export industries would have to shut down. Faced with these prospects, only the most secure and cost-competitive export industries are willing to undertake new investments.

There is also a financial dimension to the falloff in investment. The large current account surpluses have flooded the island with external savings. There is now far more liquidity available for investment than there are profitable investment outlets. Banks now routinely turn away new depositors, and pay lower interest rates on large deposits in an effort to discourage further inflow of funds into the banking sector. In April 1987, $44 billion of the nation's $107 billion in commercial bank deposits were "idle"—placed in low-yielding government securities rather than loans or investments in productive firms.

The underdeveloped nature of private capital markets creates additional risks in managing the growing pool of liquidity. Investors frustrated by an inability to put their funds in bank accounts turn to the local stock market, which lists only 126 publicly traded companies. Very few of the traded firms issue new shares to raise funds, so the stock market has a highly speculative character. The stock exchange index has doubled since mid-1985, and average daily trading volume has increased 20-fold in the same short period. The surge of funds into the market creates enormous daily variation in share prices, and gives the stock market an extremely speculative air. Excessive speculation is one prominent feature of financial markets suffering from a classic "liquidity trap"—excess cash and poor investment alternatives.

Finally, Taiwan's export success has been purchased at some cost in terms of domestic living standards. Export subsidies and an undervalued exchange rate favor production of export goods over the production of goods to meet domestic market demands. Similarly, access to internationally traded consumer goods is restrained by the undervalued exchange rate. Relative to their income and productivity, Taiwan's workers enjoy a lower standard of living than do their counterparts in countries with more balanced external trade.

THE BURDENS OF SUCCESS: TAIWAN'S TRADE SURPLUS AS A PROBLEM FOR THE UNITED STATES

Taiwan's emergence as an economic power did not occur overnight. It was instead the result of historical circumstances, deliberate decisions, and longer term changes in the global economy. These changes create problems for the United States, particularly in the area of trade. But in examining these problems, it is important to bear in mind that a significant portion of Taiwan's commercial success is attributable to U.S. actions, either direct and targeted (such as industrial assistance and foreign aid to Taiwan) or indirect and diffuse (such as enormous U.S. trade deficits with the entire world). Other factors in Taiwan's growth are the result of broad world historical trends largely beyond the control of either the United States or Taiwan.

As global markets for capital and technology become more integrated, the production of goods tends to become more mobile internationally and less rooted in the markets where final consumption is to take place. Countries such as Taiwan, with a high degree of political stability, a well-educated and motivated work force, and a competent central government are well-positioned to take advantage of the internationalization of markets, first in labor-intensive industries and later, as their skill and capital base develops, in more capital and knowledge-intensive industries.

This shift can be seen in the changing composition of Taiwan's trade over the post-World War II era. Before World War II, sugar and rice accounted for three-fifths of the island's exports. Food and fibers made up two-fifths of imports and the remainder consisted of textiles and assorted goods. Industrial development after 1945 greatly increased the demand for raw materials, semifinished goods, and machinery. Food and fibers accordingly account for less than 25 percent of total imports today.

Exports have also undergone substantial changes. During the 1950's industrial products in exports averaged less than 21 percent. By 1965, they made up over half of Taiwan's exports. Agricultural raw materials and processed goods accounted for only 12.5 percent of exports in 1977, whereas industrial products made up 87.5 percent of exports. This shift in the composition of imports and exports was facilitated by a number of government initiatives including: tax rebates on exportable industrial products and establishment of export-processing zones in coastal exporting centers capable of attracting foreign capital and technology to Taiwan's export sectors.

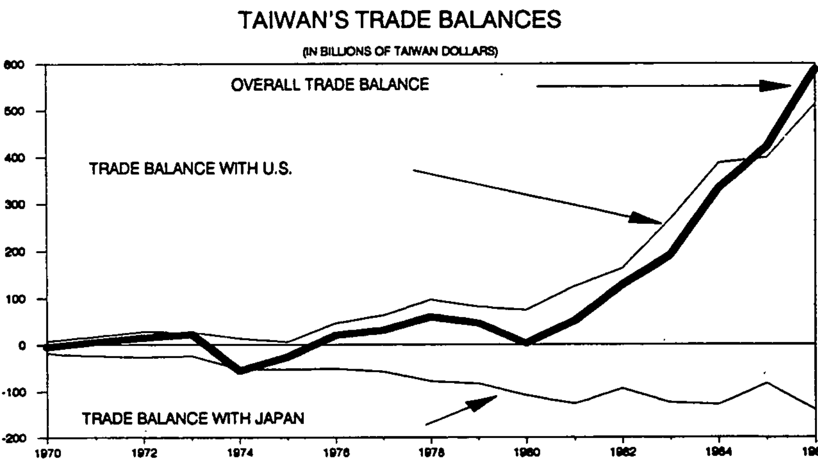
By the early 1980's, the composition of U.S.-Taiwan trade clearly reflected these policy shifts. In 1975, for example, electrical machinery and apparatus and textile products, respectively, accounted for 21.8 percent and 28.2 percent of Taiwan's exports to this country. The share of textile products has since declined to 23.2 percent in 1978, 22.3 percent in 1980, and 16.9 percent in 1984. Meanwhile, electrical machinery and apparatus rose to 22.5 percent in 1978 and 25.9 percent in 1984. By then, more than 95 percent of Taiwanese exports to the United States consisted of industrial products.

At the same time that Taiwan was upgrading the quality of its export industries, it was also reducing its dependence on high-value imports from the United States. Machinery and tools, which accounted for one-third of Taiwan's imports from the United States in the mid-1970's, dropped sharply to 23.3 percent in 1984. U.S. sales of transportation equipment also suffered a steady decline; this was largely attributable to a fivefold jump in the growth of Taiwan's domestic motor vehicle production. The most promising U.S. export item to Taiwan has been chemicals and pharmaceuticals, whose share advanced from 11.6 percent in 1975 to 20.8 percent in 1984.

These statistics suggest a change in the underlying structure of trade between the United States and Taiwan, a change which will make unwinding the bilateral trade imbalances between the two countries extremely difficult. The United States increasingly purchases manufactured goods from Taiwan, and sells agricultural products and industrial raw materials in return. Changes in international terms of trade have recently favored manufactured goods over raw materials, a trend which is likely to persist and contribute to Taiwan's bilateral trade surplus with the United States.

It is interesting to note that Taiwan's other major trading partner, Japan, has managed to achieve far better results in its bilateral trade with Taiwan. As Figure 7 demonstrates, Taiwan continues to run a significant bilateral trade deficit with Japan, while the bilateral surplus with the United States accounts for almost the entire total trade surplus of Taiwan with the rest of the world.

FIGURE 7



Part of the reason for these differences is that Japanese firms have managed to maintain a firm grip on high-value export markets in Taiwan. The China External Trade Development Council recently compiled a list of 20 "Major Manufacturing Products" imported into Taiwan. Japanese companies were the primary exporters into the Taiwan market of 15 of these products, including transportation equipment, electronic products, plastics, and scientific equipment. The United States was the leading exporter of only three products: pulp and paper, chemicals, and food and tobacco.

Japan's stronger structural position in the Taiwan market is further enhanced by prevailing business practices. The Japanese presently enjoy a marketing advantage over their American competitors because of language familiarity, aggressive marketing techniques, and better after-sale services. With respect to machinery products, for example, while U.S. exports typically require nine months for delivery, Japanese delivery time for a similar item takes but three.

The use of Taiwan as an export platform by many U.S.-based multinational companies helps contribute to both the bilateral trade deterioration, and the shift in the underlying structure of trade. U.S. multinational firms, particularly in the advanced manufacturing and high technology areas, will continue to contribute a powerful push toward upgrading Taiwan's exports and directing those exports toward the American market.

For these reasons, the United States clearly has a unique problem with respect to Taiwan, one shared by no other major industrialized country. The United States accounts for fully 80 percent of Taiwan's total trade surplus, and has developed a network of institutional, market, and product connections with Taiwan which will make it extremely difficult to balance trading relations between the two nations.

TAIWAN'S CHALLENGE: MAINTAINING GROWTH AND REDUCING SURPLUS

Today, Taiwan stands at an important crossroads. The export-oriented development strategy which served it so well in the 1960's and 1970's has achieved impressive results, but its very success creates tensions with its international allies and stifles both new investment and future growth.

The central challenge facing Taiwan today is to find a new strategy for maintaining growth in national income without widening the already substantial external surplus and worsening the already severe liquidity problems for the economy. Four broad strategies appear to be available to the Taiwanese government to improve its external economic and political position:

1. *Restore Macroeconomic Balance.*—Fundamentally, Taiwan's external imbalance is the result of a strong imbalance in its domestic economy. Taiwan's high savings rate (averaging nearly 40 percent of national income) and its relatively low investment rate (16 percent of national income) combine to create a major imbalance. Any nation which saves 40 percent of income, and invests only 16 percent, is going to run an external account surplus of equivalent proportions.

From a simple macroeconomic perspective, therefore, reducing the internal savings-consumption-investment imbalance in Taiwan is the key to reducing the external surplus. In a recent report on the East Asian economies, economists Balassa and Williamson put the challenge as follows:

> According to standard balance-of-payments theory, eliminating a balance-of-payments surplus without creating a domestic recession requires a judicious combination of two types of measures. On the one hand, there is a need for *expenditure switching* polices, designed to switch both domestic and foreign demand from domestic to foreign sources of supply. On the other hand, there is a need for *expenditure increasing* policies designed to expand domestic demand so as to absorb into the production of nontradables the resources released from the production of tradables by the expenditure-switching policies. ("Adjusting To Success: Balance of Payments Policy of the East Asian NICS," Institute for International Economics, June 1987, p. 26.)

Expenditure-switching, through reduced import protection, reduced export subsidies, and a revaluation of the currency is an essential part of a viable strategy for reducing Taiwan's surplus [see below]. But implementing such policies without a similar effort to expand domestic consumption would impose unnecessary and painful costs on Taiwan's entire economy. Expenditure increasing policies must therefore be a part of any positive and nondisruptive path to reducing the external surplus. The precise pattern of expenditure-increasing policies is a matter to be resolved between the public and private sectors in Taiwan. Either could take the lead role in increasing domestic demand through an expansion of consumption or through an expansion of investment.

On the consumption front, a variety of measures could have a positive effect. Consumer and mortgage credit is very restricted on the island; easing those restrictions might stimulate a marked increase in consumer spending. The lack of a broad-based national pension system also contributes to extremely high household savings rates. Creating an effective nationwide retirement insurance system might relieve some of this pressure on families and permit a welcome increase in current living standards without jeopardizing retirement security.

Opening up the financial system to international competition also might help to stimulate domestic growth. Foreign banks are severely restricted in the kinds of operations they can undertake in the Taiwanese domestic market. Yet the same banks often have considerable expertise in the areas of consumer and mortgage credit, precisely the type of financial services which might be most helpful in boosting domestic demand. Liberalizing foreign access to the financial services industry in Taiwan could conceivably be a part of an overall strategy to stimulate domestic demand.

Government also could play a role in the expansion of domestic consumption. The major banks are government-owned, and through the banks the government could take a lead role in expanding consumer credit. The recent decision to introduce "debit cards" (where purchases are deducted from a customer's bank balance) represents a cautious move in financial policy toward broadening domestic demand. Tax policies which encourage excessive domestic savings could also be reformed as part of a broad-based effort to raise current living standards.

Expanding domestic demand in Taiwan through monetary and credit policy is likely to be seriously constrained by concerns about inflation which arise from the unique exchange control system. With residents prohibited from exporting foreign exchange assets abroad, and the central bank required to soak up all excess foreign exchange through the issuance of NT dollars, the domestic money supply has expanded enormously as the current account surplus has risen. While inflation has remained almost nonexistent on the island, and the excess liquidity has not turned into a consumer spending binge, there is concern that a shift in political or cultural emphasis from savings toward consumption would risk a dangerous surge of inflation. This fear is reinforced by the fact that many of the senior policy elite in the KMT remember vividly the runaway inflation in Shanghai in 1947, and would be prepared to go to great lengths to prevent a recurrence of that phenomenon. Policymakers have chosen to dismantle the system of exchange controls and permit some of the financial pressure to be exported before considering any moves toward domestic demand expansion [see below].

While Taiwan's enormous current account surplus can be substantially reduced over the long run only through rising domestic living standards, short-term measures to increase domestic demand appear to be constrained by cultural disposition, policy habit, and a reasonable fear of inflation. Given these constraints, expanding investment may offer the most feasible mechanism for a timely reduction of the domestic macroeconomic imbalance. Here, too, a number of policy initiatives might profitably be undertaken.

The banking system could be restructured to make it more accommodating to business needs. Collateral practices could be modified, banks could be persuaded to lend for longer terms, and the banking market could be further opened to competition from international banks, which are traditionally more aggressive in promoting loans and investment than are state-run Taiwanese banks.

Other financial innovations also might help in this direction. The stock exchange could be expanded into a real source of capital for a larger number of firms, and in the process could become more of a genuine market for corporate control, facilitating the creation of larger private enterprises which could undertake bigger capital investment projects. Such a move would also require a standardization of accounting practices on the island, since the current system of vague and contradictory accounting principles makes it very difficult for firms to trade their equities on a public market.

Venture capital is another financial area which could be strengthened. Businessmen, particularly those in high technology enterprises, frequently lament the lack of any organized and sophisticated venture capital pools in the country. To some extent, the venture capital problem may reflect entrepreneurs' unwillingness to give up ownership and control of a business, but this would not rule out nonownership forms of venture capital such as royalty finance for new product development. Improving the availability of funds for long-term but somewhat risky venture finance might significantly improve the investment behavior by Taiwanese private industry.

For a variety of reasons, there is serious question about the ability and willingness of Taiwan's private business sector to produce the needed expansion of investment demand. If private investment is not forthcoming in sufficient quantity, then the government might need to consider playing a direct role in expanding investment demand. Government and government-owned enterprises are traditionally responsible for roughly half of total local capital formation, and a significantly larger share of investment in larger, capital-intensive projects. A significant increase in public-sector capital spending would help produce the needed rise in total investment in the economy.

To its credit, the Taiwanese government has launched 14 new infrastructure investment projects which should help provide a stimulus to investment demand. These projects will not only provide investment demand for the Taiwan economy, they are also likely to involve extensive imports of expensive equipment from abroad, thus helping to trim the trade surplus directly. It is not yet clear, however, that government investment will be sufficiently large to compensate for inadequate private investment.

2. *Exchange Rate Policy.*—A second route toward improved external balance would be to change prevailing policy on the exchange rate. Traditionally, the exchange rate was pegged to the U.S. dollar by official central bank policy, and, as noted earlier, was pegged at a level which gave Taiwan's businesses a strong incentive to

export. The NT dollar was revalued from 40:1 to 38:1 in 1973, then adjusted to 36:1 until 1979 when the depreciation of the U.S. dollar put Taiwan at an increasing competitive disadvantage with Japan and other nations not tied to the dollar.

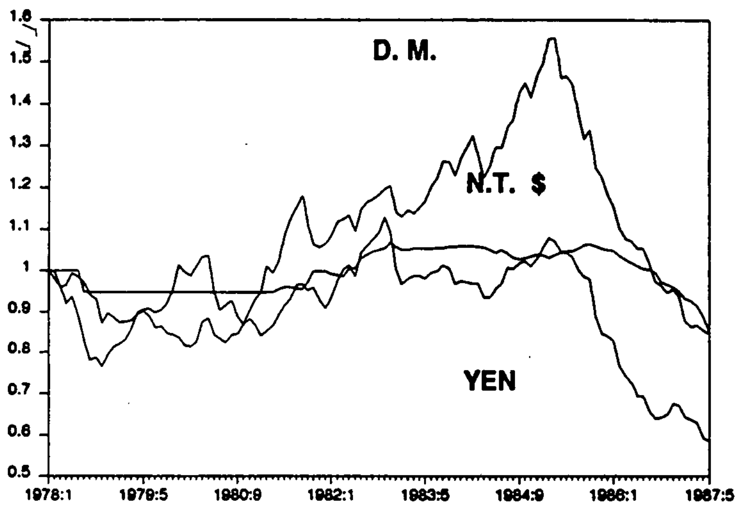
To maintain its competitiveness in world markets (and improve its relative competitive position in the U.S. market), Taiwan allowed the NT dollar to "float" against the U.S. dollar starting in 1979. This uncoupling occurred just before the strong appreciation of the U.S. dollar, and permitted a modest depreciation of the NT dollar during the first part of the 1980's. This made Taiwanese goods more attractive in U.S. markets and helped fuel the nation's growing trade surplus.

Although the NT dollar's value is nominally established in a local auction market among the country's 31 official "foreign exchange banks," the central bank's control over international currency movements and its huge reserves give it effective control over the exchange rate. Since 1985, the central bank has used its influence to engineer a slow, gradual appreciation of the NT dollar as the U.S. dollar began its fall against the other major currencies.

As Figure 8 suggests, the central bank has used its influence in the local currency market to maintain a relatively weak currency and to moderate the pace at which the NT dollar appreciated against the U.S. dollar. In comparison with the Japanese yen or the deutsche mark, two other currencies with substantial bilateral trade deficits with the United States, the NT dollar has appreciated much more slowly. This pattern has allowed Taiwan to maintain a competitive edge in the U.S. market against products from countries with a more sharply rising exchange rate, as well as permitting increased penetration by Taiwanese exports into the market of strong currency countries such as Japan.

FIGURE 8

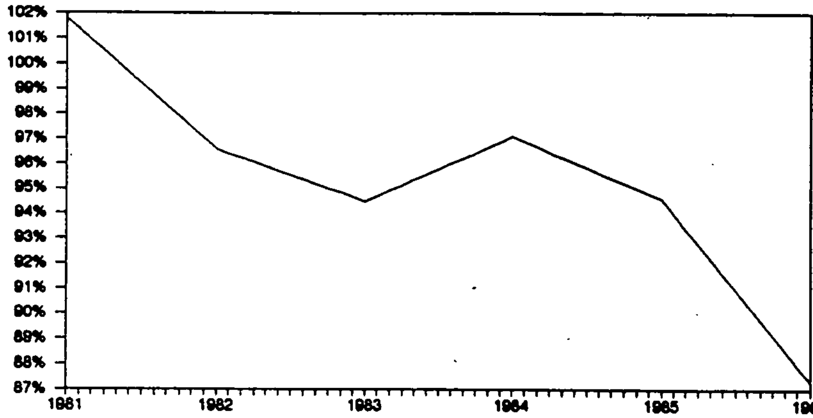
U.S. DOLLAR EXCHANGE RATES AGAINST SELECTED CURRENCIES



Comparisons of nominal exchange rates do not, however, tell the full story, since differential inflation performance among countries alters their competitive position in ways not fully captured by nominal exchange rate relationships. Figure 9, which is based on data compiled by Morgan Guaranty Trust, shows that, on an inflation-adjusted and trade-weighted basis, the NT dollar remains some 15 percent below its rate in 1980. On a bilateral basis, Morgan calculates that the NT dollar remains 20 pecent undervalued against the U.S. dollar.

FIGURE 9

TRADE WEIGHTED REAL EXCHANGE RATE INDEX



Two policy questions arise with respect to the exchange rate: First, what is the appropriate target for the bilateral exchange rate between the U.S. and NT dollars? Second, how quickly should the currencies move toward the desired values?

If a goal of exchange policy is to be the elimination of the Taiwanese current account surplus over the medium term, then there can be no doubt that a substantial further appreciation of the NT dollar will be required. A recent article in The Economist magazine concluded:

> A further big rise in the exchange rate is needed. . . . For, despite the recent appreciation of Taiwan's currency against the weak American dollar, Taiwan's trade-weighted real exchange rate against the rest of the world is 15 percent below what it was two years ago. . . . (The Economist, March 28, 1987.)

Deciding precisely how far the NT dollar needs to appreciate in order to restore balance to the current account involves a good deal of guesswork, assumption, and projection. Estimates are necessarily tentative, since they must be based on assumptions about how consumers and producers will react to exchange rate movements. But according to Balassa and Williamson, effective measures to produce balance-of-payments adjustment by Taiwan:

> . . . will also need to include a further substantial real effective appreciation of the New Taiwan dollar, perhaps in the range of 15 percent to 25 percent, over and above the 15 percent appreciation against the U.S. dollar under-

taken between September 1985 and April 1987. (Op. cit., p. 65.)

This calculation would suggest a value of the NT dollar somewhere between 20 and 25 per U.S. dollar. In this context, it is interesting to note that, if the NT dollar had appreciated over the last two years against the U.S. dollar at the same rate as did the Japanese yen, the NT dollar today would be in the range of 18-20 to the U.S. dollar.

While this target may be appealing to international economists, and Taiwan's international competitors, for obvious reasons there is little support for such a strong appreciation of the currency among Taiwan's political or business elite. In discussions on the exchange rate issue, officials and businessmen repeatedly asserted that any significant additional appreciation of the NT dollar would "kill" many important export industries.

This observation points to the political reality of exchange rate policy. In every country where exchange rates are directly under the control of the central government, determination of the exchange rate is a political process in which groups struggle for a rate which maximizes their interest. In Latin America, the most powerful political constituency historically has been domestic industrialists concerned about foreign competition, and the result has been a history of overvalued currencies. In Taiwan, the favored constituency is not producers for the domestic market but exporters, with the result that the exchange rate has historically been undervalued. It will be a difficult process to counter the legacy of "everything for export" in an effort to produce a more appropriate and sustainable exchange rate.

On the question of pace, the Taiwan central bank has clearly chosen a gradualist approach, seeking to "feel its way" toward an exchange rate which will reduce the external surplus without overshooting or causing excessive hardship for Taiwanese exporters. Over the past several months, the NT dollar has appreciated roughly 6 NT cents per day and there is frequent discussion in the press and among policymakers about whether the current level is the "right" one or not.

This gradualist approach has some virtues with respect to "fine tuning" the dislocation inflicted on Taiwan's export industries, but it has a number of perverse financial effects. The market expectation clearly is that the NT dollar is headed higher, and that it has not yet found a level which the central bank and the country's trading partners find satisfactory.

If the NT dollar is seen as appreciating more in the future, there is a strong perverse incentive for Taiwanese investors to keep assets in the already extremely liquid market in the anticipation of future appreciation of the exchange rate. To the extent that excess cash is already depressing investment in Taiwan, the central bank's policy of gradual appreciation can only make matters worse.

This problem is multiplied by foreign interest in the speculative gains to be had from appreciation of the NT dollar. For the past year, central bank reserves have been increasing at roughly twice the rate of increase in the current account, proof that "hot money" is flowing into the country in the hopes of a speculative windfall.

In March, the government announced stiff new controls on the import of capital, but these seem to have done little to slow down the pace of speculative capital movement. In April 1987, somewhere between $2 billion and $7 billion of "hot money" flowed into the country, according to a report just released by the central bank.

Anecdotes of capital inflow abound. Smugglers are arrested at the airport with millions in jewels. Taiwanese are emptying their bank accounts in Monterey Park, California, long a capital flight haven, and bringing the money back to the island. (Forbes, April 6, 1987.)

These problems would be substantially reduced if the government were to pick an appropriate exchange rate, move quickly to that rate, and then announce and exhibit a firm determination to maintain this rate for a considerable period of time. The financial advantages of such an abrupt revaluation would, of course, have to be weighed against the dislocation which such action would cause in domestic export industries. To a substantial extent, the pace at which exchange rate adjustment can proceed without provoking a recession will be determined by the success of other policies aimed at expanding domestic demand in the local economy.

Resolving the question of pace and timing is clearly a task for the Taiwanese authorities, and economic analysis offers no unambiguous advice on this complex question. What does seem clear from economic analysis, however, is that the Taiwanese currency must appreciate significantly if the trade surplus problem is to be addressed.

3. *Trade Policy.*—A third route toward external balance involves a liberalization of trade and tariff policy. Taiwan has a history of trade-distorting practices on both the export and import side. With today's extraordinary success in international trade, such practices should be eliminated.

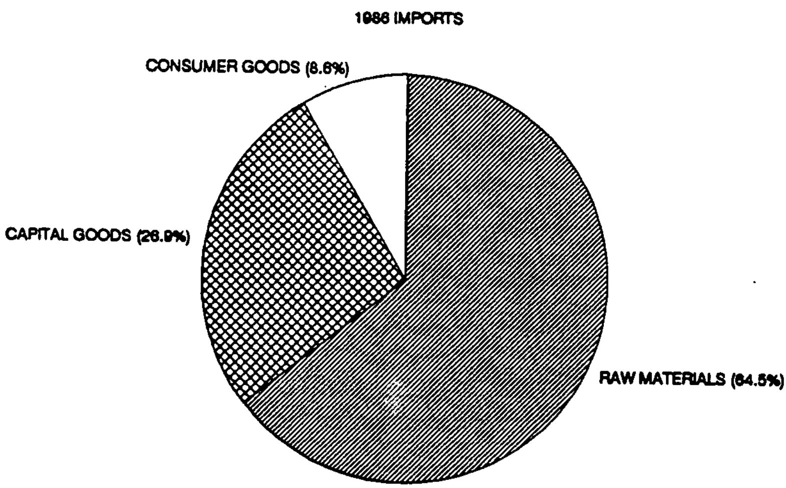
With respect to exports, Taiwan's traditional system of export incentives has outlived its usefulness. Although the preferential interest rates formerly made available to exporters have been abolished, there is still some informal bias in the financial system toward export industries. Efforts to reduce this bias, and possibly to reverse it by giving preference to firms producing for the domestic market would help facilitate the transition away from excessive reliance on exports. Other export incentives, such as the complex system of tariff rebates on intermediate products used to create exports and the tax preferences granted to multinational exporters, should also be re-examined as part of a surplus-reducing strategy.

On the import side, Taiwan has had a relatively extensive set of tariffs on a wide range of imported products. Originally, tariffs were primarily a revenue measure, and as late as the mid-1970's provided more than a quarter of government revenues. During the import substitution phase of Taiwan's growth, tariffs were used to provide protection for domestic industry, and during the export-promotion phase, they were partially a device to restrain domestic demand to free up resources for investment in exports.

In today's world, none of these considerations provide justification for a maintenance of high tariffs on imported products, and import liberalization is clearly both good trade policy and good diplomatic policy.

A major part of Taiwan's task is to transform the characteristics of its imports. As the following graph demonstrates, Taiwan imports primarily raw materials and capital goods to fuel its export industries, not consumer goods. (See Figure 10.) To the extent that this pattern reflects the influence of tariff policy, it is clearly in the interests of both the world's other exporters and Taiwanese consumers to see these restraints abolished.

FIGURE 10



In this area, the Taiwanese government appears willing to make major concessions. Tariff reductions on a wide range of products have recently been announced, and there is apparently strong government support for the creation of a "free trade zone" between the United States and Taiwan, involving the complete elimination of all tariff barriers. While there exists some question about the viability of such proposals, they do indicate a willingness on Taiwan's part to continue the important process of trade liberalization which has been advocated by American trade representatives.

Unfortunately, trade liberalization poses problems for domestic economic management in Taiwan and may do little to improve the troubling trade surplus with the United States. Domestically, a relaxation of import protection will bring an entire new range of local industries into direct competition with foreign suppliers at a time when investment in the local economy is already depressed. It is difficult to see how foreign pressure on profit margins would improve the eagerness of local businesses to invest.

On the international front, the problem with trade liberalization is that it often serves to improve opportunities for all foreign producers to sell their goods in Taiwan, and does nothing per se to reduce the extraordinary bilateral trade imbalance with the United States. As mentioned earlier, there are a number of structural factors, including both the presence of U.S.-based multinational exporters and the nature of U.S. exports to Taiwan which may make it difficult for American producers to capitalize on trade liberalization efforts by Taiwan.

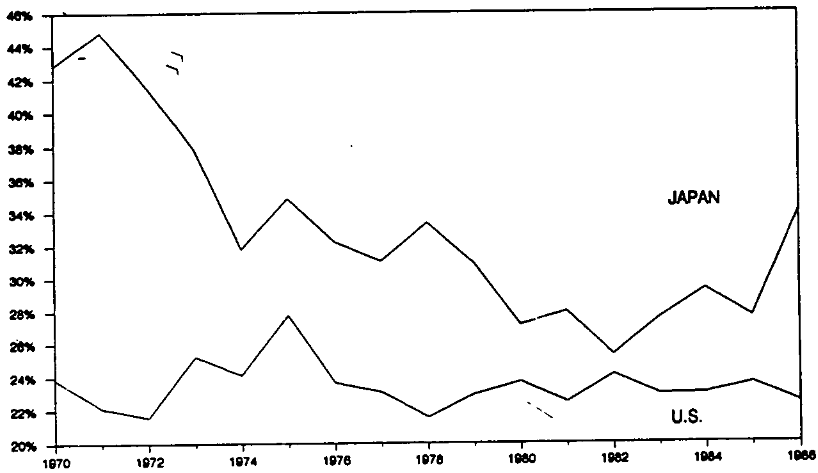
Recognizing the particular importance of the U.S./Taiwan trade imbalance, and the limited ability of trade liberalization to redress this imbalance, the Taiwanese have embarked on an ambitious "buy American" campaign. At regular intervals, the government promotes "buying missions" which are sent to the United States to discover new American products which could be imported into Taiwan. So far, these buying missions have largely purchased American agricultural products (at prices above world market levels), but there is now increased attention to purchasing American manufactured goods for import into Taiwan.

Recently, the announcement of the government's infrastructure investment program has provided another opportunity for a "buy American" campaign. Government "buy American" policy is likely to sway procurement decisions in the areas of earth-moving equipment (for the highway projects), electrical machinery (for electric power generation), chemical processing equipment (for two new naphtha crackers), and transportation equipment (for the new Taipei subway and the state-owned airline) toward American suppliers.

Important as these "buying missions" are in signaling Taiwan's genuine interest in reducing its trade deficit with the United States, the actual quantitative results to date have not been impressive. As Figure 11 demonstrates, the U.S. share of total imports to Taiwan has remained virtually constant since 1970 at around 22 percent, while the Japanese share declined significantly until 1982 and then began to climb, making an especially strong upward move between 1985 and 1986. Thus at a time when diplomatic and government efforts were working to "buy American," market forces were apparently driving Taiwan's importers to "buy Japanese." Whether these trends can be reversed in the years to come remains an open question.

Figure 11

SHARES OF TAIWAN'S IMPORTS



General trade liberalization to encourage imports across the board, and specific efforts to encourage imports from the United States, are an important part of a strategy for reducing the surplus, but neither can stand alone as an alternative to shifts in macroeconomic and exchange rate policy.

4. *Overseas Investment.*—Given the difficulties of redressing the fundamental imbalances in the Taiwanese economy, a fourth possible external economic strategy for the island would be to accept the existence of a strong trade surplus for the foreseeable future and seek to mute the negative international economic consequences of that surplus by redeploying the financial assets which the surplus creates in ways that benefit the world economy as a whole. For nearly a generation after the Second World War, the United States created markets for its goods by exporting its capital in the form of the Marshall Plan, the Alliance for Progress, and a variety of private investments by American corporations.

Clearly Taiwan has the financial capacity to make a similar contribution today.

In fact, Taiwan already "recycles" its current account surpluses into international capital markets. Over 90 percent of the central bank's currency reserves are in U.S. dollars, and the vast majority of those dollar assets are held in the United States itself, either as deposits in U.S. banks or in U.S. Treasury securities. In this sense, Taiwan, like Japan, uses its financial resources to help finance the U.S. trade deficit.

But if the United States is to reduce its trade deficit (and thus its need for foreign borrowing), and Taiwan is to retain some sort of surplus, the clear implication is that Taiwanese financial surpluses need to be used to finance trade deficits elsewhere in the world economy.

The logical place for Taiwan to deploy some portion of its financial reserves is the Third World, particularly those middle-income countries with large markets where demand has been sharply constrained by the world debt crisis. Latin American nations, for example, have been forced to cut back import demand significantly in order to run the trade surpluses needed to service past debts. Both these countries and the international trading system would benefit from improved international capital flows to debtor countries.

Should it choose to, Taiwan could make an important contribution to world economic growth by expanding the import potential of other economies, rather than its own, through a major program of "recycling" financial surpluses to finance-hungry countries.

Japan, another major surplus nation, has recently announced a program to provide some $30 billion over the next three years in new financial assistance to debtor countries. Taiwan, in a similar reserve position, could easily and quickly match that figure.

There is some evidence that the Taiwanese leadership may be taking this "outward investment" option seriously. Recently, most major controls on the export of capital have been removed, permitting Taiwanese investors to place their funds abroad with little interference by the government.

But allowing Taiwanese private investors to ship liquid assets overseas does not by itself guarantee that such private capital recycling will in fact move funds to the areas of greatest need. Freely mobile private capital may be more likely to end up on Wall Street or Los Angeles real estate than in financing imports or investments in the Third World.

Unfortunately, measures which might improve the international allocation of financial resources have so far been resisted by the Taiwanese government. Foreign banks are still prohibited from taking deposits in Taiwan and using those deposits to fund loans elsewhere in the world economy. Direct foreign aid from Taiwan remains modest, and is concentrated in the developing countries of Asia, which, with the exception of the Philippines, do not appear to have strong financial constraints on their growth.

U.S. POLICY OPTIONS IN DEALING WITH TAIWAN

Taiwan's large current account surplus is a source of tension in the world economy, and Taiwan's bilateral trade surplus with the United States is a source of major friction between these two trading powers. Reducing both surpluses is in everyone's long-term interest: the world trading system would benefit from smaller current account imbalances, Taiwan would benefit from a healthy growth in domestic demand, and the United States would benefit from more balanced trade flows with Taiwan.

This report has suggested, however, that the task of reducing Taiwan's multilateral and bilateral surpluses is not an easy one, and that there are powerful internal and external pressures to maintain the status quo.

In this complex area, the policy of the United States should be to press both Taiwan's public and private sectors to recognize the long-term advantages of reducing the island's external surpluses in an orderly fashion which does not induce a recession in Taiwan's export sector. This implies a greater emphasis in international negotiation on macroeconomic questions, rather than a focus on trade and tariff policy alone. Recent U.S. policy toward Taiwan has focused on liberalizing tariff schedules, a strategy which has had considerable positive success in the past, but which is likely to have only a small impact in the future on either Taiwan's surplus or America's deficit. A recent article in Morgan Guaranty Trust's World Financial Markets put the problem this way:

> Hitherto, negotiations between the United States and the Asian NIC's have focused mainly on agricultural trade and intellectual property protection. Important as these topics are for the interests directly concerned, it should be realized that the scale of trade potentially affected is minuscule in relation to the overall U.S. trade imbalance with these and other countries. As President Reagan's Council of Economic Advisers recently noted, the lion's share of U.S. trade deficit correction must come through massive improvement in U.S. manufactures trade. Negotiations with trade partners, including the Asian NIC's, therefore should give pride of place to removing obstacles to U.S. manufactures exports and changing policies that skew foreign manufactures exports to the U.S. market. (Morgan Guaranty Trust, World Financial Markets, January 1987.)

Given the realities outlined earlier in this report, the United States should broaden its negotiating objectives beyond simple trade liberalization to include more complex and comprehensive adjustments in Taiwan's economic policy and strategy. Some of these negotiating objectives could include asking the Taiwan government to:

1. Revalue the NT dollar substantially, through either a gradual strengthening or an abrupt shift to a more appropriate and sustainable rate. A commitment to revaluation is needed in order to send a real signal to Taiwan's exporters that foreign markets will be much more difficult to penetrate in the future, and to encourage business enterprises to shift some of their sales toward the domestic market.

2. Accelerate the relaxation of foreign exchange controls to permit the export of savings. Such measures would have a double benefit of reducing inflationary pressure on the domestic money supply while making Taiwanese savings available to finance growth elsewhere in the world economy. Included in such relaxation should be increased access to the Taiwanese market for international financial service firms.

3. Take a leadership position in easing the financial constraint on economic development in the Third World. Using existing capital surpluses productively through expanded lending and investment in the debt-problem countries could help relieve some of the world trading system's most pressing problems.

4. In conjunction with revaluation, adopt policies to stimulate domestic demand in both consumer spending and investment. Rapid growth in domestic living standards is the best insurance against serious problems emerging from the reorientation of export industries toward the domestic market.

5. Continue with import liberalization and the reduction of export subsidies. While such actions may not make a large contribution to reducing Taiwan's bilateral deficit with the United States, they could help substantially to ease the transition from an excessive export orientation by easing the inflationary pressure inherent in the proposed exchange rate revaluation, expanding access for Taiwanese consumers to international products, and reducing distortions in the economy.

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