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Thanks in advance for having your analysts review the attached manuscript. We'd be immensely grateful if you could have a response by the end of next week. Please give me a buzz when you are ready: 226-2485. Cheers,

John Starrels

SHRINKING THE SURPLUS:EXTERNAL ADJUSTMENT STRATEGIES FOR THE TAIWANESE ECONOMY

INTRODUCTION

The Republic of China on 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% 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 largest foreign exchange reserves in the world, some $50 billion U.S. dollars.

Taiwan has a similarly disproportionate weight in discussions about world economic policy. For some, the island is a shining example of the productive power of free market economies. For others, it is a sinister beacon, luring other nations to follow a path of self-centered and ultimately self-destructive mercantilism.

This report 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 Report will look at the adjustment problem facing Taiwan from two perspectives: First, the changes which 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 improve U.S. trade and diplomatic relations with the Republic of China. Pursuit of these positive adjustment strategies should be a major goal of both Taiwanese economic policy and U.S. diplomatic and economic policy toward the island.

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 sleepy agricultural province of mainland China until 1949, when some 2 million soldiers and officials of the nationalist Kuomintang party (KMT) fled the mainland after losing a civil war with the Communist Party. The KMT established governance over the 6 million "islanders" (Taiwanese) and the 2 million "mainlanders" and were faced with the task of turning a province into an independent nation.

The new rulers found that their island garrison possessed a relatively poor, underdeveloped agricultural economy, few natural resources, and large population of recent immigrants. Rapid modernization of this economy was seen as essential to both protect the KMT from mainland aggression and to acquire the economic substructure which would enhance the viability of the island republic which claimed to be the true representative of the Chinese people.

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.

Because of this national security orientation, the government played a critical role in the evolution of the Taiwanese economy. Under martial law, the state had virtually unlimited command powers over the economy, and the KMT was not hesitant to use these powers to shape the nation's economic future. Land reform was forced on a reluctant agricultural elite, high taxes were imposed to support the national garrison, and a large number of government enterprises were established in critical sectors of the economy. Banks were government owned or controlled, 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 dollar to the U.S. dollar, and then created a set of exchange control regulations which effectively prohibited the use of the New Taiwan 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 were required to be converted into New Taiwan 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 in its military position to permit a lively debate on the island about the future course of the nation's economic development. Two schools of though were prevalent during 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 for 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"

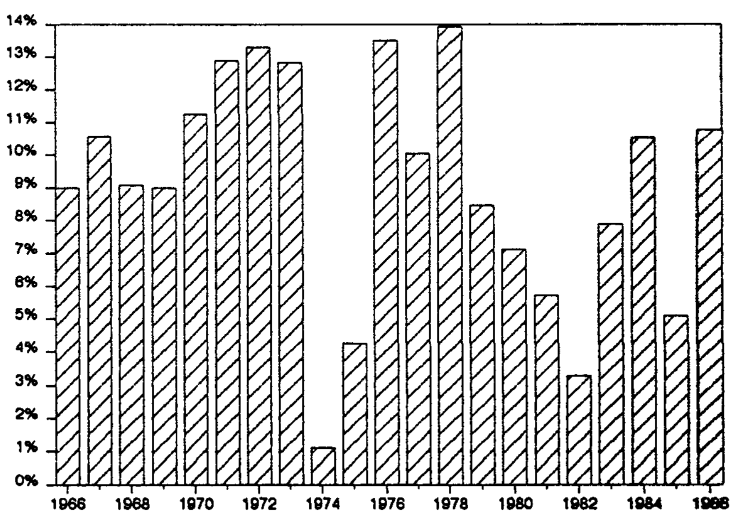
Once the decision was made to orient the Taiwanese economy toward light industry and export, the KMT moved aggressively to pursue this objective. The New Taiwan dollar was pegged to the U.S. dollar at a rate of 40:1 in 1961, a highly competitive level which made Taiwanese exports very attractive to U.S.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

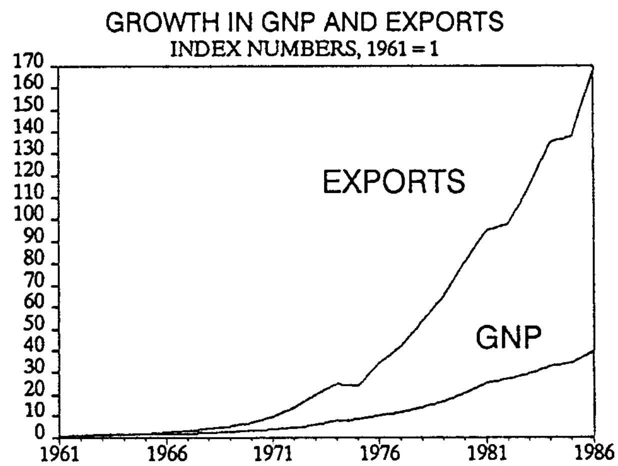
In addition to the exchange rate, the island's business community was provided with a generous set of incentives to shift their focus from domestic to export production. Government-controlled banks made loans readily available for export industries, tariff policy was used selectively to limit import 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% 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 which guided government policy during the 1960's and 1970's was "Everything For Export."

As the following charts demonstrate, "Everything for Export" turned out to be a good development strategy for the island. Taiwan's GNP expanded by an average of 8.2% per year during the 1950's, 9.1% per year during the 1960's and 10.1% per year during the 1970's. And the overwhelming source of this heady growth was export

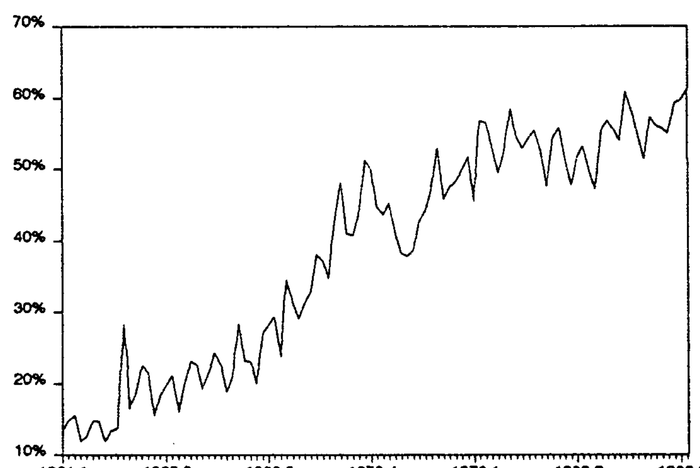
ANNUAL GROWTH RATES FOR REAL GNP





demand. Since 1961, exports have grown at a rate more than four times faster than that of GNP, and in a number of recent years, export growth has accounted for more than 60% of total growth in the island's GNP.

FIGURE
EXPORTS AS A SHARE OF GNP



And this export orientation was not merely the product of an early stage of Taiwan's development. As the following graph demonstrates, the importance of exports in Taiwan's GNP has 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.

Taiwan's external success has not been incompatible with rising domestic welfare, 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 seems 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 seats through land reform before 1965, and by creating urban employment through export promotion after 1965, Nationalist policy has greatly contributed to such equal outcomes." (Lodge/Vogel, 1987, pg. 193).

A key element in this strategy has been a bold program for educating and training the Taiwanese workforce. 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 a former pupil, 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 one 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. Such appreciation of Taiwanese exploits is, if anything, deepened by personal ties between the two societies that were initially established when many of the ROC's leaders came to the United States for education and training. The result is that a good number of Taiwan's present leaders are graduates of American universities.

U.S. assistance policy toward Taiwan which played a vital role in the islands' early development. Between 1951 and 1965 U.S. aid to the Republic of China came to about $1.5 billion. Such assistance proved highly beneficial. Over this period, it financed 26 percent of the total value of capital, providing start-up 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. 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 recipients's eligibility based on these considerations: the nation's level of economic development; its eligibility status in other industrialized countries' tariff preference programs; and the extent to which the LDC (lesser developed country) grants U.S. exporters equitable and reasonable access to its markets.

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. Lop-sided trade and current account surpluses generated by major recipients has 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, Taiwan's and South Korea's GSP benefits were respectively reduced by 37.5 percent and 24 percent.

AMERICAN INDUSTRY AND THE TAIWANESE 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 one is to be found in the export activities of American multinational firms, nearly half of whose exports derive from production outside of the United States. One-fifth of the total capital invested in U.S. manufacturing firms is accordingly found in facilities outside this country where unit labor costs are frequently lower. Three-quarters of this output is for sale abroad and one-quarter is for export back to the United States -- to be sold in, or incorporated into goods for, the American market.

Taiwan's low unit labor costs and high productivity has not surprisingly turned this island into one of those vital links in the chain of U.S. multinational production. For unlike the Japanese, who design and export their own products to the United States, it is U.S., not Taiwanese, firms who sell proprietary items in the United States. American concerns come to Taiwan to seek out and send back to the United States, under American brand names, everything from cheap shoes to consumer electronics. If the Taiwanese do not make something, the American companies help them get started. And many U.S. companies operate their own factories in Taiwan solely for the purpose of shipping products back to the United States. Case in point, electronics.

Spurred on by Japanese competitors, a number of American electronics corporations went to the ROC 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, the ROC had surpassed Japan in exports of televisions to the United States.

These arrangements are not foisted on the Taiwanese. On the contrary, its government allows virtually any kind of U.S. business investment: from partnerships with Taiwanese companies to wholly owned subsidiaries, who in turn have encouraged the growth of a large core of suppliers whose expertise in working with Americans tends to draw more U.S. investment. As a result, "You really can't consider Taiwan an exporting nation. Taiwan is simply a collection of international subcontractors serving the American market" is the way one source expressed it to the Wall Street Journal (5/27/87).

THE CONTEMPORARY STRUCTURE OF TAIWAN'S ECONOMY

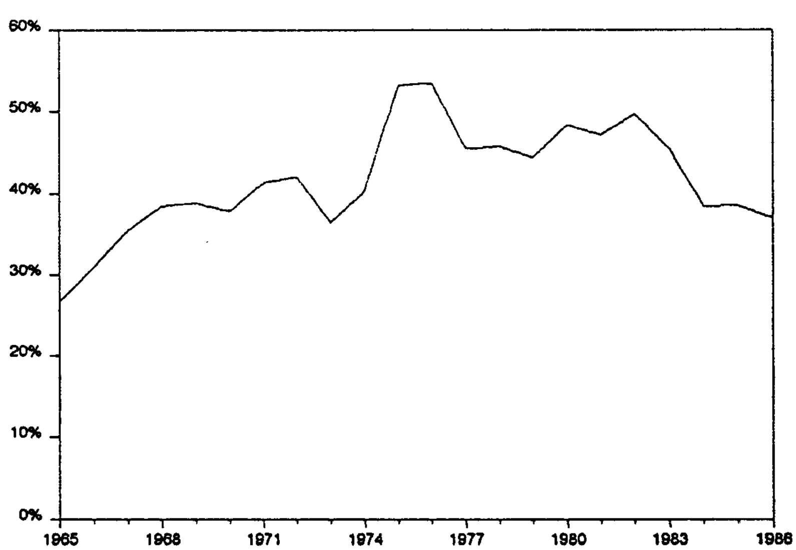
Although the aggregate statistics would suggest that Taiwan's economy is strong and vital, the peculiar nature of the island's development strategy has left the nation with a lopsided and imbalanced economy which may well have considerable problems adjusting to future changes in the world economy. Taiwan's 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 primitive by international standards, with the banks owned or controlled by 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 no 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 fully 26% of gross capital formation on the island between 1952 and 1960. Much of this investment was channelled 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. Mainlanders, who controlled the government apparatus, were initially not very popular with the Taiwanese, and there were few avenues for either employment or entrepreneurship open to mainlanders. Government enterprises provided an effective way of providing mainlanders with access to economic resources as well as political power. To this day,

FIGURE 1
GOVERNMENT'S SHARE OF TOTAL DOMESTIC CAPITAL FORMATION



mainlanders account for a majority of employees in government enterprises, while the private sector continues to (quietly) discriminate against mainlanders and in favor of native Taiwanese.

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

When the development strategy shifted 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.

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 sterotypes of "bureaucratic business" which plague public enterprise in much of the rest of the developing world. The steel mill, for example, a flagship government enterprise, returns a tidy profit on its operations, a rare feat in today's world economy where most integrated steel mills lose money.

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 help 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 the operations of foreign financial institutions in the country also restrict the diversification of the financial sector.

Government policy has also not favored the development of effective non-bank 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 fewere than 50 employees and less than U.S.$ 1.5 million in annual sales. These businesses are largely self-financed, or financed through family networks, owing to the primitive nature of capital markets and the timidity of banks, 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 firm consolidation. Open financial markets in other countries provide many more opportunitie for consolidation than does Taiwan's.

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 descendents. Having a large small business community 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 pose a challenge to the political power of those who presently control the government, and if so it would be a relatively easy task for government elites to use their control of the banking system to discourage this kind of industrial concentration.

The dominance of small firms in the Taiwanese private sectors 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 precisely the "industries of the future" for a rapidly-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 incapable of mobilizing significant blocks of capital on its own.

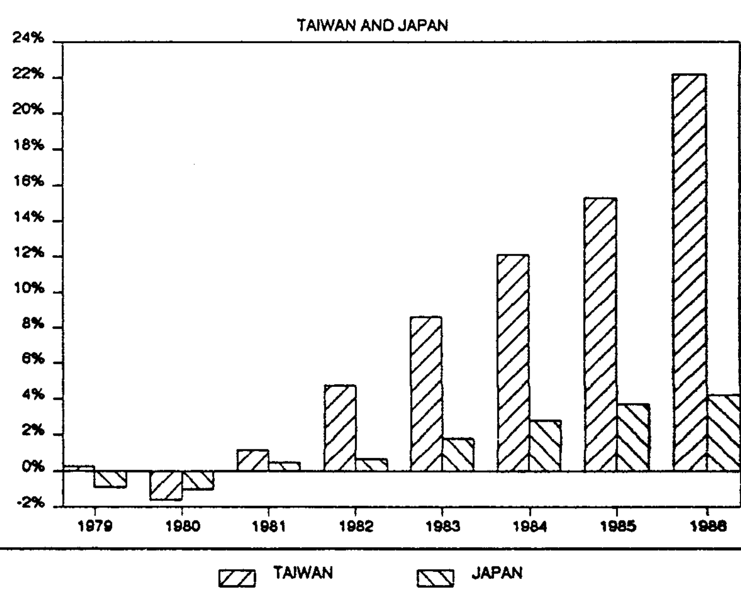
THE BURDENS OF SUCCESS: TAIWAN'S TRADE SURPLUS AS A PROBLEM FOR THE ECONOMY.

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

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 U.S. The U.S. accounts for over 80% of Taiwan's merchandise trade surplus, consuming 47% of the nation's exports while supplying only 22% of the island's imports.

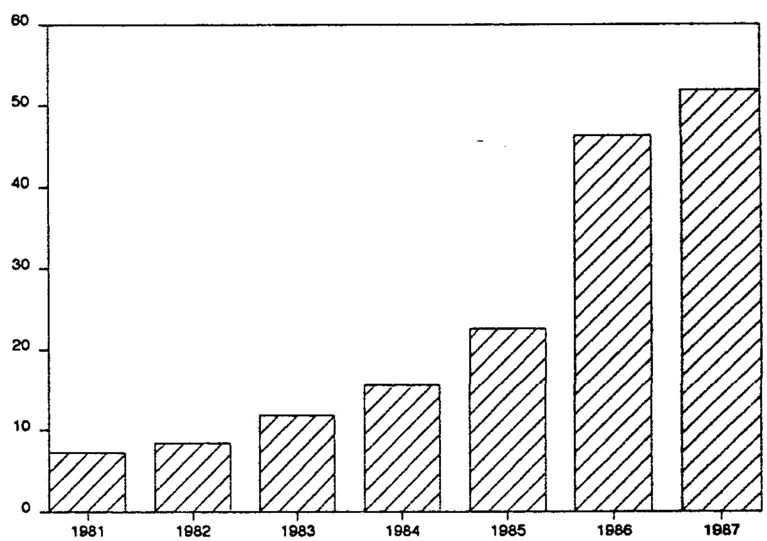
FIGURE

CURRENT ACCOUNT AS A PERCENT OF GNP



Driven by the bilateral surplus with the U.S., the Taiwanese economy during the 1980's has accumulated what can only be described as an "embarrassment of riches" This success creates three distinct but interrelated problems. The first of these is the problem of the surplus itself. Taiwan finds itself in the company of such nations as Japan and Germany in the aggregate size of its bilateral trade deficit 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% of GNP, more than 4 times larger in relative terms than the current account surplus of Japan

FIGURE
CENTRAL BANK RESERVES
IN BILLIONS OF U.S. DOLLARS



and rivaling the OPEC surpluses of the late 1970s. Surpluses of this magnitude invite critical attention at a time when the U.S. is urgently seeking ways of reducing its own trade deficit.

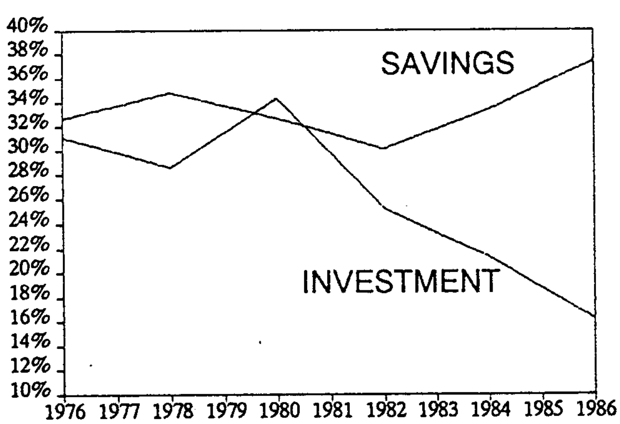
The second problem is the rapid build-up of currency reserves which have resulted from current account surpluses combined with exchange controls. With little foreign debt and only a small amount of foreign investment, payments of dividends or interest to foreigners consume only a tiny fraction of Taiwan's 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 April of 1987, the central bank had reserves of some $59 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 3 years worth of imports, versus the 3 month coverage most major countries maintain as central bank reserves

This huge accumulation of financial reserves in government hands both increases negative attention from 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:

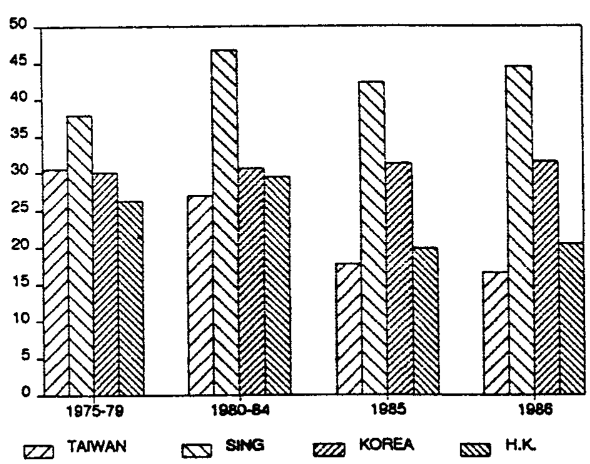
> " Taiwan's reluctance to open its markets is particularly inexcusable since it maintains the second-largest foreign exchange reserve in the world," (Business Week, April 13, 1987)

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 New Taiwan dollars. Thus far in 1987, the domestic money supply has grown at an annualized rate of more than 50%, leaving local capital markets awash in liquidity and heightening fears of inflation among government policy makers 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).

SAVINGS AND INVESTMENT AS SHARE OF GNP



INVESTMENT AS A SHARE OF GNP



The third "burden of success" on the Taiwan economy is the effect which the trade and reserve surpluses 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 dragons" of Asia, and one of the largest gaps between savings and investment.

This decline in investment has been induced by both political and economic factors. Politically, the decision by the U.S. to sever diplomatic ties with the island in 1979 significantly increased the uncertainty about the political future of the nation and dampened the spirits of investors for new fixed-capital construction projects. The national liquidity preference apparently rose as the possibility of a future exodus from the island for military or diplomatic reasons seemed increasingly possible.

This sense of uncertainty about the future has been heightened by growing concern about a protectionist reaction from major industrial countries to Taiwan's economic success. Although they are proud of their export success, most Taiwanese businessmen also are fearful that the lopsided trade surplus of the nation 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. Only the most secure and cost-competitive export industries are willing to undertake new investments in light of this reality.

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 of 1987, $44 billion of the nations $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 this 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. This surge of funds into the market creates enormous daily variation in share prices, and gives the market the air of a speculative gambling casino rather than a rational investment market. Excessive speculation is one prominent feature of financial markets suffering from a classic "liquidity trap"--excess cash and poor investment alternatives.

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 portion's of Taiwan's success are due to broad world historical trends largely beyond the control of either the U.S. or Taiwan. If Taiwan is now an economic problem for the United States, it is important to understand precisely the nature of that problem.

The shift from labor-intensive to knowledge-intensive industries in advanced industrial countries (particularly the United States) -- and their transfer to emerging, low wage/labor intensive economies, such as Taiwan. This is, in Peter Drucker's words, a "structural and irreversible" trend. Even in the absence of dollar appreciation, growing budget deficits and rapid expansion of U.S. import demand since the early 1980s, these longer term trends would have been translated into healthy trade surpluses for Taiwan with this country; as they undoubtedly also would have for Japan, South Korea, and a host of other advanced developing countries.

This shift is reflected 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, semi-finished goods and machinery. Food and fibers accordingly account for less 25 percent of total imports today. Exports have also undergone substantial changes. During the 1950s, industrial products in exports averaged less than 21 percent. By 1965 they made up over half of ROC 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 ROC 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 1980s, the composition of U.S.-Taiwan trade clearly reflected these policy shifts. In 1975, for example, electrical machinery and apparatuses 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 to 16.9 percent in 1984. Meanwhile, electrical machinery and apparatuses rose to 22.5 percent in 1978 and 25.9 percent in 1984. By then, more than 95 percent of ROC exports to the United States consisted of industrial products.

The composition of U.S. exports to Taiwan over this same period shows reflects some significant variations although the bulk of U.S. sales to the ROC continue to consist of agricultural goods, machinery and tools, chemicals and pharmaceuticals and transportation equipment. In the 1975 through 1984 period, the share of soy beans, wheat and raw cotton declined from 26.4 percent. Machinery and tools, which accounted for one-third of Taiwan's imports from the United States in the mid-1970s, 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 five-fold 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.

Relatively speaking, the U.S. share in Taiwan's total trade has continued to increase, moving from 29.5 percent in 1952 to 32.6 percent in 1972, and 38 percent in 1984. In contrast, Japan's share of Taiwan's two-way trade registered a continuous decline, moving from 39.4 percent in 1952 to 18.4 percent in 1984. Taiwan's exports to Japan dropped from 52.6 percent in 1952 to 10.5 percent in 1984, while Taiwan's exports to the United States jumped from 3.5 percent to 48.8 percent over the same period.

American trade concerns with Taiwan focus on the growing U.S. deficit with that country. The deficit has grown steadily over the past 15 years: moving from -\$708 in 1972, to \$14.7 billion in 1986. The biggest jump, however, occurred between 1980 and 1984, when the U.S. merchandise imbalance more than quadrupled, from -\$2.086 billion to -\$9.827. As with other countries whose trade surpluses with the United States jumped over this period, the steep rise in the America's merchandise imbalance with Taiwan between 1980 and 1984 probably results from an over-valued dollar.

The use of Taiwan as an export platform by many U.S. based multinational companies only helps to complicate the bilateral trade picture between the countries, as these firms combine their knowledge of U.S. marketing with the cost-advantages of Taiwanese production. The use of the ROC as a commercial base for U.S. exports only underlines the strong possibility that with respect to a growing number of items, the United States confronts serious obstacles in attempting to balance its trade account with Taiwan. On the import side, these obstacles translate into a substantial Taiwanese comparative advantage in selling low-technology, labor-intensive and resource-intensive consumer goods within the United States. On the export side, American products are confronted with increasingly stiff competition from Japan -- along with continued Taiwanese import barriers.

Similar problems confront the United States on the export side. To begin with, there are the Japanese, who because of their geographic proximity, aggressive marketing techniques and better after-sale services, now enjoy a comparative advantage over the United States. 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. Taiwanese trade experts further point out that U.S. pressure on Taiwan to further open its domestic market to imports will benefit Japan far more than the United States. This is due to a number of factors: Japan's 50-year stewardship of Taiwan; thus its superior grasp of Taiwan's business culture and practices; which in turn explains why Japanese salespeople are frequently more adept than Americans in cultivating their Taiwanese counterparts -- interactions which in many instances are facilitated by the ability of both parties to communicate in either Japanese or Chinese.

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 threatens to isolate the nation from its international allies and stifle both new investment and future growth.

The central challenge to Taiwan today is finding a new strategy to maintain 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. Just as America's desire to consume more than it produces is the root cause of the U.S. trade deficit, Taiwan's surplus is caused by its national propensity to produce far more than it consumes. The very high savings rate (averaging nearly 40% of national income) depresses consumption of both domestic and imported goods, and is not balanced with an equivalently large commitment of resources to investment. Any nation which saves 40% of income, and invests only 16%, 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. This task could conceivably be tackled by initiatives aimed at both increasing consumption (decreasing savings), or increasing 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. There is only a primitive national pension system, forcing people to rely on their own savings to provide for old age or infirmity. Creating a social security system which spread such risks over the population might help reduce some of the excessive savings engendered by the present system.

But, as with the U.S., the key policy initiative which might affect the savings/consumption balance is the government budget. Just as the U.S. budget deficit was the driving force behind rising consumption and falling savings in the U.S., the Taiwanese budget is a major contributor to the nation's high savings rate. Throughout most of its history, the central government has run either a balance in its fiscal budget, or a slight surplus. This very conservative fiscal posture has helped the process of public capital accumulation in the past, but may now stand as a major obstacle to domestic demand expansion.

Given the size of its domestic and foreign savings pool, the government of Taiwan could easily run very substantial budget deficits without any fear of rising interest rates or "crowding out" of private investment. In fact, a commitment by the government to significant fiscal deficits might help to revive private investment geared to the domestic market, in anticipation of steady growth in future domestic demand.

But despite the apparent attractions to increased domestic consumption, there are important obstacles which have so far inhibited moves in this direction. Deep-seated cultural attitudes regard savings as virtuous and consumption as irresponsible self-indulgence. The conservative practices of banks with regard to consumer credit are derived from their status as government agencies--bureaucrat/bankers do not want to assume the responsibilities for loan losses which more aggressive consumer banking would entail. Recently, and reluctantly, the government permitted Taiwanese to use "debit" cards, but the idea of creating a "credit" card was simply too radical for the bankers. In a similar vein, proposals for deficit spending by government have been summarily rejected by the conservative policy makers who view balanced budgets as the only prudent fiscal stance.

This resistance to rapid domestic demand stimulation is buttressed in the Taiwanese case by genuine 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 New Taiwan dollars, the domestic money supply has grown furiously as the current account surplus has risen. Yet inflation has remained almost nonexistent on the island, and the excess liquidity has not turned into a consumer spending binge. There is, however, reasonable 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 1927, and would be prepared to go to great lengths to prevent a recurrence of that phenomenon. Policy-makers 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].

If expanding consumption appears to be constrained by cultural disposition, policy habit, and a reasonable fear of inflation, then expanding investment would appear to be the only possible mechanism for redressing the significant internal 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 might also 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 entrepreneur's unwillingness to give up ownership and control of a business, but this would not rule out non-ownership 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.

But ultimately, it is once again the government which has the key role to play in expanding domestic investment. 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 be required if overall investment spending were to rise markedly.

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.

But it is not clear at this point whether government investment will be sufficiently large to compensate for the falloff in 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 very competitive level. 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.

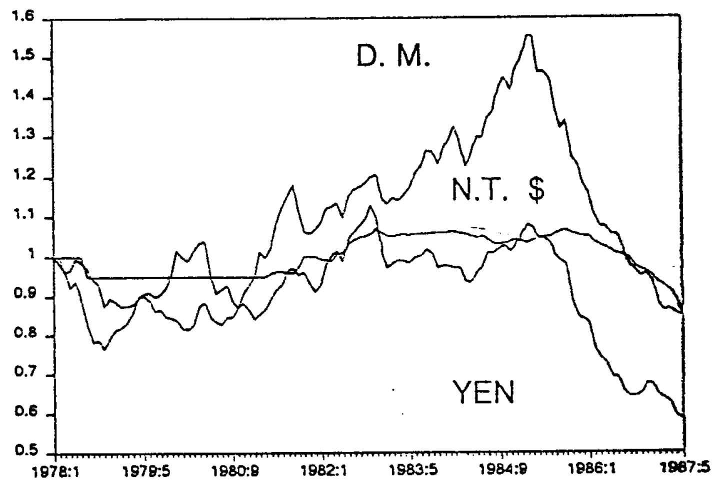
To maintain its competitiveness in world markets (and improve its relative competitive position in the U.S. market), Taiwan allowed the NT dollar to "float" against the U.S. dollar starting in 1979. This uncoupling occurred just before the strong appreciation of the U.S. dollar, and permitted a modest 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 an 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 the following graph 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 New Taiwan dollar appreciated against the U.S. dollar. In comparison with the Japanese Yen or the Deutschemark, two other currencies with substantial

FIGURE 2

U.S. DOLLAR EXCHANGE RATE AGAINST SELECTED CURRENCIES



bilateral trade deficits with the U.S., the New Taiwan dollar has appreciated substantially 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 markets of strong currency countries such as Japan.

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. The following chart based on data compiled by Morgan Guaranty Trust shows that, on an inflation-adjusted and trade-weighted basis, the NT dollar remains some 15% above its rate in 1980. On a bilateral basis, Morgan calculates that the NT dollar remains 20% overvalued against the U.S. dollar.

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 New Taiwan dollars? Second, how quickly should the currencies move toward the desired values.

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

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

Deciding precisely how far the New Taiwan 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. One recent paper by economist John Williamson provided estimates of appreciation required of from 6% to 50%, with a "best guess" at 30-40%. This 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, there is little support for such a strong appreciation of the currency among Taiwan's political or business elite. Throughout our recent trip to the country, officials and businessmen repeatedly asserted that any significant additional appreciation of the New Taiwan 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 has historically been domestic industrialists concerned about foreign competition, and the result has been a history of over-valued 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 seems unlikely that the legacy of "everything for export" is likely to erode the influence of the export sector any time soon, and thus while a substantial appreciation of the New Taiwan dollar would clearly help reduce the trade surplus, a commitment to achieving such an exchange rate is unlikely from the government.

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

FIGURE 3

1986 IMPORTS

cents per day and there is frequent discussion in the press and among policy makers about whether the current level is the "right" one or not.

This gradualist approach has some virtues with respect to "fine tuning" the pain 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, that it has not yet found a level at 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 seems to have done little to slow down the pace of speculative capital movement. In April of 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, Calif. long a capital flight haven, and bringing the money back to the island. (Forbes, April 6, 1987)

If the government could muster the resolve to take the heat from the export industries, from a financial point of view it would be clearly more in the interest of the country to pick a clear target for the exchange rate, move quickly to that target, and then indicate a commitment to maintain that rate for the foreseeable future.

3. TRADE POLICY. A third route toward external balance involves a liberalization of trade and tariff policy. Traditionally, 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 in the 1950's. 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 provides 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. 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.

In this are, 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 U.S. and Taiwan, involving the complete elimination of all tariff barriers.

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 merely 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 U.S. Trade liberalization is thus good economic policy which may do little to improve the key diplomatic problem of large bilateral trade surpluses.

According to a number of authorities, this is precisely what is taking place. A liberalized Taiwan market is leading to a substantially greater surge in Japanese and other imports than in imports from the U.S.

FOREIGN AID IN REVERSE: THE BUY AMERICA CAMPAIGN. Recognizing the particular importance of the U.S./Taiwan trade imbalance, and the limited ability of trade liberalizaiton to redress this imbalance, the Taiwanese have embarked on an ambitious "buy American" campaign. The theme of this campaign generally is "We know we could buy equivalent goods cheaper from other sources, but our tradition of friendship with the U.S. is strong enough that we will forgo economic advantage and buy from the U.S. even though it is more expensive." This rationale animates a long series of "buying missions" which are sent from Taiwan every few months to see if they can find something to buy from the U.S. So far, these buying missions have largely purchased American agrucultural products (at premium prices), which does little to improve the U.S. manufactures trade balance with 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 earthmoving equipment (for the highway projects), electrical machinery (for electric power generation), chemical processing equipment (for two new naptha crackers) and transportation equipment (for the new Taipei subway) toward American suppliers.

While the fruits of such preferential contracting may be sweet to American producers, it is difficult to argue that American economic policy toward Taiwan ought to be geared toward encouraging more such efforts. First, in the absence of more substantial moves to alter the internal macroeconomic balance of the island, efforts to redirect imports toward America will merely shift around the geographical distribution of the trade surplus, not reduce its overall magnitude. The Taiwanese may import more from the U.S. and less from Japan under a "buy American" policy, but the domestic and international problems posed by Taiwan's trade surplus would still persist.

Second, a "buy America" policy which is not rooted in sound economic realities risks an ultimate deterioration in economic relations between the countries rather than an improvement. The following news story appeared recently in a Taiwanese english-language newspaper, and it points to the potential downside of the Buy American campaign:

"Tang Eng Iron Works, which says it was sold low-quality steel by American steel companies last year, will take action to claim indemnity. Local steel industry insiders pointed out that the procurement of the hot rolled steel hoops was based on policy coordination rather than profit consideration. They stated that the main purpose of the purchase was to ward off U.S. pressure on the ROC to sign the voluntary restraint agreement on steel exports." China Post, May 26, 1987

"Buy American" strategies might also send a dangerous signal to American industry if increased exports to Taiwan were taken as an indication that U.S. firms had recovered their competitive edge in international competition. Taiwan's preferential treatment of U.S. products amounts to foreign aid for America, and signals a fundamental weakness in America's competitive position, not a basic strength.

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 which benefit the world economy as a whole. For nearly a generation after the Second World War, the U.S. 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% of the central bank's currency reserves are in U.S. dollars, and the vast majority of those dollar assets are held in the U.S. itself, either as deposits in U.S. banks or in U.S. treasury securities. In this sense, Taiwan, like Japan, uses their financial resources to help finance the U.S. trade deficit.

But if the U.S. 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 America, for example, ran deficits of as much as $42 billion a year as recently as 1982, before the collapse of external finance created by the debt crisis forced them to cut back to less than $16 billion. Arguably, there is at least $30 billion a year worth of demand for imports in Latin America which is not realized because of an inability to borrow funds to support it.

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 bold program to provide some $30 billion over the next three years in new financial assistance to debtor countries. Taiwan, in a far stronger reserve position than Japan, could easily match that figure, and could do so much more quickly.

There is some evidence that the Taiwanese leadership is taking this "outward investment" option seriously. Recently, the cabinet asked the legislature for authorization to suspend the system of outward capital controls. If this proposal is accepted and enacted, Taiwanese would be allowed to own financial assets overseas, and to hold their own foreign exchange resources without having to turn them into the central bank. Such a move would doubtless facilitate capital flow from the liquidity-rich Taiwanese market to international capital markets.

But allowing Taiwanese private investors to ship liquid assets overseas does not by itself guarantee that this 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 investment in the Third World.

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

The Republic of China (ROC) on Taiwan has experienced major shifts in its relations with the United States since 1949. It has moved from the status of being a key U.S. ally in containing Asian Communism in the 1950s and 1960s, to a residual focus of U.S. strategic concern in the Pacific region in the 1970s and 1980s. Coincident with this shift, however, has been a continuous upgrading of Taiwan's economic importance to the United States. If political considerations have required the United States to downgrade its diplomatic ties with Taiwan, economic realities have compelled it to do opposite.

Long-run U.S. interests in Asia could be advanced by a Taiwan actively committed to the economic growth and development of the region. The challenge facing the two countries is found in establishing new instruments to facilitate this larger Taiwanese role.

At the moment, the extraordinary bilateral trade imbalances between the two nations stand as the major obstacle to an improved set of relationships. But trade tensions should not be allowed to obscure important common strategic and political connections between the two nations.

From 1949, when the Republic of China was officially established on Taiwan, to 1972, the United States recognized the island regime as the sole legitimate government of all China. These diplomatic commitments were, if anything, strengthened by the presence of the U.S. 6th fleet in the straits of Taiwan -- a visible deterrent against potential aggression directed against the ROC by the People's Republic of China (ROC). Richard Nixon's trip to Peking in 1972, however, changed all that, representing as it did a U.S. decision to reorient American foreign policy toward the PRC.

1972 to 1978 was a transition period in U.S.-Taiwan relations. Diplomatic ties remained intact. But a growing number of high-level meetings between U.S. and PRC officials during these years indicated that the United States was preparing to shift diplomatic relations from Taipei to Peking. The process was completed on January 1, 1979, when the United States formally broke diplomatic relations with Taiwan and established them with its arch-rival, the People's Republic of China. Congress rushed in to fill part of the political void on March 16 of that year, however, by passing the Taiwan Relations Act, which establishes an alternative mechanism for transacting bilateral affairs between the two countries. And there the matter stands.

In the meantime, U.S. commercial involvement with the Republic of China is growing. In terms of long-term U.S. interests in the Pacific Basin, the emergence of a strong, economically confident Taiwan could -- on its own merits -- easily be viewed as a triumph of American foreign policy and a potential source of U.S. influence in promoting liberalized trade and investment arrangements throughout the region.

Before those potentials can be realized, there are some tough commercial issues confronting these two countries. For if the United States can take some credit for helping launch the ROC, it has increasingly been forced to absorb some of the direct economic costs as well in the form of large, and growing merchandise imbalances with this island nation. These U.S. concerns are not confined to the government. Parallel feelings have also been reflected in certain sectors of the American private sector which has been forced to absorb some of the costs of Taiwan's dramatic market penetrations since the early 1980s.

While U.S.-Taiwanese commercial ties have their own peculiarities, recent trade tensions between the two countries no less reflect larger patterns of change set into motion after World War II. As with West Germany, Japan, and South Korea, domestic expansion in the Republic of China has been calibrated to the requirements of a vigorous mercantilist policy involving intimate collaboration between government, business, and labor. The result is that in each country, trade and current account balances figure prominently in setting parameters for domestic monetary, labor market, and investment actions by public and private authorities. Not surprisingly, relative success or failure in the global economy is considered to have a major impact on the prestige and political stability of various advanced and developing country economies.

The external surpluses of these countries indicates the advantages of mercantilism. It is doubtful that any of them could have achieved their present, and rising, levels of national wealth in the absence of such aggressive, government-private sector driven trade practices. With respect to West Germany and Japan, there has been the additional advantage of seeing them re-deploy their energies away from political and toward market conquests.

The fall in oil prices last year was combined with a sharp rise in the Japanese yen. The result: Taiwan was suddenly exposed as a super-competitive manufacturer, with real gross national product surging by nearly 11 percent, and the volume of its exports by one-quarter to make it the 11th biggest exporter in the world. This "embarrassment of riches" also contains some uncertainities and potential dangers with it for what still remains an isolated, island nation of 19.5 million inhabitants whose ultimate security continues to depend on the United States. With close to 50 percent of Taiwan's exports directed toward the United States, the ROC remains uncomfortably dependent on the goodwill of a benefactor who feels the time has come for Taiwan to absorb a larger share of the adjustment cost in the bilateral trade account.

The United States cannot continue running such huge trade deficits, and the world economy cannot tolerate imbalances between surplus and deficit nations which have developed over the past 6 years. It is in all of our interests to work toward a reduction of both the U.S. trade deficit and the Taiwanese trade surplus, and the U.S. should approach economic and diplomatic dealings with Taiwan with these priorities in mind.

At the same time, neither world stability nor American interests would be served by pushing the Taiwanese economy into a deep recession as a result of policies intended to reduce the external trade imbalance. Taiwan is an important U.S. strategic ally in a vital part of the world, and despite the recent frictions over trade, it is clear that friendly relations with the island are very much in the U.S.'s long term interests.

This leaves American policy makers with a tricky diplomatic and economic task: pressing the Taiwanese government to undertake economic adjustments which will lower the country's trade surplus without provoking either a recession or runaway inflation.

POLICY INITIATIVES: WHAT THE U.S. COULD ASK OF TAIWAN

Recent U.S. policy toward Taiwan has focused on liberalizing of tariff schedules, a strategy which is likely to have only a small impact on either Taiwan's surplus or America's deficit:

> Hitherto, negotiations between the United States and the Asian NICs 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 miniscule 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 NICs, 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)

But it is a serious question whether the sum total of Taiwan's trade barriers constitute a serious impediment to U.S. exports. The United States did not seem to be unduly concerned about the existence of these barriers through the 1970s. Nor has the

U.S.'s most serious competitor in the Taiwanese market, Japan, seemed unduly exercised about these impediments. For all that, Taiwan's trade barriers have become a visible point of contention with the United States. And for this reason alone must be discussed.

Given the realities outlined earlier in this report, the U.S. should broaden its negotiating objectives beyond simple trade liberalization to include a more complex and comprehensive set of changes in Taiwan's economic policy and strategy. Some of these negotiating objectives could include:

1. Revalue the NT dollar substantially and abruptly, and then announce a commitment to maintain the new rate for a substantial period of time. The rate selected should be high enough to send a real signal to Taiwan's exporters that foreign markets will be much more difficult to penetrate in the future, but low enough not to drive large numbers of firms out of business. The goal should be an exchange rate which encourages the shift of production out of export industries and into local production, not a wholesale bloodbath in the export sector.

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.

3. Take a leadership position in proposals for financing a new multilateral facility to provide investment for the debt-problem countries of the Third World.

4. Expand the fiscal deficit, at least on a temporary basis, to provide a stimulus to domestic demand. This temporary stimulus will be necessary to counterbalance the shock imposed on the export sector by a sharp revaluation of the currency.

5. Continue with import liberalization. While this may make only a small contribution to reducing Taiwan's bilateral deficit with the United States, it could help substantially in easing the inflationary pressure inherent in the proposed exchange rate revaluation.