

Economic Impact of Alternative Us-Roc Relations

Yuan-Li Wu

K. C. Yeh

Follow this and additional works at: <http://digitalcommons.law.umaryland.edu/mjil>



Part of the [International Law Commons](#), and the [International Trade Commons](#)

Recommended Citation

Yuan-Li Wu, & K. C. Yeh, *Economic Impact of Alternative Us-Roc Relations*, 3 Md. J. Int'l L. 139 (1977).

Available at: <http://digitalcommons.law.umaryland.edu/mjil/vol3/iss1/21>

This Conference is brought to you for free and open access by DigitalCommons@UM Carey Law. It has been accepted for inclusion in Maryland Journal of International Law by an authorized administrator of DigitalCommons@UM Carey Law. For more information, please contact smccarty@law.umaryland.edu.

ECONOMIC IMPACT OF ALTERNATIVE US-ROC RELATIONS

Y. L. WU* AND K. C. YEH**

The central question discussed in this paper is the economic impact of alternative US-ROC relations. As US-PRC relations develop further, alternative forms of the relations between the US and the ROC must be considered. Among these broad alternatives are: (a) continuation of US-ROC relations as they now stand, (b) a more unambiguous two-China policy on the part of the United States which will reaffirm the latter's determination to abide by existing treaties and to maintain its political and economic relations with the ROC under bilateral agreements at the government level, whatever may be the relationship between the United States and the PRC, and (c) downgrading of US-ROC relations, which can be carried out in varying degrees either following or simultaneously with the diplomatic recognition of Peking. We assume for the purpose of this paper that the term "normalization" is used by most people at present as a code word for diplomatic recognition of Peking, although the two terms are not necessarily identical. (Some countries that have maintained full diplomatic relations with Peking for some time do not seem to enjoy closer substantive relations with the PRC than does the United States. It is hard to define precisely what one means by "normal relations" with Peking.) By "economic impact" we mean the effect on (a) the economic viability of Taiwan as an independent economic entity, (b) the present and future economic interests of the United States, and (c) the economic interests of such major interested parties as Japan.

We shall attempt, in the first place, to identify the basic factors, insofar as they are relevant for our purpose, that have made possible the impressive economic performance of Taiwan, both in the decade and a half before the 1973 oil crisis and since that crisis (see Figure 1). Taiwan's past economic performance can best be illustrated here by a quick reference to (a) the growth of its GNP and foreign trade, (b) the relative price stability up to the eve of the oil crisis in spite of Taiwan's rapid economic growth, (c) the continuous improvement of its balance of payments until the oil crisis and even in spite of it, and (d) the relatively equitable

* Consultant, Hoover Institution, Stanford University; and Professor and Chairman of Economic Department, University of San Francisco.

** Senior Economist, The Rand Corporation.

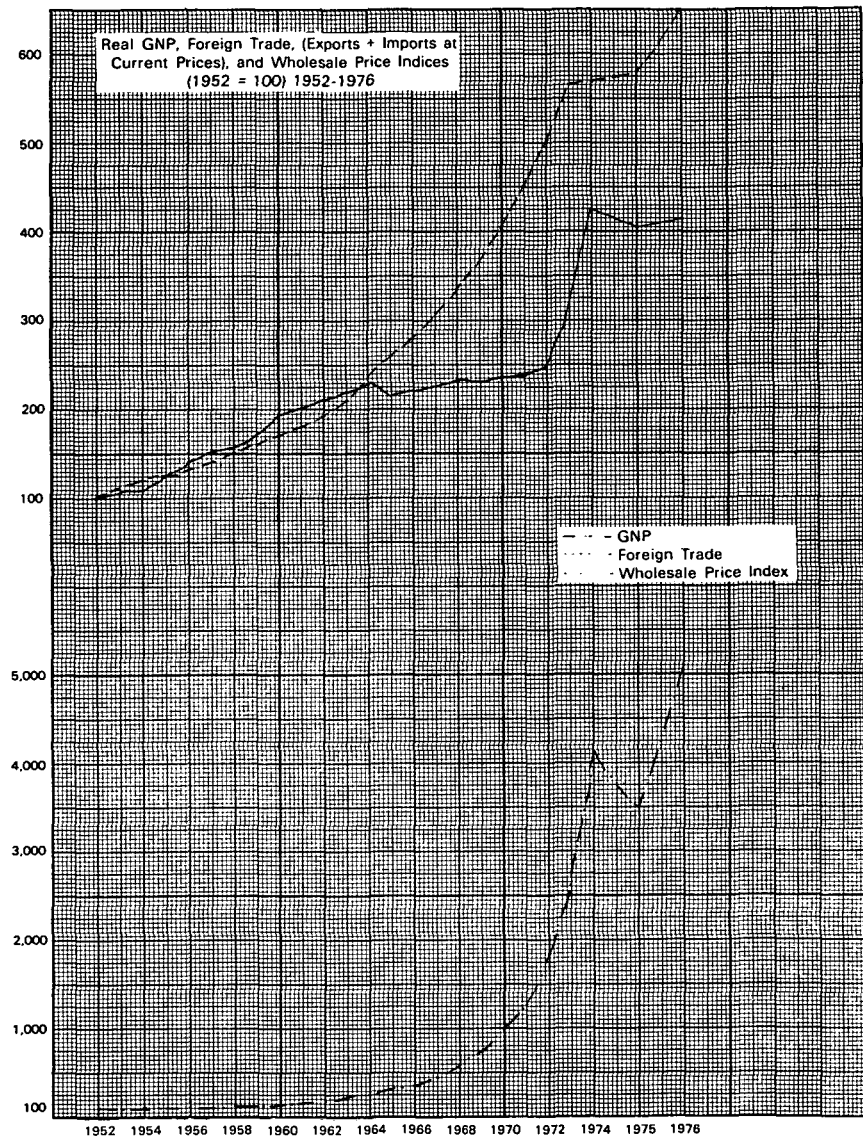


Figure 1

distribution of income and economic power among the island's population.

The United States resumed large-scale economic aid to Taiwan in 1952. The index of Taiwan's real GNP (at constant 1966 prices) in 1972, the year immediately preceding the oil crisis, stood at 538.2 (1952 = 100).¹ The annual rate of growth during the two decades averaged 8.8 percent, rising from 7.2 percent a year during the first decade to 10.4 percent during the second decade. Alternatively, we can point to the increase in the average annual growth rate in successive periods from 7.2 percent in 1952-60 to 9.6 percent in 1960-65 and 10.1 percent in 1965-72. The latter comparison is perhaps more meaningful, for reasons which will become clear later. The trend was briefly interrupted by the world-wide recession in 1974, but the economy has moved upward again since then. While the real growth rate fell to only 0.6 percent in 1974, it returned to 2.0 percent in 1975, and bounced back to over 10 percent in 1976.² On a per capita basis, Taiwan's GNP growth rate between 1952 and 1972 averaged 5.6 percent a year in real terms, far exceeding the corresponding rates of most other developing countries including the PRC. There can be little doubt that Taiwan has taken off on a path of sustained economic growth. The record of 1974-76 testifies further to the resilience of the economic system in the face of exogenous shocks.

This remarkable growth record was achieved with only moderate price increases. The average rate of increase of wholesale prices between 1952 and 1972 was 4.6 percent a year; that of consumer prices, 5.8 percent. The rate of increase of wholesale prices slowed considerably from 8.8 percent a year in 1952-60 to 3.4 percent a year in 1960-73; correspondingly, that of consumer prices fell from 9.7 percent a year in 1952-60 to 4 percent in 1960-73. As a result of the oil crisis, wholesale and retail prices rose by 35.2 percent and 47.5 percent respectively in 1974. However, the price index was again stabilized after that. It dropped by 5.1 percent in 1975 for wholesale and rose by 5.2 percent for retail.

After its reform in 1958, the official exchange rate of the New Taiwan Dollar has not varied significantly from the free market rate, except for a brief period following the loss of Taiwan's U.N.

1. Council for Economic Cooperation and Development, *Taiwan Statistical Data Book*, 1973, Taipei, p. 18.

2. *Taiwan Statistical Data Book*, 1975. For 1976, see report in the *Central Daily News* (Taipei), December 11, 1976.

membership in 1971 and, to a lesser extent, during the oil crisis in 1973-74. Taiwan's official international reserves were at the level of about \$1.6 billion in October 1976, apart from which additional holdings of probably about the same amount are available.

From the point of view of social stability, the trend toward more equitable distribution of income is even more significant. The Gini coefficient declined continuously from 0.6 in 1953 to 0.30 in 1972.³ The top 20 percent of all households on the income ladder received 61 percent of total income in Taiwan in 1953; this share dropped to 39 percent in 1972. The shares of those with lower incomes increased correspondingly. A comparison of Taiwan's pattern of income distribution with those of other countries shows that the lowest 40 percent of its population on the income ladder had a distinctly larger share of total income than the corresponding segment of populations in most other Asian countries such as Korea, Thailand, the Philippines and India. In fact, its relative shares of income by income class were almost identical with those of Japan and came rather close to those of the United States. Measured in these terms, income distribution in Taiwan in 1972 was only slightly "less equal" than that of Poland in 1964 and slightly "more equal" than in Yugoslavia in 1968.⁴

The underlying factors of Taiwan's rapid economic growth are many and their interrelationships complex. Two, however, stand out as fundamental and are especially relevant to an assessment of Taiwan's economic viability in the future; to wit, the rapid growth of human and material capital stock and the phenomenal expansion of exports. During the period in question, the former laid the groundwork for the increase in the economy's productive capacity while the latter provided the necessary stimulus for the expansion of aggregate demand. At the initial stage, that is, during the 1950s, when the economy faced a dual gap in foreign exchange and domestic savings, massive U.S. aid played a key role in sustaining a high rate of investment. Subsequently, domestic savings and foreign investment replaced U.S. aid as the major source of financing development; foreign investment also served as a supplement to Taiwan's foreign

3. See, Wan-Yong Kus, "Income Distribution by Size in Taiwan Area — Changes and Causes," *Income Distribution, Employment and Economic Development in Southeast and East Asia*, The Japan Economic Research Center, Tokyo and the Council for Asian Manpower Studies, Manila, July 1975, p. 94.

4. Y. L. Wu, *Income Distribution in the Process of Economic Growth*, (forthcoming).

exchange earnings. Finally, although its amount has been small relative to U.S. aid in the 1950s, foreign investment has been an indispensable vehicle in export marketing and in the transfer of technology, two of the principal factors that have made possible the growth of Taiwan's export-oriented economy and its structural change.

STAGES OF GROWTH OF TAIWAN'S EXPORTS AND IMPORTS

Since Taiwan is an island with limited natural resources, its continuous growth and economic viability must be predicated upon its ability to draw upon available resources in other countries. The fruits of these overseas resources must in general be purchased. Accordingly, *a priori*, the sustained growth of the economy requires the unimpeded growth of foreign trade and investment, as well as long-run equilibrium in the balance of payments. Furthermore, as long as the domestic market is relatively small, demand for increasing production must rely largely upon the export market. Hence our attention should be focused, in the first place, upon the principal factors underlying Taiwan's expansion in foreign trade.

A statistical overview of the growth of Taiwan's exports from 1952 to 1973 suggests that this historical development can best be divided into four distinct periods. (Figure 2 depicts the annual rate of growth of Taiwan's exports on a year-to-year basis; the index of any given year is calculated by using the preceding year as 100.) (a) Continual fluctuations were exhibited during the period before 1959. Increases in exports in some years were followed by declines in others, and the annual growth rate in value terms varied within a wide range, from +30 percent to -30 percent. (b) The second period began in 1959 and ended in 1966. The annual growth rate of exports in real terms increased steadily through 1964. The corresponding rate in value terms fluctuated more widely due to changes in export prices. (An increase of 50 percent in value was registered in 1962.) During the second part of this period exports in real terms grew at about 20 percent a year. (c) The third period began in 1967 and ended in 1973. During this period Taiwan's exports grew generally at 20 percent or more in quantum each year. The annual increase in value terms was, of course, at a faster rate, reaching a peak of 50 percent in 1973 due to a considerable rise of prices during that year. (d) The fourth period began in 1974. Because of the sharp increase in crude oil price and the world-wide recession that ensued, Taiwan's exports declined

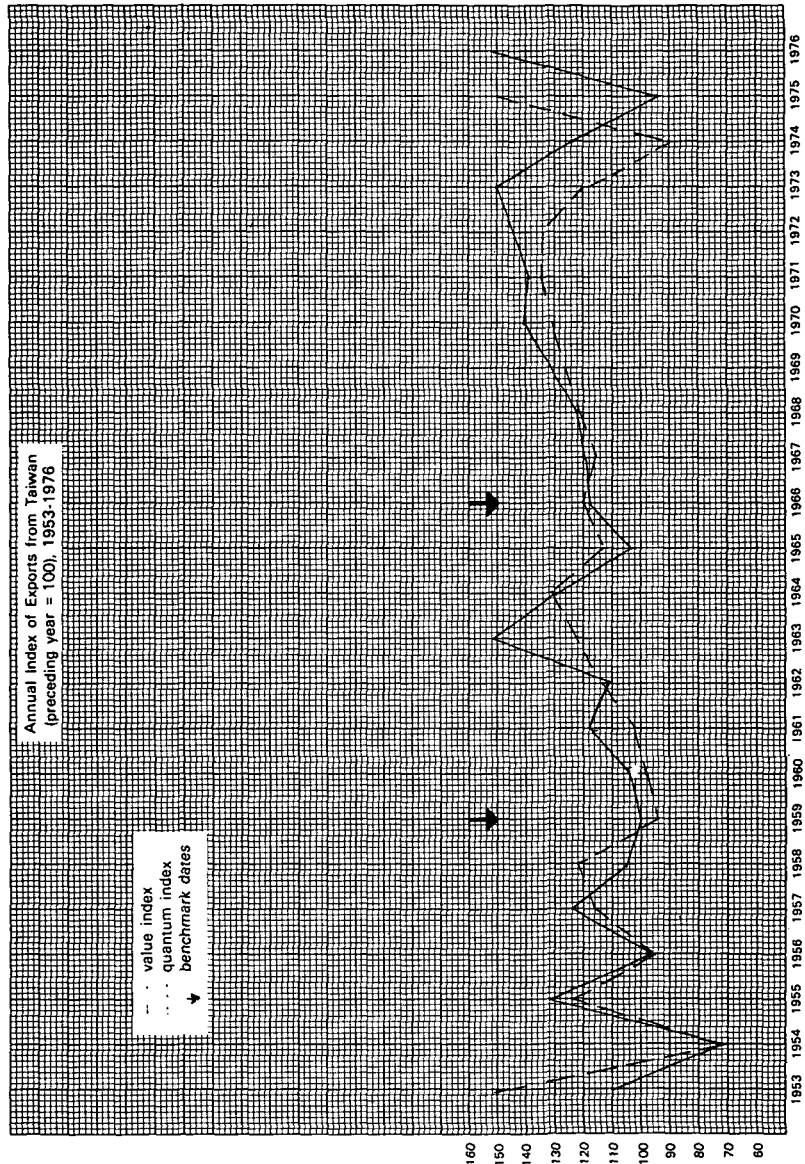


Figure 2

by 4.4 percent in real terms in 1974. Recovery began in the latter part of 1975 and the volume was substantially larger in 1976.

A similar review of the history of Taiwan's imports presents us with the following picture (Figure 3). (a) Before 1963, the annual growth rates of Taiwan's imports fluctuated considerably, although the fluctuations were within a narrower range than those of pre-1959 exports. The corresponding annual growth rate of imports in quantum varied from +10 percent to -7 percent in most years; greater fluctuations were registered in value terms. However, declines in quantum were reported only in two out of the eleven years in this period; declines in value were registered only in three years. (b) The second period began in 1963 and ended in 1973. In value terms, imports rose at above 20 percent a year in most years during 1963-71 with larger variations in quantum. Between 1971 and 1973 the rate rose to substantially above 20 percent a year, reflecting price increases, while the rate of increase in quantum remained at slightly above 15 percent. (c) The third stage began in 1974. In that year the value of Taiwan's imports rose very sharply as a result of the price increases of oil and other intermediate products, as well as stepped-up purchases in the preceding year. However, the recession led to a decline of real imports by 11.2 percent in 1975, followed by a substantial recovery in 1976.

MAJOR BENCHMARKS IN FOREIGN TRADE DEVELOPMENT

The transition of imports from one stage of development to another lagged behind that of exports, apparently for two reasons. First, imports fluctuated less than exports before 1963 because of the availability of substantial imports financed by U.S. aid. Second, although production and exports could not rise without increasing imports, the expansion of imports in the later stages was also an effect of the prior expansion of exports. The conservative and cautious policy makers who managed Taiwan's balance of payments apparently made sure that import expansion would lag slightly behind the growth of exports. They were apparently anxious to build up the country's foreign exchange reserves in the light of their experience with balance of payments deficits over a number of years.

The first benchmark in the expansion of Taiwan's exports occurred in 1959, midway between 1958 and 1960 when major foreign exchange reforms were instituted. During these three years multiple exchange rates were abolished step by step, and the

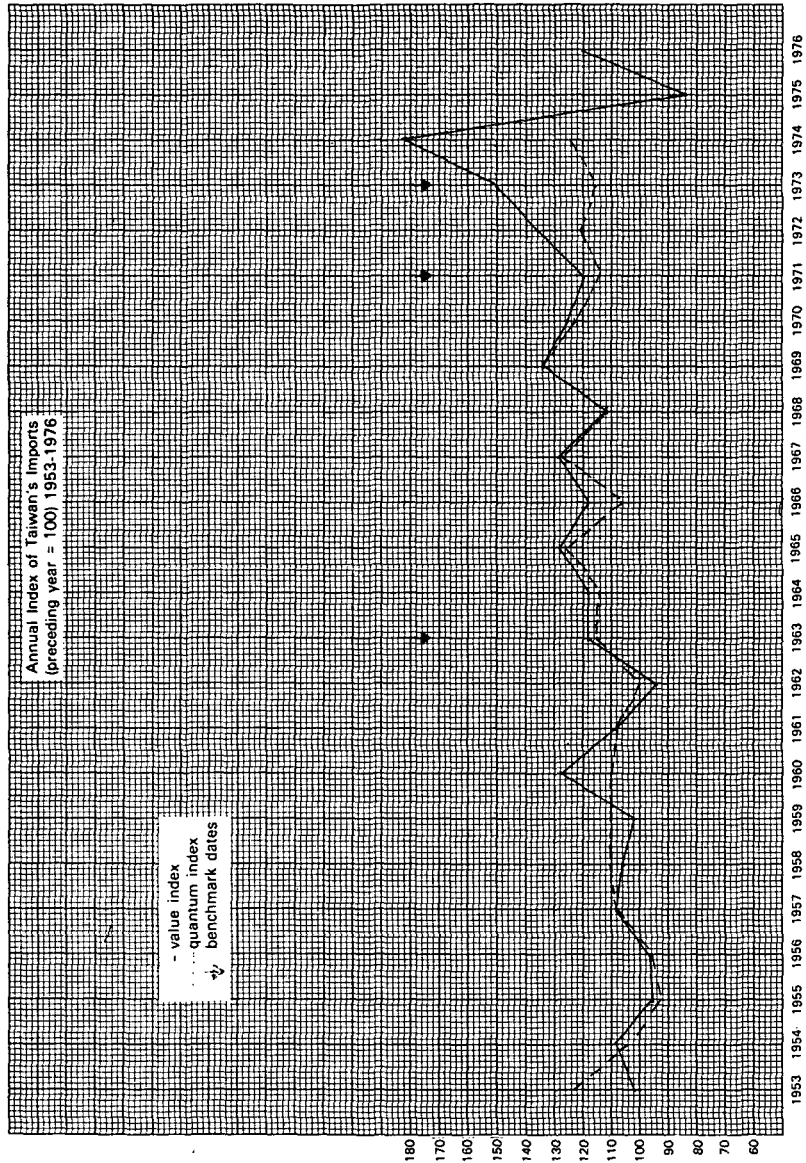


Figure 3

differential between the official and free market rates was successfully narrowed. The premium of the free market rate over the official rate, which stood at NT\$24.78 to one U.S. dollar in 1957, declined from 54.9 percent in that year to only 9.6 percent in 1961. The official rate in 1961 was NT\$40.03 to one U.S. dollar while the free market rate was NT\$43.89. Minor fluctuations occurred during the intervening years between 1961 and 1966, when the second phase of Taiwan's export development ended. However, by 1966, the two rates were virtually at par, NT\$40.10 being the official rate, and NT\$41.00, the free market rate.⁵ The removal of multiple exchange rates and the effective devaluation of the New Taiwan dollar were approached in a very gingerly manner, and even this cautious approach was not adopted until the price level had become sufficiently stabilized during the preceding years. While price inflation was rampant in 1951 and 1952 — wholesale prices rose by 66 percent in 1951 and 23.2 percent in 1952 — the rate of increase had dropped to 7.2 percent in 1957 and 1.4 percent in 1958.⁶ Without this prior development and the restoration of confidence in a stable currency, the foreign exchange reforms could not have been instituted; nor would they have been so successful in promoting exports and in doing away with the price distortions and inequities the multiple exchange rates had engendered.

Establishment of the necessary prior conditions for economic reform was in a very significant measure also a result of U.S. aid. During 1951-55, U.S. aid amounted to 47 percent of Taiwan's gross capital formation and 43 percent of total imports; these ratios fell to 34 percent and 36 percent respectively in 1956-60, and 17 percent and 19 percent respectively in 1961-65.⁷ Absence of either of these two conditions — exchange rate reform and U.S. aid — would have made a critical difference.

The benchmark separating the second and third stages of Taiwan's export growth occurred in 1965-66. Having already liberalized its regulations governing investment by overseas investors at the time of the earlier exchange reform, Taiwan took

5. These data, originally derived from the Central Bank of China, are given by Mo-huan Hsing in "Taiwan: Industrialization and Trade Policies," in a volume entitled *The Philippines and Taiwan, Industrialization and Trade Policies*, published for the Development Center of OECD, Oxford University Press, London, 1971, Table A. 23, p. 292.

6. See Neil H. Jacoby, *U.S. Aid to Taiwan, A Study of Foreign Aid, Self-Help and Development*, Praeger, New York, 1966, Appendix C. Table 16, p. 286.

7. Mo-huan Hsing, *op. cit.*, p. 197.

additional steps in the same direction in January 1965. The first Export Processing Zone was established at Kaohsiung, and a sharp increase in direct investments from abroad followed immediately. The cumulative total of foreign direct investment approvals rose from \$93.1 million at the end of 1964 to \$134.7 million a year later.⁸ By 1973 the corresponding total had risen to \$1,287.1 million; it was \$1,405.2 million in 1975. The data in Table 1 will provide a historical perspective in capsule form.

Table 1. Foreign Investment Approvals
(U.S. \$ million)

	U.S. Investors	Investors from Japan	All Countries
1952-59	9.5	1.4	20.2
1960-64	38.0	6.4	72.9
1965-69	126.9	52.7	327.2
1970-74	254.5	132.2	866.7

Source: Sjou-eng Koo, "Foreign Investment and Industrialization in Taiwan," *Academia Economic Papers*, Nankang, Taipei: The Institute of Economics, Academia Sinica, Vol. 4, No.1, p. 128, March 1976. Original data from the Foreign Investment Commission.

LIBERALIZATION OF FOREIGN TRADE, EXCHANGE AND CAPITAL INFLOW: THE DOMESTIC AND WORLD ENVIRONMENT

The history of Taiwan's foreign trade expansion points indisputably to the importance of appropriate domestic economic measures. Exports became profitable as a result of the 1958-60 reform which directed the attention of private business toward export promotion, away from the hidden subsidy of licensed imports at artificially low foreign exchange rates. The export processing zones (EPZs) successfully attracted foreign investors to Taiwan; not all of them located their plants within the zones. Encouragement of direct foreign investment in general, both inside and outside the zones, was undoubtedly instrumental in solving the very important marketing problem on which export expansion depended. Once established in Taiwan, the foreign firms outside the zones also supplied their products to Taiwan's domestic market where demand was expanding with the very

8. These data are from the Foreign Investment Commission, Ministry of Economic Affairs, Republic of China.

economic growth to which export expansion contributed most decisively. The EPZs apparently served a path-breaking function, providing this initial attraction to induce foreign investors and other businessmen to come to Taiwan, and encouraging domestic firms to locate the items solely to promote exports.

As of March 1977, there were 10 sole U.S. and 68 sole Japanese-owned firms in the EPZs. In addition, there were 68 joint ventures composed of U.S.-Japanese interests; 4 composed of U.S.-Japanese and other interests; 9 composed of U.S. and other interests; and 51 composed of Japanese and other interests. Still other investors, many from Hong Kong, are also located in EPZs. Thus many Japanese, Hong Kong and other firms export to the United States, as well as to other markets, from Taiwan.

An earlier incomplete count shows that as of 1974, 14 U.S. firms had been established within EPZs.⁹ In addition, 313 American firms were located outside the zones. Of those outside the zones 250 firms, or 80 percent, were established after 1965. It was in 1965 that foreign investment rules were further liberalized and U.S. aid to Taiwan officially came to an end. A more recent count based on 1976 data shows that there were 63 additional U.S. firms on the later list that were not on the 1974 list. A number of these, if not all, must have been established after 1974. All the 63 are located outside the EPZs.

Figure 4 presents a vivid illustration of the rise of Taiwan's exports and imports in current dollars. However, neither effective marketing with the aid of foreign investors nor unilateral reform on the part of Taiwan would have sufficed had not the demand for Taiwan's exports expanded considerably during this period. Figure 5 shows that the share of the U.S. market in Taiwan's exports for the first time surpassed that of Japan during 1966-67. The shares of the two countries became about equal in 1962. Before 1962 Japan's share had been consistently higher. However, the emergence of certain new agricultural exports from Taiwan to Japan again pushed up Japan's share between 1962 and 1966. The crossing of the two lines depicting the respective shares of the United States and Japan as buyers of Taiwan's exports in 1966-67 (Figure 5) signaled the rise of the role of new exports of manufactures from Taiwan. Their appearance was a direct outcome of the increase in foreign direct investment.

9. Calculated from directories of U.S. and Japanese firms. The figures are not all inclusive.

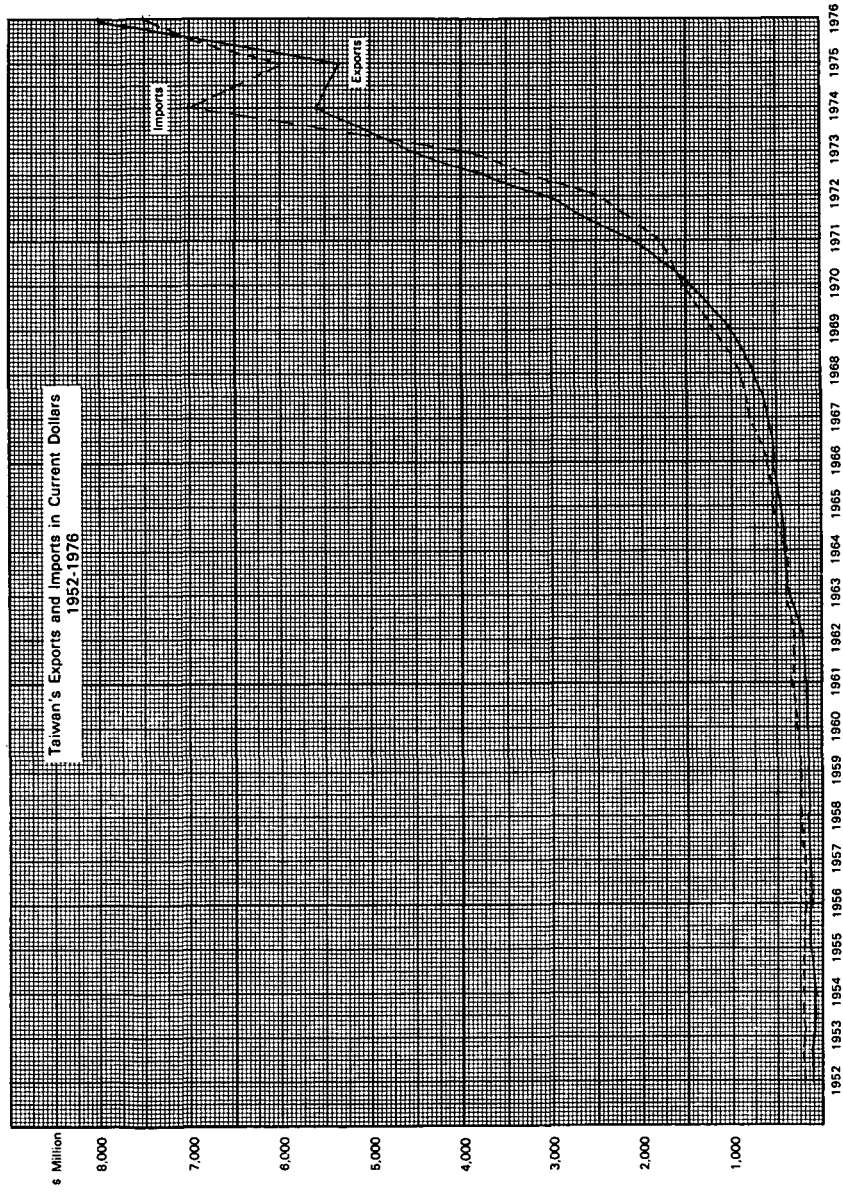


Figure 4

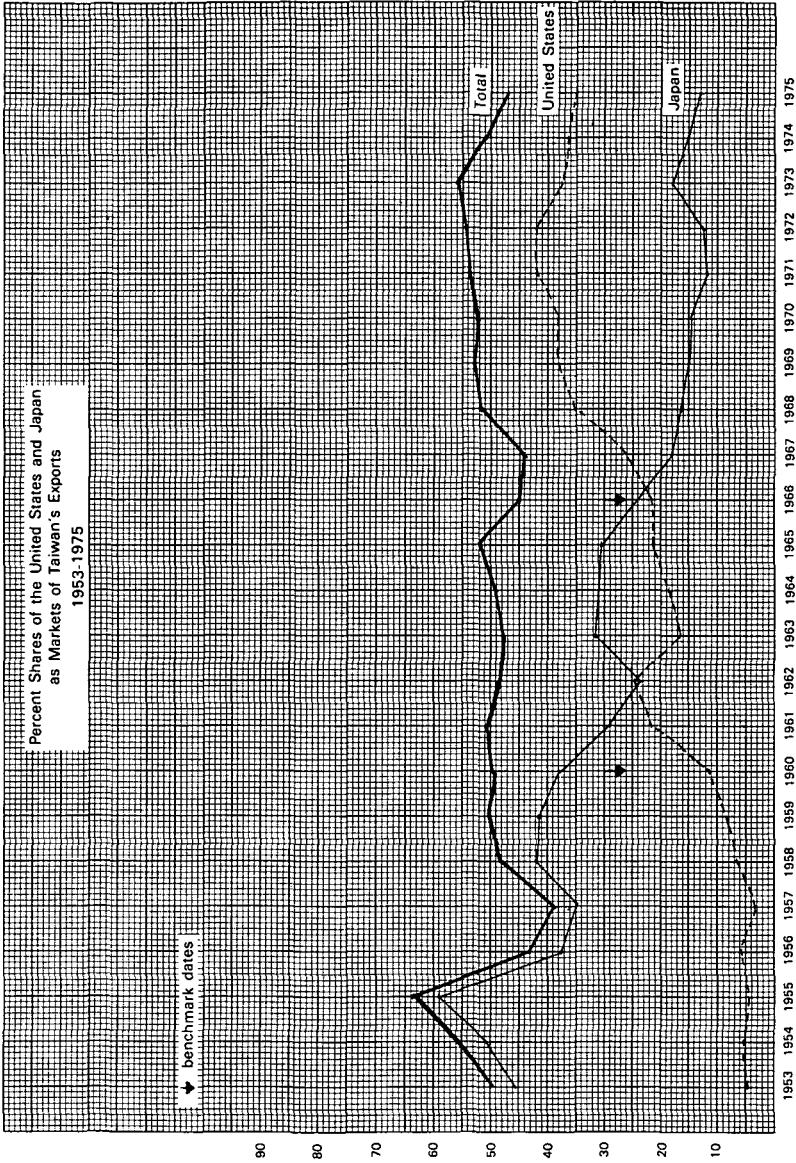


Figure 5

Between 1966 and 1973 U.S. general imports rose from an index of 100 to nearly 400 (see Figure 6). During the same period, Taiwan's exports to the United States rose much more sharply, from an index of 100 in 1966 to 1377 in 1973. This nearly 14-fold increase was partly a reflection of the greater competitiveness of Taiwan products on the U.S. market, but the increase was also aided by the general expansion of U.S. imports. Furthermore, Taiwan's exports to the United States had been so small that the large increase scored during this period could in most cases be better tolerated by Taiwan's competitors. Given the competitiveness of Taiwan's products and the increasing U.S. demand for imports, the existence of U.S. as well as Japanese firms in Taiwan, both making exportable goods for the American market, contributed significantly to Taiwan's expanding share in U.S. imports.

In the case of Japan, Taiwan's exports to Japan in general increased after 1966 *pari passu* with the expansion of Japan's import demand as a whole (see Figure 6). Taiwan's exports to Japan did not rise in as extraordinary a manner as did Taiwan's exports to the United States. Japanese direct investments in Taiwan probably contributed as much to the increase in Taiwan's exports to the United States as they did to increase exports from Taiwan to Japan.

SENSITIVITY OF FOREIGN DIRECT INVESTMENT TO POLITICAL EVENTS

The rate of foreign direct investment in Taiwan was apparently very sensitive to political events, as is to be expected. The rate of U.S. investment in Taiwan dropped in 1971 and 1972 probably as a result of the ROC's international setbacks during those years and doubt about its future status (Figure 7). Between 1972 and 1973 there was a sharp increase in new U.S. investment in Taiwan, which seemed to reflect some recovery of confidence on the part of U.S. investors. However, the increase was smaller in real terms if price increases are discounted. Investments fell again in 1974 because of the general recession and postponement of investment plans by many firms.

The flow of direct investment from Japan, including investments by "overseas Chinese" residents in Japan, rose steadily during 1965-70, immediately after the establishment of the export processing zones (Figure 8). The rate of flow fell in 1972, reflecting the same concern felt by U.S. investors. Following Japan's

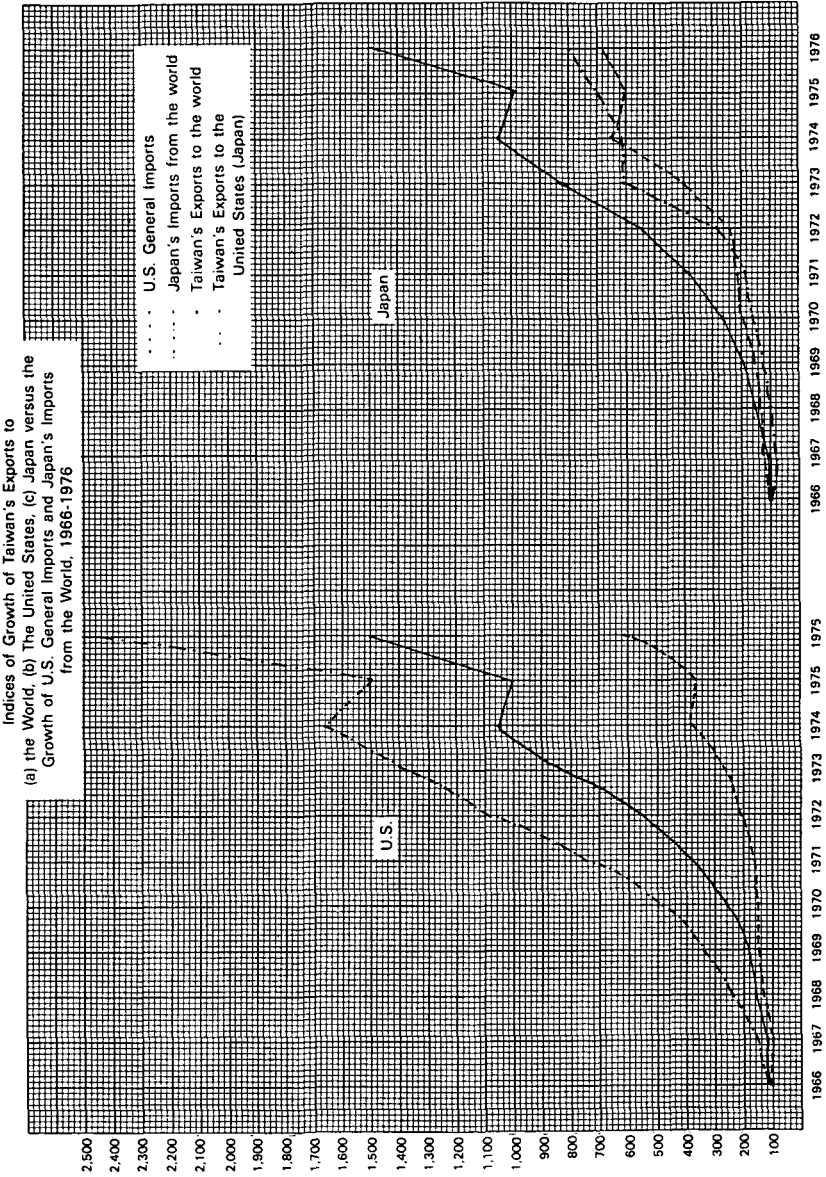


Figure 6

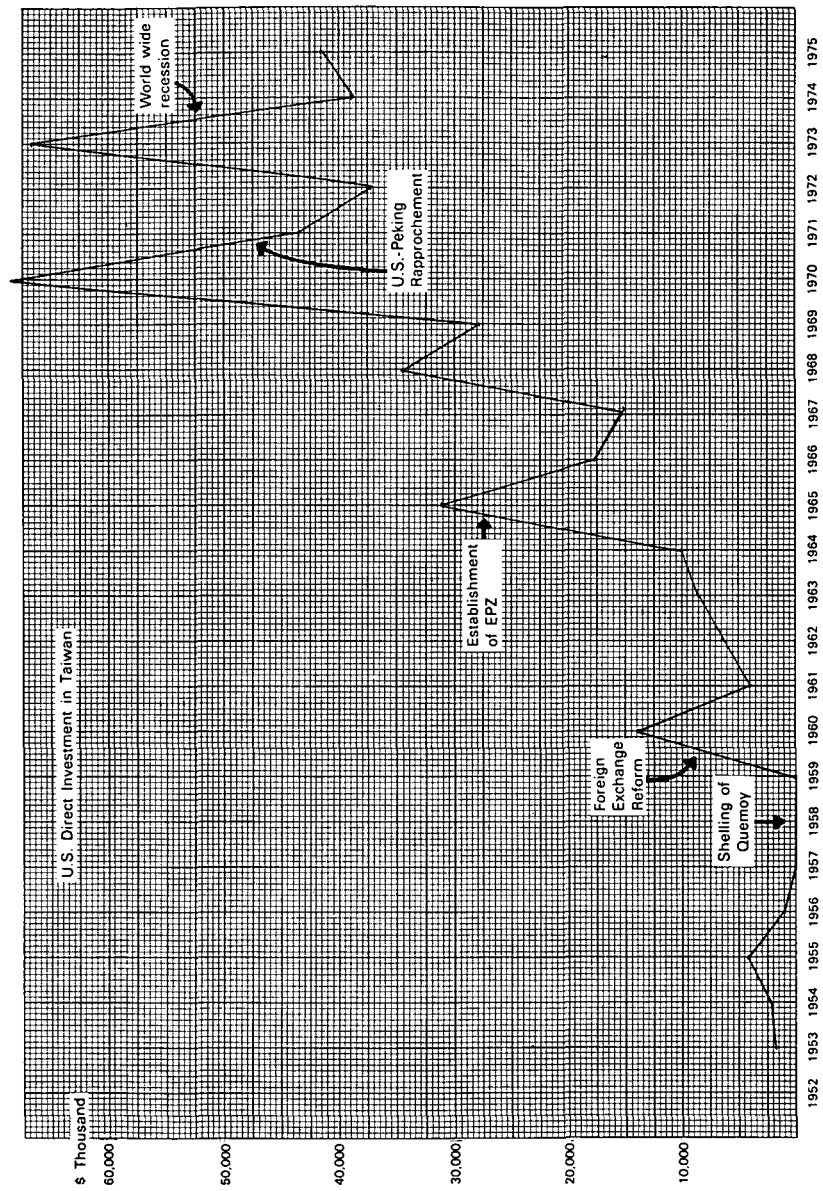


Figure 7

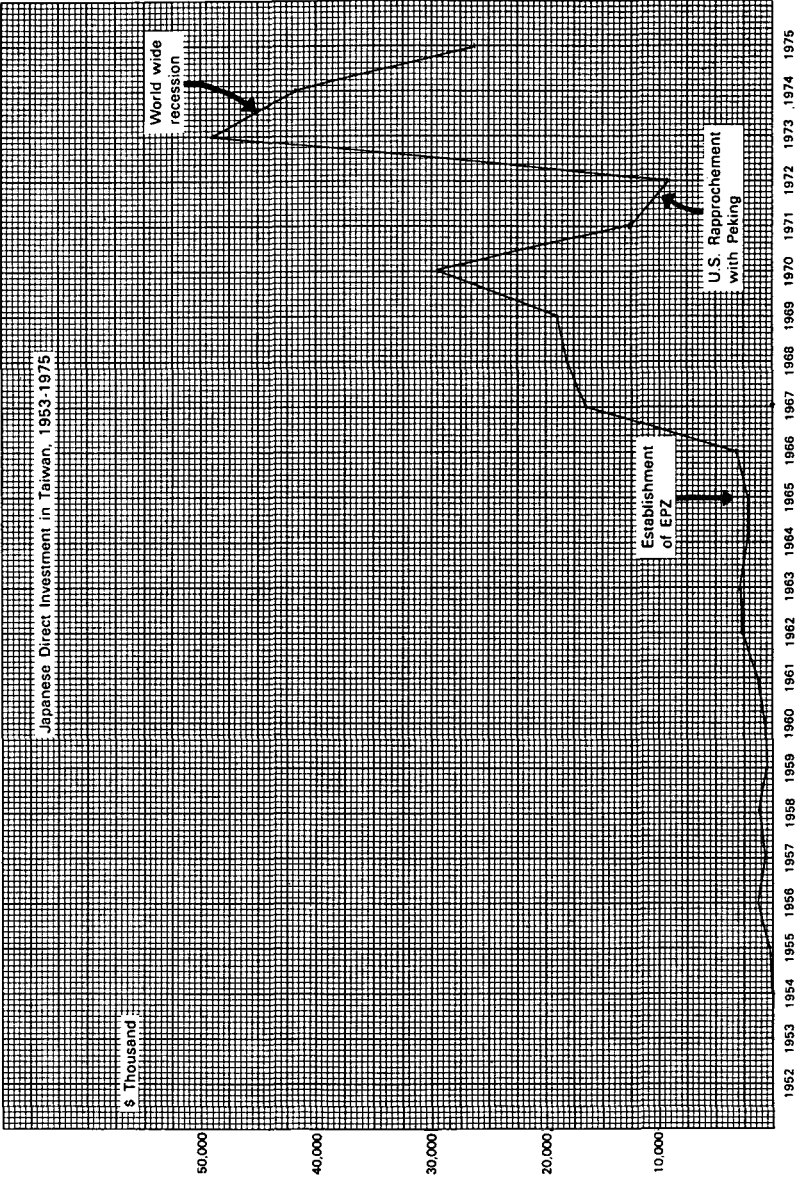


Figure 8

transfer of diplomatic recognition from Taipei to Peking in 1973, another decline of new Japanese investment in Taiwan occurred in 1974 and 1975 although the cause of the decline is again somewhat ambiguous because it coincided with the recession.¹⁰

STRUCTURAL CHANGE OF TAIWAN'S ECONOMY AND FOREIGN TRADE

As the economy of Taiwan develops further, not only will there be an increase in GNP and the volume of trade, but the domestic sector of the economy should expand even faster. Such a development would reduce the "foreign trade ratio" — defined here as the ratio of foreign commodity trade to GNP plus imports — which was as high as 60 percent in 1973. In this connection, the case of Japan presents an appropriate illustration and comparison. During 1908-17 the Japanese "foreign trade ratio" averaged 29 percent.¹¹ It declined to 20 percent in 1950-54. The Japanese ratio has always been much smaller than that of contemporary Taiwan because of the latter's smaller size. To put it in another way, Japan's very large GNP has dwarfed the tremendous size of its foreign trade. Because of its smaller size, Taiwan probably will have for a long time a much higher foreign trade ratio than Japan. However, Taiwan is clearly fast approaching the point when it should begin to expand the domestic sector of the economy by "filling out" the many linkages which its export-oriented economy has already succeeded in developing. Even during 1972-74, domestic sales were already accounting for over 40 percent of the sales of enterprises owned by overseas investors in Taiwan.¹²

In the case of Japan, the ratio of export of goods and services to GNP remained at a fairly stable level of 10 to 11 percent during 1955-73 — in comparison with about 20 percent in the 1930s — while per capita GNP grew by leaps and bounds.¹³ The percentage

10. According to Taiwan statistics, Japanese direct investment approvals, including applications by "overseas Chinese" residents in Japan, declined 14.4 percent between 1973 and 1974, from \$48.9 million in 1973 to \$41.9 million in 1974. Another 37.5 percent drop was registered in 1975. On the other hand, Japan's overall direct investment to foreign countries declined even more during 1973-74, from \$3.5 billion to \$2.4 billion, or 32.5 percent. *Japan's Direct Investment Overseas, Present State and Future Outlook*, Keidanren, Tokyo, March 1976.

11. Simon Kuznets, *Six Lectures on Economic Growth*, Free Press of Glencoe, Illinois, 1959, p. 103.

12. Private communication.

13. Lawrence B. Krause and Sueo Sekiguchi, "Japan and the World Economy," in Hugh Patrick and Henry Rosovsky, Eds., *Asia's New Giant*,

contribution of export to economic growth from 1921-25 to 1934-38 was estimated at 39 percent as compared to only 17 percent in 1955-71.¹⁴ The decline of the export to GNP ratio and of export as a component of growth in the post-World War II period was accompanied by a dramatic change in the structure of exports. The proportion of such labor-intensive exports as textiles and clothing, food, beverage and tobacco, etc. dropped from 65 percent of total exports in 1955 to 43 percent in 1973. Meanwhile, the share of R and D-intensive (e.g., optical and precision instruments), capital-intensive, and high-wage exports (e.g., automobiles, consumer electronics and so forth) rose sharply. If the Japanese experience is any useful guide, the continuation of Taiwan's GNP and export growth will also have to be accompanied by an increase in value-added in export, as well as a reduction of import content per dollar of export. Rising wage rates and an increasing share of exports originating from domestic enterprises as compared to exports by foreign enterprises will make these changes both necessary and possible.

However, upgrading of the technological content of Taiwan's products in general, including exports, an increase in the ratio of skilled to unskilled labor in the labor content of these products, and a gradual rise in their capital content will take time. Nor can they occur without the sustained infusion of new technology, much of which will be embodied in capital equipment. Thus there will have to be more direct foreign investment, more licensing arrangements between Taiwan and foreign firms, and more joint ventures between Taiwan capital and new technology from abroad. Between 1972 and 1974 exports by Taiwan enterprises registered a 53.4 percent increase in value; however, the share of foreign enterprises in total exports increased from 22.3 percent to 29.2 percent. This means, therefore, that foreign businessmen will have to help in marketing an increasing amount of new exports.

Brookings Institution, Washington, D.C., 1976, p. 399; Edward F. Desnon and Willing K. Chung, "Economic Growth and Its Sources," in *ibid.*, p. 84. Also, *Economic Statistics of Japan*, Hitotsubashi University, Tokyo, 1961, pp. 4 and 88.

14. N. Baba and M. Tatemoto, "Foreign Trade and Economic Growth in Japan: 1858-1937," in Lawrence Klein and Kazushi, Eds., *Economic Growth: The Japanese Experience since the Meiji Era*, Irwin, Homewood, Illinois, 1968, p. 177; Denison and Chung, *op. cit.*, p. 79; Krause and Sekiguchi, *op. cit.*, p. 399. The percentage contribution of exports is measured by dividing the increment in exports by the increment in GNP, in constant prices.

Figure 9 shows in a scatter diagram the close correlation ($r = +0.966$) between the volume of cumulative direct U.S. investment and Taiwan's export to the United States. A similar correlation exists between total direct overseas investment in Taiwan and Taiwan's total export.

It follows from the above that at this stage of its development the continuation of direct foreign investment and technological inflow are indispensable to the economic viability of Taiwan. Furthermore, the flow of goods, people, capital and technology must not be impeded or subjected to delay in any way. On the contrary, they must expand further and be quickly responsive to changing conditions. Finally, as the volume of Taiwan's exports increases, further expansion needs to be accompanied by greater commodity and geographical diversification in order to minimize the effect of protectionist sentiments in the importing countries. Thus a primary condition of Taiwan's economic viability is the maintenance of the freedom of the high seas, the freedom to travel to and from Taiwan, the freedom to communicate between Taiwan and the rest of the world, and the ability to enter new markets and to diversify — including upgrading — into new exports. Taiwan needs the traditional open-door policy of the United States in which the door will swing open both ways.

IMPACT OF ALTERNATIVE US-ROC RELATIONS ON THE ECONOMIC VIABILITY OF TAIWAN

How alternative US-ROC relations will affect Taiwan's economic viability will depend, in the first instance, upon their effect on the factors mentioned in the preceding paragraph.

A. Direct Foreign Investment

A statement of the American Chamber of Commerce in the Republic of China, dated August 25, 1976, raised a number of questions about the future status of American business in Taiwan if diplomatic recognition is extended to Peking. Will American business continue to enjoy national treatment in the hands of the ROC government? Will there be nationalization? If so, what will be the level of compensation? Will the various insurance schemes against inconvertibility and expropriation offered by the U.S. government and its agencies (*e.g.*, OPIC) continue to be valid? What will be the proper procedure for resolving questions, or settling disputes, that may arise in present and future contracts or in the course of doing business (*e.g.*, in case of oil spills by one

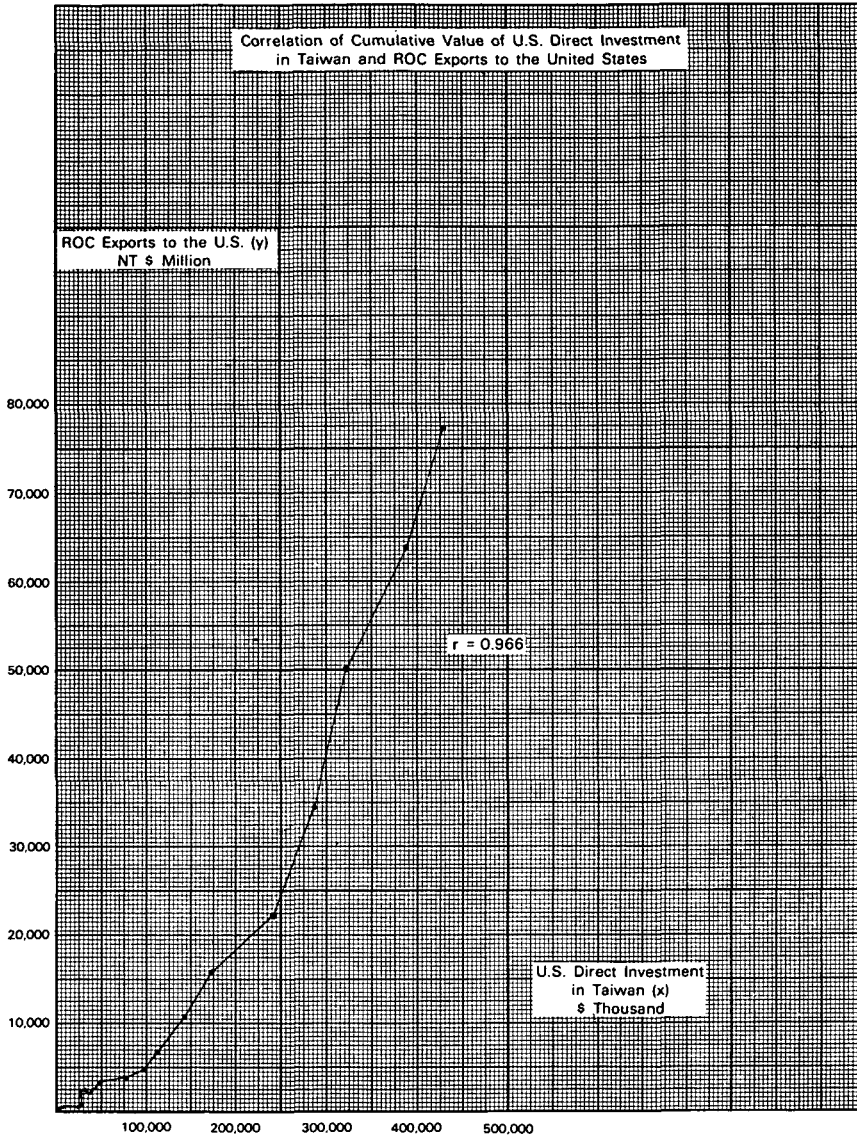


Figure 9

party's tankers in the territorial waters of the other). Whether continuation of relations between the two countries as they now stand will remove the uncertainty that has inspired these questions is by no means sure. It will depend upon how long the present status is expected to last. If the present condition is expected to be transitory, investors will tend either to stay away or to avoid heavy or long-term commitments. This attitude would tend to increase Taiwan's dependence on (i) loans, (ii) export earnings, and (iii) licensing arrangements for the acquisition of capital goods and foreign technology. Conceivably Taiwan may then be faced with a higher debt service ratio, and its balance of payments position may deteriorate, which would in turn affect its credit standing.

If relations between the two countries are downgraded and U.S. diplomatic recognition of Peking takes place, many of the questions that inspired uncertainty among American businessmen in Taiwan will become immediately relevant. Even if efforts are made by either the ROC or the U.S. government to allay fears, and even if none of the untoward developments mentioned by the American Chamber of Commerce actually transpires, fear of loss will not go away entirely. A process of gradual withdrawal by U.S. business interests may begin. Such a debilitating process can be avoided only if the governments of both countries can offer joint assurances, which would seem to require a degree of mutual trust and good will that may not be consistent with the initial assumption of the downgrading of their bilateral relations.

Only in the two-China case, which presupposes a reaffirmation of the current *de facto* situation on a more or less permanent and *de jure* basis — that is, at least as far as the United States is concerned — will the above uncertainties be removed. Long-term large commitments would then involve no more than the usual business risks. In view of Taiwan's past economic performance, these risks would be less than in most other developing countries. As Taiwan's economic structure changes gradually in the directions noted earlier, economic vulnerability to external influence will also diminish. This process of progressive improvement will be in direct contrast to the progressive deterioration of the previous case.

B. Current Exports and Imports

If US-ROC relations remain as they are, Taiwan's external trade can continue to expand as long as its products remain competitive and the world economy — the U.S. and Japanese

economies in particular — remains reasonably prosperous. However, even under present conditions, there have been repeated PRC-inspired efforts to isolate Taiwan internationally. One of the latest examples was the attempt in 1976 by members of the INTELSAT to replace the ROC with the PRC in its membership, which could become a prelude to an attempt to deny the ROC access to the INTELSAT Indian Ocean satellite for direct communication with such countries as Spain, the Federal Republic of Germany, Italy, France, Austria, Switzerland, the Netherlands, the United Kingdom, Saudi Arabia, Singapore, Malaysia and Indonesia.

If US-ROC relations are downgraded and the legal status of Taiwan can be questioned, both private organizations and governments will be in a position to raise issues that are disruptive of Taiwan's foreign trade. For instance, would Taiwan continue to enjoy MFN status in the United States and other markets? Would Eximbank facilities continue to be available to private and public ROC firms? Would Taiwan benefit under the General Preference Scheme of tariff reductions? Would ROC flag ships and aircraft be able to function in foreign countries without interference and delay? Would ROC government and private interests be able to exploit resources in the deep sea and on the continental shelf under whatever protection international law normally provides? Would ROC fishing vessels be able to operate in ever-widening areas as they do now? (One experimental voyage to the South Polar region for shrimping was completed early this year.) Can visa applications by ROC businessmen and other travelers be processed quickly? Would contractual obligations between ROC and other nationals be enforceable and in what court? Perhaps some of these questions cannot be answered without court tests. In other cases, administrative interpretations of ambiguous regulations and statutes may be necessary. In either case, delays will be unavoidable. As a matter of fact, delays can be easily created, which alone may raise the cost of doing business with Taiwan and by Taiwan businessmen, with the attendant adverse effect on profit prospects.¹⁵ Such tactics can be adopted by

15. An example of such delay, which borders on deliberate harassment, is the recent case in San Francisco where the acceptance of a gift from the city of Taipei to the city of San Francisco in the form of a pavilion to be erected in Golden Gate Park has been held up by the San Francisco Planning Commission's insistence that the donors file an environmental impact report to show how the aesthetic quality of the park would not be adversely affected.

Taiwan's political detractors. They can also be initiated by business rivals. Only in the case of the two-China alternative can the risks noted above be minimized.

C. Taiwan's Economic Response

One of the factors that will affect confidence on the part of foreign investors and traders who deal with Taiwan is the latter's response to the uncertainties and challenges posed by US-ROC relations. For instance, following the unfavorable international political developments in 1971-72 and partly as a response to them, the ROC government has further liberalized its rules governing foreign remittance and travel. Import restrictions have also been liberalized. Conceivably, a similar response could be forthcoming if US-ROC political relations are downgraded, or in spite of such a downgrading. However, a diametrically opposite response could have been made in the past, and it would be no less possible in the future. This possibility is greater if a major adverse economic impact, or the rapid worsening of an initially minor impact, is envisioned by ROC policy makers. In such an eventuality, Taiwan may turn inward with the result of stricter foreign trade and exchange controls, rising defense expenditures and a slow-down of economic growth and foreign trade. The issue involves weighing short-run gains against long-run disadvantages. So far Taiwan has kept its economic policies focused on long-term gains. However, short-run risks could loom too large to be ignored.

D. Third Country Policies and Responses of Private Individuals

Threats to curtail the freedom of access between Taiwan and the rest of the world in terms of communication, travel by air and sea, freight transportation, national markets, legal redress, and exploitation of marine and undersea resources are unlikely to materialize in the near future as a result of the direct physical intervention of the PRC as long as the latter's capacity to do so is limited. Implementation of such threats by Peking at this time will require the cooperation of other governments or private organizations and individuals that take advantage of Taiwan's particular international status. While concrete actions can be instigated by Peking, they can also be initiated by the individual interests of third parties. Hence the policies of countries other than the PRC and ROC can play an important role. Will they be

willing to be a party to the infringement of the freedoms mentioned above with respect to Taiwan or any other economic entity regardless of the latter's *de jure* international political status? Will they permit their own citizens to engage in discriminatory practices that aim at the economic isolation of Taiwan? U.S. policy and leadership in this regard are of vital importance and can affect the attitudes of other countries. The following examples in 1976 will serve as illustrations.

1. A message was delivered to the president of the National Council for US-China Trade by a member of the PRC Liaison Office in Washington in May 1976 to the effect that U.S. firms might find their trade with the PRC adversely affected by their membership in a recently formed US-ROC Economic Council. The message ostensibly originated from the China Council for the Promotion of International Trade in Peking and was duly passed on by the president of the National Council to the latter's members in a memorandum for their attention, dated May 11, 1976.

2. According to a *Los Angeles Times* report on September 8, 1976, several U.S. firms had been targets of PRC discrimination in their trade probes because of their attempts to do business with both Taiwan and the Mainland. This point was made amply clear to them by the PRC. A less clear case was reported by the *Wall Street Journal* on September 14, 1976, concerning the refusal of Mainland China banks to cash American Express travellers checks for visitors, presumably because of the company's relationship with the ROC.

A directive by President Ford to the then Secretary of Commerce, officially released by the White House on October 7, 1976, during the heat of the presidential campaign, reaffirmed our national policy of opposition to boycott actions against "nations friendly to us" and made Arab boycott request reports filed by U.S. companies with the Department of Commerce available to the public. The kind of implied request by Peking that U.S. firms intending to sell to the PRC not engage in various relationships with the ROC would seem to fall under the purview of U.S. Export Administration Regulations paragraph 369.2 and paragraph 369.3 requiring reporting within 15 calendar days of receipt of the request. A California law (A.B. No. 3080) has specifically made it unlawful to exclude persons or corporations from business transactions on the basis that the party conducts or has conducted business in a particular location or on the basis of sex, race, creed, color, etc. On the national level several anti-boycott

bills with provisions of economic penalties for offenders are now in the Congress. It remains to be seen whether the same principles would in fact apply to discriminatory measures practiced by the PRC aimed at US-Taiwan economic relations.

POSSIBLE IMPACT OF ALTERNATIVE POLICIES ON U. S. ECONOMIC INTERESTS

The foregoing discussion attempts to identify the economic consequences of alternative U.S. policies for Taiwan. From the standpoint of the United States the relative desirability of the three alternatives depends on which of them would on balance further U.S. objectives the most. What are the fundamental U.S. economic interests in the present context? In the short run, one might include stable and expanding markets for U.S. exports and sources of supply of U.S. imports and protection of existing U.S. investments abroad. The major long-run U.S. international economic objectives are economic security of the countries concerned, expansion of world trade and economic growth of per capita income in the developing countries, and safeguarding of new investment opportunities for American investors. The relative weights assigned to these objectives vary somewhat with the decision-maker's perceptions, their relation with other noneconomic objectives, and the specific circumstances in which the choices present themselves. There are, therefore, always some uncertainties regarding the relative importance of different U.S. objectives at any given time. By and large, however, these do represent the basic U.S. economic interests.

US-PRC VERSUS US-ROC TRADE

Since 1971 the United States has been trading with the PRC and Taiwan at the same time. A no-change policy or a two-China policy would probably have little short-run effect on US-ROC trade prospects but might increase U.S. direct investment in Taiwan. The PRC could be antagonized by such stands and divert its U.S. trade to elsewhere, other things being equal, if shifts are possible. Downgrading of US-ROC relations, together with diplomatic recognition of Peking, may also create a similar but reverse situation in which the United States may lose in its trade with Taiwan and gain in its trade with the PRC. To provide some background information for discussion of the possible tradeoffs, Figure 10 compares U.S. exports to, and imports from, the PRC and Taiwan in 1971-76. The comparison shows two distinctive

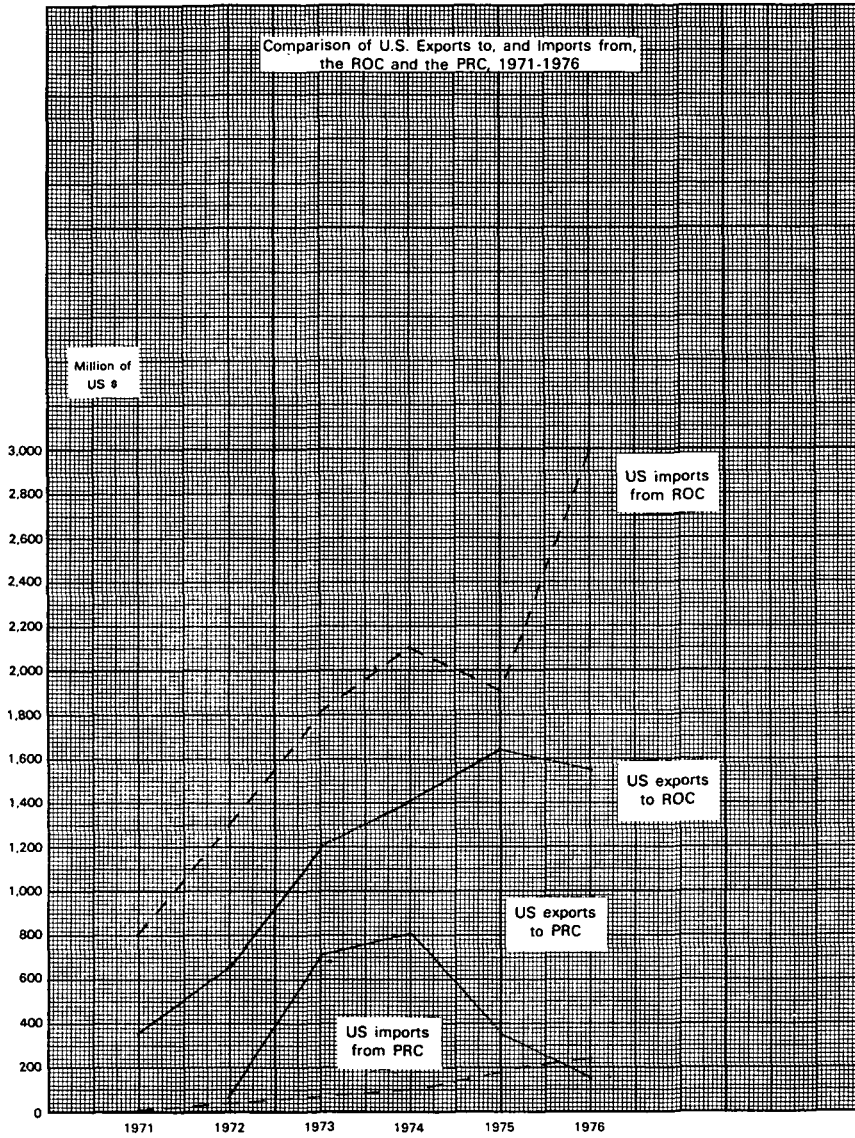


Figure 10

features. First, US-ROC and US-PRC trade are of very different orders of magnitude. Two-way US-ROC trade in 1975 was \$3,602 million, almost eight times the US-PRC trade of \$462 million. In 1976, the respective totals were \$337.3 million for US-PRC trade and \$4,527.3 million for US-ROC trade, or 13 times larger. The enormous difference suggests that Taiwan is at present a far more important market for U.S. exports and source of supply of U.S. imports than the PRC. A 10 percent loss of trade with Taiwan would have to be compensated by a 130 percent increase in US-PRC trade. On the other hand, a total loss of US-PRC trade could be made up with a 7.4 percent increase in US-ROC trade. Second, U.S. exports to the PRC were more erratic than U.S. exports to Taiwan. For instance, there was a sharp drop in U.S. exports to the PRC in 1974-75. In part this was a result of overcommitment by Peking in the early 1970s. In part it was due to a shift of its grain purchase to suppliers. In any event, Peking makes no secret of its position that trade is a legitimate economic tool to be used to enhance its diplomatic and political leverage, as has been made abundantly clear in Teng Hsia-ping's speech before the United Nations General Assembly on April 10, 1974. Therefore, in expanding exports to the PRC, one must be prepared to face the constant risk of abrupt shifts.

At any rate, a sustained increase in US-PRC trade cannot be based on a shift of PRC trade from other partners to the United States, but rather on growth of the PRC's total trade. The crucial question is, therefore, the trade potential of the PRC. Since Peking's imports depend on its exports, trade potential, in the long run, means essentially export potential. In the two decades up to 1970, PRC exports grew at the rate of two to three hundred million dollars a year, a small amount compared to Taiwan's current level. When the PRC began to export oil in significant quantities in 1973, it was widely believed that this new export would provide the key to an upsurge of exports. There was indeed an upsurge during 1970-75, but it was due largely to price increases during this period. More important, it is questionable whether the PRC's oil exports could indeed play a leading role; they have not lived up to expectations thus far. Whether their growth has been restricted by internal supply or demand conditions, or by the leadership's change of plans, is not entirely clear. However, one external factor is significant in limiting the contribution of the PRC's oil exports to its foreign exchange earning power. Peking began exporting oil at a time when the oil crisis triggered world-wide inflation and recession. As a result, the prices of the PRC's imports rose much

faster than those of its traditional exports (i.e., exports other than oil). That is to say, the terms of trade became adverse to the PRC so far as traditional exports were concerned. This was offset by the rise in price of its oil exports. The net effect is that the increase in export capacity in real terms was rather limited. In addition, two recent events would probably delay export growth somewhat. These were the Tangshan earthquake, which inflicted heavy damage on a major coal production center, and the need for foreign exchange to pay for the large number of plants contracted earlier.

PRC earnings from exports to the U.S. can increase if Peking is granted MFN status, which would enable suppliers of these products to promote them more vigorously even if their dollar prices were to remain unchanged. Greater sales are possible, of course, if prices are reduced somewhat although lower prices are by no means contingent upon MFN status since there is no direct relationship between external prices and Chinese domestic cost.

When we compare the types of U.S. imports from the PRC and Taiwan, as shown in Table 2, one interesting feature emerges. What the United States buys most from Taiwan it buys very little from the PRC, and vice versa. This suggests that Taiwan and the PRC supplement each other as sources of U.S. imports. The PRC provided mostly crude materials, food, chemicals and some manufactured goods. Taiwan supplied large amounts of machinery and transportation equipment and manufactured goods. The implication of this complementarity for the United States is that it would be difficult to replace one source of supply with the other. To make up for the loss of a supplier, it might be possible to restructure the other's exports or to turn to a third source. But restructuring exports is not a simple task and the question remains as to whether the country's comparative advantage would justify such a drastic change economically. As for the possibility of a third supplier, the alternative is certainly feasible. To a degree, South Korea or Hong Kong could partially take the place of Taiwan. But again, there is the question of the terms of trade. When there is less competition among the suppliers, the terms of trade generally work against the buyer. This brings us to the problem of the PRC and Taiwan as alternative markets for U.S. exports.

Table 3 shows U.S. exports to the PRC and Taiwan by commodity groups in 1971-76. The picture here is quite different from U.S. imports. Both the PRC and Taiwan buy more or less the same group of U.S. products. Both are competing for U.S. exports.

Table 2.
U.S. Imports from Taiwan and PRC, 1971-76 (Million U.S. \$)

	1971	1972	1973	1974	1975	1976
Total imports						
Taiwan	817.4	1,293.5	1,772.5	2,107.6	1,946.0	2,958.4
PRC	4.9	32.3	64.0	114.7	158.3	201.9
Food, live animals						
Taiwan	54.2	84.1	85.3	111.9	192.4	142.0
PRC	1.5	4.2	6.0	13.5	14.2	23.8
Beverages, tobacco						
Taiwan	—	—	0.3	0.4	—	0.09
PRC			0.7	2.8	1.8	0.3
Crude materials, inedible (except fuel)						
Taiwan	7.0	11.7	15.0	14.1	11.1	13.9
PRC	2.2	12.3	14.6	16.3	17.6	38.5
Mineral fuels, lubricants, etc.						
Taiwan	—	0.4	2.1	0.4	3.4	0.01
PRC	—	—	0.4	0.1	—	neg.
Oils & fats, animal, vegetable						
Taiwan	—	—	0.1	0.1	0.5	0.3
PRC	—	—	0.7	0.4	1.9	2.4
Chemicals						
Taiwan	6.9	9.5	12.1	31.9	16.2	26.1
PRC	0.3	2.1	8.2	18.4	15.9	18.0
Manufactured goods						
Taiwan	119.4	193.2	242.2	288.0	238.0	355.4
PRC	0.5	7.4	21.0	42.7	79.4	68.5
Machinery, transportation equipment						
Taiwan	202.2	401.1	600.5	685.3	488.5	780.2
PRC	—	0.1	0.4	0.1	0.3	1.3
Miscellaneous manufac- tured articles						
Taiwan	420.1	584.0	797.6	954.7	964.5	1,618.0
PRC	0.3	6.1	11.2	19.2	25.6	47.5
Miscellaneous						
Taiwan	7.5	9.4	17.1	20.8	31.4	22.4
PRC	—	0.1	0.8	1.2	1.6	1.6

Sources: 1971: U.S. Department of Commerce, General Imports, World Area by Commodity Groups, U.S. Government Printing Office, 1972, pp. 374.

1972-75: *Far Eastern Economic Review* (Hong Kong), July 2, 1976, p. 44.

U.S. Dept. Commerce, Bureau of East-West Trade, Office of East-West Policy, U.S. Trade Status with Communist Countries, February 1977.

Table 3.
U.S. Exports to Taiwan and PRC, 1971-76 (Million U.S. \$)

	1971	1972	1973	1974	1975	1976
Total exports						
Taiwan	342.7	629.5	1,165.0	1,423.8	1,655.7	1,568.9
PRC	—	60.2	689.1	806.9	303.6	135.4
Food and live animals						
Taiwan	30.5	55.9	154.1	167.8	180.9	202.1
PRC	—	56.0	410.1	329.6	0.02	—
Beverages and tobacco						
Taiwan	10.1	14.9	18.7	30.8	27.5	13.2
PRC	—	—	1.4	2.7	—	neg.
Crude materials, inedible (except fuel)						
Taiwan	141.6	149.1	319.1	307.3	407.5	304.5
PRC	—	—	171.9	328.0	100.1	13.0
Mineral fuels, lubricants, etc.						
Taiwan	2.1	2.6	3.5	7.2	7.2	0.01
PRC	—	—	—	0.2	0.2	0.1
Oils & fats, animal, vegetable						
Taiwan	4.4	4.3	5.2	18.4	10.0	12.2
PRC	—	2.2	19.2	7.5	—	—
Chemicals						
Taiwan	25.2	32.4	90.0	127.4	125.3	154.6
PRC	—	—	7.9	10.2	5.2	10.4
Manufactured goods						
Taiwan	25.3	31.4	76.2	123.4	141.3	132.2
PRC	—	—	9.0	18.5	73.8	43.3
Machinery, transporta- tion equipment						
Taiwan	157.5	233.4	398.2	562.7	599.7	666.2
PRC	—	2.0	69.0	106.7	118.8	65.1
Miscellaneous manufac- tured articles						
Taiwan	13.1	20.5	21.2	32.4	39.2	69.5
PRC	—	1.1	0.8	2.7	4.9	3.4
Items not classified by kind						
Taiwan	1.8	2.5	5.9	6.7	6.2	3.4
PRC	—	—	—	0.3	0.4	0.02

See Sources, Table 2 *supra*.

It would be to the advantage of the United States to have two buyers rather than one. On this account, the two-China case is perhaps preferable to others simply because it offers the U.S. more options so far as export markets are concerned.

LONG-RANGE U.S. INTERESTS: INTERNATIONAL STABILITY AND GROWTH

The oil crisis has brought into sharp focus the need to insure economic security for all countries in an international environment characterized by growing interdependence through trade, flow of technology and investment. It is a declaratory policy of the United States to pursue this goal.¹⁶ Any abrupt move by the United States that causes serious disruption and tension in international economic relations is therefore contrary to U.S. interests and to what it has been preaching to the OPEC countries. By this criterion the no-change policy would obviously be less disruptive than the other alternatives, particularly in the short-run. As we have noted above, diplomatic recognition of Peking and withdrawal of recognition of the ROC would probably generate an economic shock in Taiwan with adverse effects on its growth rate and perhaps even its viability.

In its struggle for economic survival, Taiwan may resort to rather drastic measures such as devaluation to offset a possible export decline, and stricter control of the free flow of goods, people, information and capital — a series of measures that probably would not hurt the U.S. economy seriously but nonetheless could have destabilizing effects in the region. The two-China policy might also generate a shock, but it is likely to be a political rather than economic shock, and would have its main impact on the PRC. If we look beyond the immediate future, the potential disputes over resources on the continental shelf could be further complicated by an additional claimant. But the emergence of Taiwan as an independent state has positive elements. The current trend toward expanding trade and international flows of technology and investment might continue as risks and uncertainties subside. They may even accelerate in the event of diplomatic recognition of the PRC and Taiwan at the same time.

If indeed the latter occurs, a two-China policy would help to attain the long-range U.S. objective of assisting the developing

16. Address by Henry A. Kissinger, delivered by Daniel P. Moynihan, at the Seventh Special Session of the United Nations General Assembly on September 1, 1975.

countries to raise their living standards. A no-change policy would probably have neutral effects, if we accept the premise that Peking could expand its trade and technology transfer as much as it can under the present arrangement. By contrast, diplomatic recognition of Peking is likely to bring about economic stagnation if not a decline in the Taiwan economy.

For Japan, U.S. diplomatic recognition of Peking has yet another unfavorable effect. Like Taiwan, Japan depends heavily on the free flow of raw materials and fuels. It is therefore important that no precedent be established so that shipping and trade involving Japan would be disrupted. Since diplomatic recognition might lead to economic warfare and possibly military confrontation between Taiwan and the PRC, it would be in Japan's economic interest that the United States adopt another alternative.

Dr. Sigur thanked Dr. Wu for giving us quite a bit to think about and discuss in the coming hour and a half or so. He was particularly grateful that Dr. Wu brought in the Japanese dimension, because he thought as we discussed the whole question of US-ROC relations and involvement with the PRC, we had to keep in mind that successive presidents of the U.S. over the past several years as well as the present incumbent, Mr. Carter, had stated over and over again that the fundamental American relationship in the Asian Pacific is the U.S.-Japanese alliance. Therefore we must understand how important this was in any discussion that we had on events in Asia.

Dr. Sigur then introduced Dr. Robert Heuser of the Max Planck-Institute at Heidelberg to speak. He said that he need not tell the participants very much about that institute since all of us knew of that famous institute. Dr. Heuser was going to speak on the legal aspects of trade with, and investment in the Republic of China in the experience of the German Federal Republic (FRG).

Dr. Heuser sketched the history of FRG-ROC trade relations up to 1976, when Germany was the ROC's third-ranked trade partner, following the United States and Japan. He noted also the growth of German capital investment in the ROC, especially in the last few years. Lack of diplomatic relations between the two countries, according to Dr. Heuser, is not a substantial impedi-

ment to trade. Government investment guarantees are available to the German investor in spite of the lack of an FRG-ROC "investment protection agreement"; however, because of the short-term nature of most German investment in the ROC and because of, among other things, the ROC's internal investment protection scheme, German investors rarely take advantage of these guarantees. Dr. Heuser also noted that protection with regard to trademarks and patents is available, but that protection against infringement of copyrighted textile designs remains unsatisfactory. Dr. Heuser concluded by discussing the effects of the EEC common commercial policy on FRG-ROC economic relations. To date, the common commercial policy has only affected German textile imports from the ROC. However, the effects of protective measures undertaken by the EEC remain an important matter of concern.

[The following is the text of the paper prepared by Dr. Robert Heuser.]
