

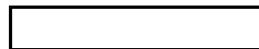
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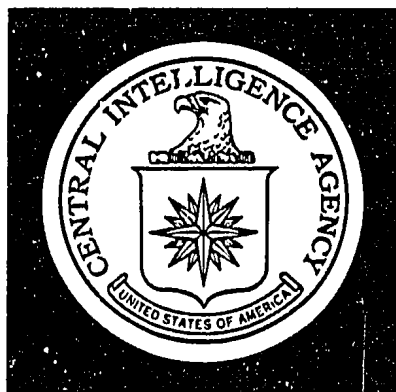
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DIRECTORATE OF  
INTELLIGENCE

# Intelligence Memorandum

*Economic Progress in Taiwan*

**Secret**

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CENTRAL INTELLIGENCE AGENCY  
Directorate of Intelligence  
April 1968

## INTELLIGENCE MEMORANDUM

Economic Progress in TaiwanSummary

Taiwan's economic performance during the past decade offers an impressive example of growth and development for the less developed countries. The 9-percent annual real growth rate for gross national product (GNP) during 1959-67 is among the most rapid in the world and is about double the average growth for all less developed countries. Per capita real income has increased by more than 50 percent since 1960. The average annual increase of more than 20 percent in Taiwan's exports since 1960, sparked by rapid export diversification, has been a major stimulant to the economy's recent accelerated growth. With industry progressively emerging as the mainspring of economic growth, a significantly increasing share of Taiwan's exports consists of industrial goods. More fundamental reasons for Taiwan's economic progress since the arrival of the Chinese mainlanders include the environment of political and monetary stability provided by the Government of the Republic of China (GRC), the encouragement of private investment, and assistance from abroad, particularly the large-scale official aid from the United States.

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The heavier strains on Taiwan's consolidated budgets that are likely to result from an expected increase in GRC commitments to defense, education, research and development, and public works may have a moderately retarding effect on the rate of economic growth. Prospects for commensurate boosts in budget revenues are dim; and, in the absence of major tax reforms, large deficits are likely during the next few years. Increased sales of national bonds by the GRC to offset deficits will be attended by a more stringent supply of domestic funds for private investors; and, alternatively, increased reliance on bank loans and overdrafts will raise the risk of inflation.

Nevertheless, the prospects for rapid industrial development appear favorable and are not likely to be disrupted by Taiwan's budgetary dilemma. Although continued rapid industrial development will require proportionally greater capital investment than in the past, Taiwan's capacity for generating domestic savings and acquiring foreign funds will probably be sufficient to fill these requirements. Export prospects in Japan and the United States are likely to remain bright, and Taiwan will probably press for wider opportunities in other markets. A growing labor shortage in Japan and the low costs of labor on Taiwan will also favor stronger trade ties and increased economic complementarity between the two countries.

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### Introduction

1. The economy of Taiwan has recovered from a difficult period of postwar reconstruction and rampant inflation to become in recent years a showcase of development for the less developed countries. Taiwan inherited from its period as a Japanese colony (1895-1945) some important assets and also several problems. The Japanese left a considerable infrastructure and a substantial sugar industry, but few managers or skilled workers remained. Moreover, the sugar industry, which had sold nearly all of its produce to Japan under preferential terms, was a high-cost operation. Sugar and rice were Taiwan's only significant exports until the early 1950's. The arrival of the mainland Chinese replaced the loss of Japanese skills, but the additional burden of 2 million mainland evacuees on the economy and the mounting budgetary deficits caused by massive defense expenditures generated a galloping inflation.

2. The GRC took appropriate steps in the early 1950's to stabilize the economy and to undertake sweeping land reforms. The failure of the Chinese Nationalists to lay these economic cornerstones had contributed to the regime's downfall on the mainland, and the GRC was determined not to repeat this error. The well-conceived domestic reforms contained in the first four-year development plan, which was launched in 1952, checked the inflation; and with the help of large-scale US aid, introduced a period of relative economic stability and growth.

3. The GRC gave priority in the first stage of economic development on Taiwan to reforming and modernizing agriculture. The island had been developed during the first half of the century as a colonial supplier of foodstuffs for Japan, but agricultural productivity remained low until after the land reforms and technological improvements that were accomplished after 1949. Agricultural production since completion of the reforms in 1953 has increased at an average annual rate of 6 percent, considerably outpacing a population growth rate of 3.3 percent in the same period.

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Economic Growth Since 1958

4. During 1959-67 Taiwan sustained an annual real growth rate in GNP of more than 9 percent despite a deficiency in natural resources, a high population density and growth rate, and disproportionately high defense expenditures. This high rate of growth is about double the comparable growth rate for all less developed countries and places Taiwan in the company of Japan and Israel among the fastest growing economies in the world. Per capita income on Taiwan was about US \$210 in 1967, more than 50 percent greater in real terms than in 1960. Exports grew even more rapidly than GNP -- at an average annual rate of 17 percent during 1959-66 and of 22 percent during 1961-66 -- as was the case in other countries with a high growth rate in output (see Table 1). This rapid increase in exports helped Taiwan to obtain the

Table 1

Growth of Gross National Product and Exports  
of Selected Countries  
1959-66

	Percent	
	Average Annual Rate of Growth	
	GNP (Constant Prices)	Exports (Current Prices)
Japan	10.4	16.5
Taiwan	9.4	16.7
Israel	8.8	17.2
Thailand	8.0	10.6
South Korea	6.8	41.0
Malaysia	6.2 <u>a/</u>	5.6
Iraq	6.2	6.5
Pakistan	5.4	9.0
Philippines	4.8	6.9
Turkey	5.4	8.9
India	3.9	3.3
Ceylon	3.1 <u>b/</u>	0

a. Rate of growth for 1961-66.

b. Rate of growth for 1960-66.

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necessary foreign exchange to finance the rising imports of capital goods and raw materials essential for industrial development and made it possible for the United States to terminate its economic aid program by mid-1965, except for PL 480 assistance. Much of Taiwan's success in exports can be attributed to unusual ingenuity in developing new lines of exports, which in turn provided a major stimulant to industry and commercial agriculture.

5. Since 1960, Taiwan has stressed the development of its industrial sector, which is rapidly becoming the mainspring of economic growth. By 1966, Taiwan was the first less developed country in Free Asia (except for the unique entrepot ports) to have its industrial sector contribute a larger portion of the net national product than the agricultural sector. Taiwan's principal advantage in industrial development is its low-priced, hardworking labor force. Although it has concentrated on labor-intensive light manufacturing, there are plans to shift emphasis from light to heavy industry in the next few years.

#### Factors Contributing to Past Growth

##### Political and Monetary Stability

6. The political stability brought by the strong central government under Chiang Kai-shek has been one of the most important conditions underlying Taiwan's economic progress. Taiwan has avoided the political vicissitudes and insurgencies that have characterized the transition from colonialism to independence in such countries as Burma, Indonesia, Malaysia, the Philippines, and the countries of Indochina. Another significant factor was the encouragement to the private sector to take the lead in economic activity. Government policies on Taiwan, such as low taxation for corporations, tariff protection, and generous depreciation allowances, were designed to create incentives for private investment. The private sector in recent years has provided more than two-thirds of the total domestic investment in Taiwan, compared with less than one-third in countries like Burma, Ceylon, India, and Pakistan. Capital appropriations from the government's consolidated budget in Taiwan are limited primarily to infrastructure and social capital.

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7. The financial policies instituted by the government, after subduing the runaway inflation in the early 1950's, laid a firm foundation of monetary stability, which has fostered a steady rise in domestic savings over the past ten years. Gross saving as a percentage of GNP increased from 9.2 percent in 1958 to 19.8 percent in 1965. Depreciation reserves, which had been an especially important source of investment capital for government enterprises, had generally accounted for more than half of annual gross domestic saving until 1961. However, in recent years net saving has provided the lion's share of gross domestic saving, mainly because of an increasing rate of saving in the private sector.

8. The expanding domestic saving rate has enabled Taiwan to support a high annual ratio of gross investment to GNP in the face of greatly diminished receipts of US economic aid since 1962. Until the end of 1962, foreign capital usually contributed one-third to one-half of the annual gross domestic investment, but by 1965, gross domestic saving was providing about 85 percent of gross investment. Gross fixed investment in the 1960's has generally fallen within the range of 15 to 20 percent of GNP, substantially exceeding ratios attained in Burma, Ceylon, India, Pakistan, the Philippines, and South Korea.

Role of Export Growth

9. Since 1960, export demand has provided a greater spur to Taiwan's development than domestic demand. During the previous decade the Chinese Nationalists had concentrated on the development of import-substitution production behind extensive government import barriers to satisfy an eager domestic market. The US aid program, by financing a large import surplus, had permitted the government to temporarily relegate export-promotion to a subordinate policy status. Little was accomplished in developing new exports, particularly manufactured goods. As the limited domestic market became satiated and plans for terminating US economic aid were being formulated, Taiwan recognized that continued high industrial growth would depend heavily on export expansion.

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10. With substantial government assistance, a number of manufacturing and processed food industries have successfully expanded their sales on the world market. Exports have risen at an average annual rate of 22 percent from 1960 to 1966, and the 18.5 percent ratio of exports to GNP in 1966 was about double the ratio of 1960. Some of the most active industrial products that have led the rapid increase in exports since 1960 are given in the following tabulation:

	Value of Goods Exported 1966 (Million US \$)	Average Annual Increase 1961-66 (Percent)
Textiles	81.8	25
Metals and light machinery	61.3	47
Canned pineapples, mushrooms, and asparagus	58.7	38
Chemicals	39.8	34
Plywood	33.6	52
Cement	18.6	59

Special Relationships with the United States  
and Japan

11. Although the policies adopted by the Government of the Republic of China and the industry exhibited by the people of Taiwan were immensely important, the country is indebted to the United States and to Japan to a lesser extent for the boosts given Taiwan's rapid economic progress through economic cooperation. From 1951 to 1965 the United States supplied Taiwan with about \$1.5 billion of economic aid and technical assistance. This aid averaged 6.5 percent of GNP annually, filled one-third of Taiwan's import requirements, and was equivalent to about 35 percent of Taiwan's annual gross investment.\* Until the

\* *Some other countries have received relatively as much aid. Foreign aid covered 40 percent of Pakistan's imports and about one-third of its investment during the 1960's, and in India foreign aid has accounted for more than 40 percent of its imports and 20 percent of its investment.*

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late 1950's, annual disbursements of US economic aid substantially exceeded in scale the GRC defense expenditures. Particularly in the 1960's, US aid has been tailored to support and accelerate the structural change from agriculture to industry. US economic grants and development loans were terminated in 1965, although PL 480 assistance has increased. In addition to economic assistance, the US has furnished more than \$2.5 billion of military grant aid since 1951 to cover the bulk of Taiwan's defense needs other than personnel costs, which make up nearly all of Taiwan's domestic defense expenditures.

12. US trade with Taiwan has expanded sharply during the past 15 years, in part because of imports from the United States under official aid programs. The United States accounted for 26 percent of total Taiwanese trade in 1966 and has consistently ranked second only to Japan as a trading partner for Taiwan. Reinforcing US aid and trade ties with Taiwan is the important US share in foreign private investment. By the end of 1966, \$42.7 million of US private capital had been invested in Taiwan, representing 55 percent of total foreign investment.

13. Japan has been especially important to Taiwan because of the latter's former status as a Japanese colony, the complementarity of the two economies, and their geographical proximity. During 50 years of colonial rule, Japan significantly developed Taiwan's agriculture, established a large sugar refining industry, built a considerable infrastructure, and contributed to the growth of commercial practices, skills, and institutions favorable to subsequent development. Since World War II, Japan has maintained a prominent role in Taiwan's foreign economic relations. It continues as the best customer for Taiwan's exports and accounted for nearly a third of Taiwan's foreign trade in 1966. Japan has purchased about one-half of Taiwan's sugar exports since the war, and until about 1964, sugar exports to Japan alone generated a major share of Taiwan's foreign exchange earnings. However, the importance of sugar as a share of Taiwan's total exports has declined significantly in recent years, from 65 percent in 1957 to only 11 percent in 1966.

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14. Japan also has been an important source of foreign investment in Taiwan. Although Japanese private investments totaled only 13 percent (\$10.2 million) of the value of foreign investment by the end of 1966, they were more numerous than those from any other source. The Japanese private ventures normally involve smaller, more labor-intensive enterprises than those of the United States. Many of the Japanese equity investments are in product lines intended for exports to markets in other advanced countries, particularly the United States, and participation by Japanese trading firms in the marketing of these and other manufactures from Taiwan provides an important stimulant to the expansion of Taiwan's trade. Moreover, the presence of numerous active Japanese trading firms in Taiwan generally has facilitated the marketing of export merchandise to third countries. These firms are among the largest, most widely distributed commercial channels in the world and can readily provide detailed, accurate information to Taiwan manufacturers on international market openings. In addition to commercial benefits of the relationship with Japan, Taiwan is receiving official economic aid in the form of a \$150 million development credit extended by Japan in 1966.

#### Problems of Future Development

15. Prospects for continued rapid growth will be determined primarily by the demonstrated resiliency of Taiwan's economy and flexibility of Taiwan's leaders in making adjustments to changing conditions. Some of the potential bottlenecks to further progress that are now confronting Taiwan's economy are characteristic, directly or indirectly, of the stage of development for the economy, and others are attributable to occurrences or decisions of a more political nature. Among the emergent obstacles to economic growth are: (1) proportionally greater requirements for capital funds as Taiwan develops more heavy industries, (2) termination of US economic aid other than PL 480, (3) probable diversion of domestic resources from development to military uses following a decline in US military aid, (4) more urgent demands for infrastructure and social welfare, and (5) limited capabilities in the field of applied science and technology.

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16. Nevertheless, if the governmental economic guidance continues to be sound, Taiwan is expected to surmount these restraining influences on growth. Despite increasing strains on the consolidated budget, Taiwan's economy probably will have available sufficient funds in the near future to maintain a high rate of growth. Private investment probably will continue to expand vigorously in response to government inducements. This will be facilitated by the fact that net private saving, which recently has amounted to about 65 to 70 percent of gross investment, will probably increase more rapidly than national income over the next few years. Also, the outlook for a sustained growth in exports is bright and favors rapid industrial development.

#### Rising Defense Spending

17. Since the Government of the Republic of China was reestablished on Taiwan in 1949, defense expenditures have been very large for a country at the stage of development of Taiwan, and have generally amounted to about 10 percent of national income. Their share in the consolidated budget has been more than 50 percent. In contrast, social services accounted for only 13 percent of total expenditures in fiscal year (FY) 1967. Most of the less developed countries in Asia have allocated at least 20 to 25 percent of their budgetary expenditures to current social services over the past decade, reflecting ambitious social welfare goals as well as lower defense spending. During the 1950's, local currency funds generated by the sale of US economic aid commodities defrayed considerable portions of the budgetary expenditures, thereby permitting the large defense outlays. More recently, part of the PL 480 local currency proceeds have been earmarked for the financing of defense expenditures (Military Budget Support). From FY 1961 through FY 1967 about 9 percent of the budgetary outlays for defense was covered by Military Budget Support. Until about 1956, when much of the US economic aid began to be appraised with an eye to its economic development merits alone, the political rationale for all US aid was to provide the economic conditions on Taiwan necessary to achieve common US-Chinese security objectives.

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18. To supplement the large defense appropriations from the GRC budget, the US has provided about \$2.5 billion of military grant aid since 1951, or an annual average of about \$160 million. The US Military Assistance Program (MAP) has financed the acquisition by the GRC armed forces of nearly all of its military hardware and equipment. From FY 1961 through FY 1967 this aid amounted to about 28 percent of total Taiwan defense costs, including both US aid and budget expenditures. With the help from the United States, the GRC has rebuilt a 600,000-man military force equipped with modern weapons, including two air-defense missile battalions and an all-jet fighter force.

19. The United States had been expected to provide \$90 million of MAP annually in fiscal years 1968 and 1969, to be followed by a reduced allocation of \$70 million in FY 1970. Because of the 37 percent cut in military assistance appropriations effected by the US Congress in November 1967, the \$90 million package for FY 1968 is expected to be reduced by about one-half and the FY 1969 appropriation by at least as much. The GRC reaction was to affirm that it is politically infeasible at this time to reduce the strength and size of the armed forces, suggesting that the GRC would substantially increase budgetary expenditures to compensate for the intended MAP reduction. The United States is planning other measures of indirect assistance as partial offsetting benefits, such as a new \$20 million long-term credit for purchases of military equipment and opportunities to increase foreign exchange earnings through contracts for repairing and rebuilding US equipment.

20. The MAP reduction will require some significant adjustments in GRC military procurement policies. The shortfall of approximately \$45 million of US military aid is, however, equivalent to less than the foreign exchange earned by one month's exports in 1967, and could be generated by a 7-percent growth in exports during 1968.

Need for Rising Public Expenditures  
for Development

21. Rising defense outlays, however, will coincide with growing requirements for public

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spending on infrastructure and social welfare. The result is likely to be a severe squeeze on budgetary resources. Usually less than 10 percent of the budget expenditures over the past ten years has been allocated to capital investment, although these shares have been somewhat enlarged by allocating to investment part of US aid local currency counterpart funds. In recent years the Sino-American Fund for Economic Development (SAFED), which constitutes the balance of uncommitted local currency counterpart funds in Taiwan, has contributed an amount of capital investment nearly as large as that provided by the budget. Although only 9.6 percent of the consolidated budget in FY 1968 is slated for capital investment, when the SAFED appropriations are added, the capital expenditures as a proportion of the combined total will be about 16.5 percent. However, this combined allocation of funds may prove to be inadequate. Shortcomings in housing, urban development, sanitation, water systems, and other public works have become increasingly aggravated and make more urgent the need for increased social overhead capital. Moreover, capital expenditures from the consolidated budget and from SAFED must take up the slack left by the cessation of the US economic aid program. Since 1951 the amount of infrastructure construction financed by US economic aid has averaged from \$30 million to \$40 million annually.

22. Budgetary appropriations for education have fallen far short of a requirement in the Chinese Constitution, which specifies that expenditures on education, science, and culture are to be a minimum of 15 percent of the central budget and 25 percent of the provincial budget. Although the annual provincial budgets have satisfied this requirement, only 3.5 percent of the central budget in FY 1966 and 3.2 percent in FY 1967 have been allocated to education, science, and culture. Nevertheless, because of the considerable emphasis the GRC has attached to education, Taiwan, already one of the most advanced countries in Asia with respect to education, continues to rank high in budgetary expenditures in this area (see Table 2).

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Table 2

Public Expenditures on Education  
as a Percent of National Income  
in Selected Countries  
1962

	<u>Percent</u>
Japan	7.2
South Korea	6.8
Malaysia	5.3
Taiwan	4.1
Cambodia	4.1
Philippines	3.6
India	2.8
Thailand	2.7
Pakistan	1.8
South Vietnam	1.8

23. There has, however, been an insufficient adaptation of the educational system to the needs of economic development. During the coming year the GRC is expected to make significant advances toward resolving this deficiency by inaugurating a program for extending free and compulsory education from the present six years to nine school years. This new examination-free junior high school admission program is designed to help meet the growing demands for a higher quality labor force. Education will become more vital to Taiwan's development as the economy shifts into the more capital-intensive industries that require a reservoir of skilled laborers, managers, and technicians. The budgetary expenses arising from the free nine-year educational program might well involve more than \$15 million per year over the three-year implementation period, a significant addition to the current level of \$20 million now being allocated annually to education, science, and culture in the consolidated budget.

24. The GRC consolidated budget has provided minimal expenditures for research and development. In response to US initiatives, however, Chiang Kai-shek has recently shown greater interest in

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devoting domestic resources to scientific and technical development. In accordance with Chiang's decision that funds for scientific research alone should account for 3 to 5 percent of the total budget in FY 1969, the GRC has decided to allocate an average of \$30 million per year for the next decade for development in the fields of science and technology. This allocation compares with a 3.3 percent share of the Japanese budget assigned to the promotion of science and technology, although such expenditures of the private sector in Taiwanese research and development will remain quite small compared with those of Japan. Taiwan may profit from the Japanese experience by concentrating on support for industrial research and commercial applications, thereby favoring further rapid expansion of exports. The US government is planning a program for pooling public and private resources to offer the GRC advisory and technical assistance in the field of industrial research and development.

25. The consolidated budget has expanded at a rate of nearly 19 percent per year during the past three years and could continue to increase at the same rate during the next few years because of the following GRC commitments: (1) to introduce a nine-year free education program in 1968, (2) to increase military expenditures consequent on the cut in the MAP, (3) to expend more funds on science and technology, and (4) to meet requirements for extensive public work projects. Revenue increases have lagged well behind expenditures, causing a budgetary deficit equal to 19 percent of total expenditures in FY 1967, and, unless a major tax reform is undertaken, the deficit in FY 1968 could be similar in scale. A sharp increase in debt service charges and repayments could impede Taiwan's development efforts. The GRC relies primarily on the sale of national bonds to finance the budget deficits, but in the past couple of years bank loans and overdrafts have financed larger shares of the deficit, thereby increasing the risk of inflation.

#### Other Sources of Funds for Development

26. The insistence of the GRC on maintaining the present size of its armed forces will continue

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to have inhibiting effects on economic growth. But despite this decision, Taiwan's governmental leaders are showing an awareness of the country's economic deficiencies and a growing capability for managing its economic problems in a manner favorable to rapid economic growth. GRC economic policies emphasize the development of private enterprise by providing for government financial and technical aid to the private sector and by offering tax benefits and various other incentives for private investment. Recently, the government has been promoting investment by developing industrial areas and duty-free export processing districts, such as the Kaohsiung Export Processing Zone. In the longer run, fiscal and monetary policies will reflect the GRC's continuing concern for economic stability and will likely contribute to a growing confidence in the national currency.

27. The GRC is expected to continue to free the movement of capital to and from Taiwan in order to attract needed foreign investment. A sustained drive has also been under way by the government in recent years to liberalize controls on foreign trade in order to rationalize the allocation of resources to its growing industrial economy. As the economy proceeds further toward export orientation, the greater exposure of industry in Taiwan to the forces of international competition should enhance the competitive position of Taiwan's products in the world market. The present pattern of Taiwan's industrial and commercial development indicates a growing level of international specialization, and future investment is likely to show even more of the same pattern.

28. Having successfully provided a foundation for light industry on Taiwan, the GRC is moving forward with plans for the development of heavier industries, such as petrochemicals and heavy machinery. Partly in support of this structural transformation, the GRC also will place renewed emphasis on the improvement of the investment climate and the expansion of exports. Taiwan will rely heavily on both the exports of its light industrial products and the introduction of foreign capital, primarily US private investment, to finance the foreign exchange costs for

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new capital plant and equipment in its budding heavy industrial sector.

29. As the development of heavy industry on Taiwan proceeds, a given expansion in industrial output will require proportionately more capital than in the past. Accordingly, there will be a need for expanded sources of savings to meet the growing capital requirements. Until the end of 1962, foreign capital usually contributed a third to a half of the annual gross domestic investment. Taiwan has succeeded remarkably well since 1962 in maintaining an upward trend in gross investment despite the sharp drop in US aid that began in 1963. Gross domestic saving increased at an annual rate of 31 percent from 1962 to 1965 and provided about 85 percent of gross investment in 1965. Domestic saving is expected to continue shouldering a predominant share of investment as the public confidence in the currency and the economy in general increases.

30. Partly on the basis of conservative estimates of Chinese authorities, it appears that from \$100 million to \$150 million of foreign capital will be needed annually through 1972 to supplement the available domestic sources of capital funds. Some economic aid will continue to arrive from the United States. For example, the US Government agreed on 12 December 1967 to provide Taiwan with \$37.5 million of PL 480 assistance during 1968 and 1969. Taiwan's credit standing among conventional lending institutions has become sufficiently strong over the last five or six years to gain substantial loan commitments from the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA), the US Export-Import Bank, and others. Taiwan is also receiving capital under a \$150 million credit from Japan and is likely to win further loan concessions from Japan in the future. Private foreign investment, principally from the United States, Japan, and overseas Chinese, has risen much more sharply than Taiwan had expected. The GRC approved \$66 million of private foreign investment in 1967, nearly double the amount in 1966, although it had not earlier counted on more than \$40 million. The existing sources of foreign capital, increased export

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earnings, and a growing capability for borrowing abroad should provide sufficient foreign exchange to insure continued rapid industrial development.

Export Demand

31. Although domestic demand may favor the development of some import-substituting industries, the primary impetus to Taiwan's industrial development over the next few years probably will come from export demand. The excellent performance of exports in recent years can be explained in part by temporary circumstances, as well as the alertness and ability of Taiwanese business to seize new opportunities for export. Taiwan enjoyed windfall earnings from its large exports of sugar in 1964 and 1965 because of the abnormally high international market prices for sugar that then prevailed. Taiwan has also benefited substantially from increased exports to South Vietnam arising from the war. Greater efforts need to be made by Taiwan to widen the geographic distribution of its exports in the less developed countries, and, more importantly, in Western Europe. Nevertheless, export prospects appear good. The increasingly active GRC overseas trade missions are evidence of a growing Taiwanese interest in developing new export markets. Taiwan's principal hopes for trade expansion, however, will hang on its commercial relations with the industrially advanced countries. Despite rising competition from other Asian less developed countries, the well-developed commercial ties with both the United States and Japan will probably continue to hold high promise for Taiwan's exports. In addition, there is considerable scope for expanding exports of industrial consumer goods to the markets of Western Europe.

32. Before some of the heavier industries can be developed in Taiwan on a sufficiently large scale to be economically competitive, Taiwan must be assured of larger markets for its output than would be available domestically. The governments of Taiwan and South Korea agreed in August 1967 to promote the construction of petrochemical plants in each country (a caprolactum plant in Korea and a dimethyl terephthalate (DMT) plant in Taiwan) to supply the markets in both countries. Additional agreements of this type for market integration with Korea and other East Asian countries may be forthcoming.

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Economic Complementarity with Japan

33. An obvious advantage for Taiwan in the continued rapid growth of the Japanese economy is that higher incomes in Japan mean rapidly increasing Japanese consumption of the kinds of goods Taiwan now exports. Higher Japanese wages, moreover, have a more profound meaning for the future of Taiwan's exports. In recent years, wages in Japan's light industries have not kept pace with the growth of productivity, as they have in heavy industries. This problem has been exacerbated by an intensifying shortage of labor, particularly at the lower levels of skill. As a result, there is a possibility of a growing international division of labor in East Asian industry with Taiwan benefiting from its lower costs in light industry.

34. Early signs of such a division of labor have included particularly rapid increases in Japanese imports of light industrial manufactures from Taiwan. This trend has occurred despite the fact that Japanese effective tariffs against such manufactures have been the highest among the advanced nations. As shown in the following tabulation, Japanese imports of textiles and clothing from Taiwan more than tripled from 1962 through 1966 and imports of miscellaneous manufactures associated with light industry and consumer goods were more than six times those of 1962.

	Thousand US \$				
	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>
Textiles <u>a/</u> and clothing <u>b/</u>	182	401	528	589	596
Miscellaneous manufactures, including printed matter, various plastic products, house- wares, and the like <u>c/</u>	82	284	363	441	519

*a. This designation is based on category .65 of the Standard International Trade Classification (SITC).*

*b. Based on SITC .84.*

*c. Based on SITC .89.*

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Although the values are still relatively small, their growth indicates significant prospects for expansion as tariffs are steadily reduced, and these and other data point toward gains accruing principally to East Asia.

35. During the next five to ten years, Taiwan and South Korea should share in the gains from the growing industrial complementarity in East Asia. A recent announcement that a Japanese manufacturer was about to sign a joint-venture contract with a Taiwan firm for manufacture and supply of shirts to Japan indicates that Taiwan is regarded as an important potential source of light industrial products. Some attempts may be made to bring Taiwanese laborers into Japan, as was recently suggested by the Japan Spinners Association, but the consensus is that Japanese planners and businessmen will generally reject labor migration, which they refer to as the "West German solution." The Japanese will probably prefer to greatly increase private investment in light industries in Taiwan and South Korea to assure imports of needed intermediate and consumer goods. This view is supported by current trends in regular trade, considerable discussion of bonded trade, and scattered evidence on the content of recent private investment. Because most of the equity investment will be on a joint-venture basis, Japanese opportunities to dominate or exercise control over Taiwan's industry will be limited.

36. Two important policy measures that Japan might take in the next five to ten years to encourage the general trends described would be the relaxation of credit facilities for Japanese firms willing to invest in Taiwan or Korea and the encouragement of bonding agreements and tariff rebates to facilitate trade in light industrial products. Considering the large capital commitments to Taiwan (\$150 million in credits) and South Korea (\$300 million in grants and \$700 million in credits) undertaken by the Japanese government, further policy adjustments to encourage East Asian economic development seem completely consistent with current Japanese policy.

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