Episode 169. Taiwan's risky trade opening and how it paid off

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Transcript

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Chad Bown: Today, Taiwan is a globalization superstar.

Taiwan is known for companies like TSMC, which makes all the best and fastest semiconductors. Taiwan's consumer electronics industry is legendary. Foxconn, one of the key companies making the iPhone for Apple, is Taiwanese.

Taiwan is a pretty wealthy economy. According to the IMF, Taiwan's income per person is right around the levels of Austria or the Netherlands.

It's not huge – Taiwan only has 23 million people compared to 1.4 billion Chinese across the Taiwan Strait. Like the mainland, Taiwan is also a big trader. In relative terms, it's even more open and trade dependent than China.

But for Taiwan, it wasn't always this way. In the 1950s, Taiwan was poor and pretty closed off.

Then, something happened. Taiwan became the first of an important group of small and poor economies taking the plunge on a new policy path of economic development: export-led growth.

Chad Bown: You are listening to an episode of Trade Talks, a podcast about the economics of trade and policy. I'm your host Chad Bown, the Reginald Jones Senior Fellow at the Peterson Institute for International Economics in Washington.

To help us understand the history and importance of Taiwan's policy decision, we're going to speak with the economic historian, Doug Irwin. Doug is a professor at Dartmouth College, he's also my colleague here at the Peterson Institute, and he has some new research on the history of Taiwan's great export idea.

Chad Bown: Hi, Doug.

Doug Irwin: Hi, Chad. Thanks for having me.

Chad Bown: Taiwan is an island off the coast of the People's Republic of China. It is a place with a super complicated history. Japan colonized the island from the late 1800s through 1945.

Then, at the end of the second world war, the island was liberated and returned to China. In 1949, when China underwent its Communist Revolution, the Chinese government at the time fled the mainland and established its home on the island of Taiwan.

Chad Bown: Doug, to start us off, tell us about the state of the Taiwanese economy in 1949.

Doug Irwin: Well, the state could be summarized in one word, and the word is bad. It had suffered a lot of shocks. World War II had just concluded a few years earlier. China had its Communist Revolution in 1949, and the government of Chiang Kai-shek, the Nationalist government, fled the mainland and came with a whole bunch of refugees and soldiers to Taiwan. They had a large fiscal deficit and hyperinflation.

It was just a desperate situation. This was a very poor agrarian economy and it had just suffered from many years of war and turmoil.

Chad Bown: In 1949, you have the Communist Revolution in China. The Nationalists move into Taiwan and set things up. From an economic policy perspective, what was Taiwan's government like in 1949 and through the 1950s?

Doug Irwin: It was a military government, there weren't many economists in the government, and they were concerned mainly about military affairs and national security. Initially, they had hoped that the Communist Revolution could be overturned and they could go back and retake China.

By later in the 1950s, they were concerned about China invading them. Throughout the entire 1950s, Taiwan's political authorities were just worried about national defense, national security, and the economy took a backseat.

To the extent they were concerned about economic policy, they just wanted to solve the immediate problems they were facing like shortages and the high rate of inflation. They wanted to plan the economy so that it could serve the military goals of the government.

But it's not as though they had some deep, impressive economic vision for the country. They were worried about short-term problems and the military situation they were in. They weren't fixed on some economic development path.

Chad Bown: What role did the United States play in Taiwan and in Taiwan's policy during this period?

Doug Irwin: The United States played a very large role in Taiwan's economic affairs during this period. The US was concerned about the spread of communism. There was concern over the Communist takeover in China. Russia was still a Pacific power. There was the Korean War in the early 1950s when Korea was almost taken over by the Communist North. The US wanted to defend Japan, wanted to defend South Korea, and wanted to defend Taiwan from these military threats.

The way the US did that was providing a lot of aid to Taiwan, both military aid to help with their defense, but also economic aid so that the economy could be viable for the people there.

The US wrote a lot of dollar checks and gave them to the Taiwanese so that they could afford to buy military equipment and the food and fuel they needed to have a sustained economy. And of course, what that aid meant was that Taiwan could afford to import a lot more goods than it could possibly afford on its own through its export earnings.

TAIWAN'S ECONOMIC PROBLEMS IN THE 1950S

Chad Bown: That's the background. By the 1950s, what were the main economic problems that the Taiwanese government was worried about?

Doug Irwin: They had managed to reduce the hyperinflation of the late 1940s and early 1950s, which was progress, but they still had a fairly large fiscal deficit. They still had an underlying rate of inflation that was pretty high. The country remained very poor. The growth rate was lackluster.

And they weren't exporting very much. They were still dependent on US aid to buy imports from the rest of the world. And they didn't really see a path of closing that gap between their low level of exports and their high level of imports. There was just very little good prospects for the Taiwanese economy.

Chad Bown: On *Trade Talks*, we always have to talk about trade policy. Did Taiwan have really high import tariffs during this period?

Doug Irwin: Compared with today, Taiwan had pretty high tariffs, but most countries at the time did. I think tariffs were about 30 to 40% on average in Taiwan. That's pretty much in line with other countries at the time. Revenue was an important purpose for those tariffs because the government had a big fiscal deficit, but they also wanted to protect some domestic industries.

At the same time, tariffs weren't really the limiting factor in Taiwan's trade during this period.

Chad Bown: If tariffs weren't the limiting factor, what then was the source of Taiwan's underlying economic problems?

Doug Irwin: The biggest problem that Taiwan had during this period was that its currency was overvalued.

Taiwan fixed the value of its currency against the US dollar – it had a fixed exchange rate – so new Taiwanese dollars exchanged for a certain amount of US dollars at a fixed rate, and they didn't change that over time.

The problem was that Taiwan had a higher rate of inflation than the US did. So what that meant was the price of Taiwanese goods kept going up and up and up relative to US goods. The exchange rate was not being adjusted to compensate for that. So Taiwan's goods were priced out of the international market, just became too expensive for foreign consumers to purchase, and that limited Taiwan's exports.

At the same time, by keeping the exchange rate fixed with the higher price of Taiwanese goods, it made foreign goods look incredibly cheap. There was huge demand in Taiwan to buy imported manufactured goods, imported raw materials, and imported consumer goods.

That's what an over-valued currency will do. It will price out your exports from the world market, make them too expensive for foreign consumers, and make foreign goods seem really cheap to domestic consumers, so import demand is really high.

Chad Bown: In general, how does a government deal with that kind of problem?

Doug Irwin: Well, there are two ways a government can deal with the problem of having an overvalued currency and the balance of payments problems that come about as a result.

The obvious thing to do is just to change the value of one's currency. If you have a high rate of inflation, then you should be devaluing your currency in line with that high rate of inflation. That would keep domestic prices and international prices in alignment with one another.

If you don't devalue, however, you're stuck with this problem that import demand is very high, your exports are very low, and you're not earning the dollars – the foreign exchange – to pay for those imports.

So you have to start rationing foreign currency. That is, the Taiwanese government only had a limited amount of dollars. The dollars weren't coming in through exports, it was coming in through US foreign aid. The government would have to allocate those dollars to the imports that it wanted to see coming into the country, not to those that the market would have generated.

To take one example, in 1953, only 7% of the requests for licenses or foreign exchange to buy imports were granted. The government simply didn't have the reserves to pay for all the imports that the private sector wanted to bring in.

THE PROBLEM OF AN OVERVALUED TAIWANESE CURRENCY

Chad Bown: To fix the overvalued currency problem, Taiwan's government would need to reduce the rate of exchange between a Taiwanese dollar and a US dollar.

It would have to pay out more Taiwanese dollars to Taiwan's exporters when they handed it a US dollar. The government would need to hand out fewer US dollars when Taiwan's importers gave it the Taiwanese currency.

Taiwan's government was really worried about what might happen if it devalued its currency.

Doug Irwin: The reason why Taiwan's government didn't want to devalue is really twofold. First of all, if you devalued, that would raise the price in Taiwan of those foreign goods, and there was a fear that that would contribute to inflation because foreign goods were such a big and important part of the Taiwanese economy, and they want to restrain inflation. They had just come out of a hyperinflation, they were very sensitive to anything that would increase prices, and they didn't want to increase prices.

The second problem was that they feared that a devaluation would not stimulate Taiwan's exports. At the time, they were exporting mainly rice and sugar. It was thought that foreign demand for these goods would not respond very much to prices.

The price of your imports would go up, you would not really stimulate exports, and that would not solve the problem. That is, a devaluation would not solve the problem of the imbalance between your low level of exports and your high level of imports.

Chad Bown: Because Taiwan was fearful of devaluing, it chose to ration the limited foreign exchange it had instead.

But in practical terms, what does that mean?

Back then, there were no foreign exchange markets. The process through which the Taiwanese government gave out to importers the very few US dollars it had, was tricky.

Doug Irwin: When a government rations foreign exchange, essentially all the dollars that come into the country, whether earned by exporters or coming in terms of US foreign aid, all of it has to be turned over to the central bank of the government.

What that means for a Taiwanese exporter is that if you earn dollars or yen from selling rice or sugar to Japan or the United States, you can't keep that for yourself. You have to turn that over to the central bank at the exchange rate the central bank is offering and get Taiwanese dollars.

Once the central bank has that foreign exchange, those dollars, it then determines how that gets spent. If you want to import a foreign good, you have to ask permission of the government. You have to apply to the government and get a license that will give you the permission to get access to the foreign exchange.

The limiting factor on imports is not the tariff that you have to pay. It's can you get the foreign exchange in the first place.

Today, we take this completely for granted. If you want to import something, as long as you're willing to pay the tariff, access to the foreign exchange is not an issue. But under a foreign exchange rationing scheme, the very first step is can you even get the wherewithal, the dollars, to buy a foreign good.

PROBLEMS WITH RATIONING FOREIGN EXCHANGE

Chad Bown: How does the government make the decisions about which licenses to grant for this foreign exchange rationing and which ones to decline?

Doug Irwin: Every government that rations foreign exchange will give a public reason, in terms of what they aim to do. And then there's the reality.

The public reason that any government – and this would include Taiwan during this period – would give is we're not going to waste this on frivolous imports. We're not going to import consumer goods or luxury goods, which is a waste. We're going to spend this on what is most valuable to the economy, where we need it the most, which would be food, fuel, raw materials, to keep industry going and keep the economy afloat. No silk dresses, no diamonds, or things of that sort.

But there's so many potential importers that want access to this foreign exchange, what tends to happen in practice is that it becomes political and it becomes corrupt.

The government will allocate the foreign exchange to its political friends, not its political enemies, or to industries where they have a lot of ties to the ruling party, and not allocate it to those who don't have those ties. Sometimes there might even be corruption involved and the payment of bribes to get the foreign exchange.

It's a bit of a black box, so there's always a gap between the stated intentions and the underlying reality of how foreign exchange gets allocated.

Chad Bown: Corruption is clearly one potentially really big concern. But how about other economic problems.

When you have this overvalued Taiwanese dollar and too little access to foreign exchange, so that the government is forced to ration their scarce US dollars, what sorts of unintended economic consequences for Taiwan pop up?

Doug Irwin: There are unintended consequences on the export side and on the import side.

On the export side, the overvaluation of the currency means that you're not really paying much to exporters when they sell their products to foreign consumers.

That's a disincentive to export, but it also leads to very low prices for the groups that are exporting – in this case, rice farmers and sugar growers. And so you'd use the rice – not for its highest value, instead of selling it to foreign consumers where there might be high demand in the world market – you'd sell it domestically as feed for domestic animals.

And on the import side, once again, the overvaluation creates a big gap between the price at which importers can obtain foreign goods (that is at a relatively low price), but then because there's a limit on how many imports are coming in, they can resell those imported goods at a very high price domestically.

Cotton yarn, for example, if you had access to the foreign exchange, you could buy it abroad at a very low price, but sell it for a third more in Taiwan.

Wheat flour, once again, you could buy it at the world market price with your foreign exchange, but then sell it at almost a 50% higher price in Taiwan.

This premium on imported goods – because there's a scarcity of these imports, because the foreign exchange is being allocated – could rise as high as 350% for, say, woolen products.

By getting access to foreign exchange, it allowed you to buy low on the world market and sell high in the domestic market.

Chad Bown: Why is this price premium for imports in Taiwan a problem?

Doug Irwin: The profits, or what is sometimes called the 'rents' from that markup, are accruing to the lucky importers who get access to that foreign exchange. That's a really easy way of making money. You don't have to strive harder to make a better product, to cut costs and to become efficient, you just have to have the political connections that will give you access to foreign exchange.

And if you get that access, you get a huge markup on just about anything you would bring into the market.

For entrepreneurs, you would divert your energy and attention not to producing good products for the market, but to gaining access to foreign exchange to earn these profits that you would have just by importing foreign goods.

WHY COUNTRIES MAKE TRADE POLICY REFORMS

Chad Bown: Taiwan would ultimately become the first in a long line of developing economies to change its international economic policy from being closed to being open. Short hand, opening up to trade and what happened next in Taiwan is often referred to now as export-led growth.

Before we get to Taiwan, I asked Doug to describe the many different potential reasons why other governments, over the years since, have chosen to open up to world trade.

Doug Irwin: One would be economic interests. So for example, when we talk about trade policy on the import side, or import protection, we often think about the economic interest that benefit from protection, the import-competing groups, producers and workers who would want a trade barrier in place.

You might think that when a country opens up, it's just the flip side of that, that exporters would be demanding that change in policy. And yet when we look at country after country, it's very hard to see how exporting firms and their workers are really demanding changes in government policy. There's a famous paper by Raquel Fernandez and Dani Rodrik that talks about how uncertainty among exporters will lead to political inaction on their part, in terms of demanding trade policy reforms.[1] If you don't know whether you're going to be one of the exporters, who will benefit from the expansion in trade, it doesn't pay to lobby the government.

Another regularity is that countries that are facing an economic crisis of some sort are forced to change policy. There have been many instances of that over the last 30 or 40 years. India faced a balance of payments crisis in 1991 and after having the license raj – an import regime, very similar to Taiwan’s during this period, where foreign exchange was rationed – decided to change that in 1991 as a result of that crisis.

[1] Raquel Fernández and Dani Rodrik. 1991. Resistance to Reform: Status Quo Bias in the Presence of Individual-Specific Uncertainty. *American Economic Review* 81(5): 1146-1155

Mexico and many Latin American countries faced a debt crisis in the 1980s, and they also decided to devalue their currencies and open up to trade in a way that they hadn't in the past.

Another example would be where the World Bank or the IMF steps in and demands, through conditional lending, that countries change policies. This often happens in the midst of a crisis, so it's very much related to the crisis hypothesis of economic policy reform. The World Bank and the IMF have not really forced countries to open up as much as they've been invited by countries that want to open up to help them in that process.

For example, Vietnam in the late 1980s, when it was considering opening up, invited the IMF to really help it in that process. But it wasn't as though the IMF was banging on the door demanding that they do these things.

Chad Bown: Out of all those reasons, why did Taiwan decide to do this?

Doug Irwin: It turns out none of those reasons is really appropriate to the Taiwan case.

Certainly it was not a case of export interest driving the process. Taiwan wasn't exactly facing an economic crisis. Yes, they had a lot of problems, but they weren't on the brink of some disaster that was forcing them to change their policy. And the IMF in the World Bank were really not heavily involved with Taiwan at this period.

TAIWAN'S GREAT ECONOMIC POLICY IDEA

Doug Irwin: The story for Taiwan is a little bit more rich and interesting in some sense.

It really comes down to one of the leading policy makers at the time, K. Y. Yin. He was trained as an electrical engineer. He didn't know much about economics. He wasn't certainly trained as an economist, but he respected economists and wanted to learn from them. And in 1954, he happened to meet a Taiwanese economist based in the United States, S. C. Tsiang.

At the time, Tsiang worked at the International Monetary Fund, but he was not visiting Taiwan in an official capacity, it's because he was visiting family and friends. He later became a professor at the University of Rochester and Cornell, but that was later in the story. He was one who, when he met Yin, criticized him quite directly and heavily for maintaining this very restrictive import regime regarding foreign exchange and foreign goods.

Yin then challenged him and said, "If you think you could do better, tell me what to do." And so we invited, Tsiang and colleague of Tsiang's, T. C. Liu, to come to Taiwan and undertake a study and tell Yin what to do.

In the summer of 1954, they visited Taiwan and wrote up a report in which they were very critical of the import licensing regime, thought that Taiwan could succeed by promoting exports, and suggested a devaluation and an overhaul of the import license regime.

I happened to find a copy of this report in the IMF archives, and it's an absolutely fascinating document. It's only about 20-25 pages, but it's very clearly written and just lays out exactly what Taiwan ought to do.

Chad Bown: Yin gets this plan. Does he ultimately implement it? Tell us what happens.

Doug Irwin: Yin receives this report in 1954. He left government for a short period after that, but he came back into government in 1958 and pushed the government to implement the report.

There was a debate within the government about whether to do so. The government was divided, but Yin had so much prestige and respect from Chiang Kai-shek and the other leaders of the government, that they bought his arguments, which were expressed very forcefully and very eloquently. They devalued their currency, established a more realistic exchange rate that helped out exporters and helped limit imports. And they were enabled as a result to eliminate all the import rationing and the foreign exchange rationing that came with the previous fixed exchange rate.

Chad Bown: Why had government policy makers in Taiwan been so fearful of undertaking this reform in until 1958? What was really holding them back?

Doug Irwin: Well, there's a saying that everyone wants progress, but nobody wants change.

There was just a great fear of the unknown. The current system had been in place for some time. Everyone knew how it worked, even if they thought it was imperfect. And the great fear was that if they devalued, that's going to lead to higher prices for imports. And once again, they were very sensitive to the inflation that they had suffered from in the past.

And there was a fear that exporters wouldn't respond – so they would just export more rice and more sugar. But they thought those were really constrained in terms of the foreign markets.

And so you wouldn't generate more foreign exchange, and you'd create a higher price for these imports. Therefore it would be better to stick with the tried and true import licensing regime that they had.

Chad Bown: What happened on the Taiwanese export side?

Doug Irwin: To the surprise of many, there was a tremendous export response on the part of the Taiwanese producers to the new exchange rate.

It wasn't just that old exports grew more rapidly because they were more favorably priced on international markets. It's that new exporters – new producers – entered the market and started selling things that they had never sold before, whether it was plywood or cotton cloth, or eventually clothing and even footwear, a whole bunch of new exports just blossomed as a result of the more favorable exchange rate.

Exports, for example, were only about 5% of GDP in the mid 1950s, but by the late 1960s, about 10 years after the reform, exports were about 20% of GDP. That's just explosive export growth as a result of the exchange rate change.

Chad Bown: Tell us a little bit about the US government's role in supporting Taiwan during this reform process.

Doug Irwin: The US really didn't initiate these reforms. They were really something that the Taiwanese policy makers were formulating amongst themselves – Yin and the Tsiang report.

But the US was supportive of the reforms. They had initially told the Taiwanese that they were going to start curtailing foreign aid – not immediately, but over time. And that ratcheted up the pressure a bit on the Taiwanese to do something to resolve the big imbalance between their low level of exports and their high level of imports.

But it was really the Taiwanese authorities themselves that decided to undertake this. But once they did so, the US was very supportive of the reform efforts in Taiwan, and they offered additional aid into the early 1960s, just to keep the process going.

Chad Bown: Taiwan has now undertaken this major reform of the foreign exchange regime, and that helps deal with a lot of the challenges and spurring exports that contributed to growth.

How about things on the import side? Did they have suddenly fully free trade at this stage?

Doug Irwin: No, Taiwan really didn't move in the direction of fully free trade. They still had import controls in place, and they still had tariffs. They didn't really reduce the tariffs much during this period.

And what they did on the export side was, of course, not just encourage exports through the more favorable exchange rate, but they set up export processing zones, which gave tax breaks and tariff breaks to companies that operated in them. The tariff breaks were important. These were tariff rebates for firms that would import intermediate components that would be used in the production of exported goods.

By setting up these export processing zones and having the tariff rebates, or sometimes called drawbacks, exporters could become more efficient and have cheaper products by not paying those tariffs on their imported components.

Chad Bown: This is a pretty impressive set of reforms that Taiwan is undertaking unilaterally – jumping off the cliff. No one had really ever done this before.

But it also might have gotten a little bit lucky as well. There were a lot of other things going on in the global economy, during this time period, that may have helped support their transition.

Doug Irwin: Yes, Taiwan benefited a lot from, first of all, reforming in the late 1950s and early 1960s because the world economy was growing very rapidly during the 1960s. The United States and Western Europe and other markets were relatively open to these products, so Taiwan had opportunities to sell elsewhere.

We also had a lot of other pro-globalization forces going on. There was a rise of foreign direct investment that had not been seen in previous decades. And Taiwan with its export processing zones benefited from that. US multinationals would set up assembly plants and other facilities in Taiwan to take advantage of this and to take advantage of the lower priced labor. We also had containerization, so that also facilitated the process of exporting goods during this period.

WHAT THE REST OF THE WORLD LEARNED FROM TAIWAN

Chad Bown: Looking back at this episode, what would you say are the main takeaways from the Taiwanese experience?

Doug Irwin: The main takeaways are not just that this was a successful policy for Taiwan and Taiwan did very well, so the whole reform started a process that Taiwan really took off as a result.

Taiwan served as an example for many other countries. There was a great deal of fear in Taiwan about what would happen if it devalued, whether that would raise the inflation rate, whether opening up to the world would stimulate exports or not, whether it would be successful in that dimension, whether it might lead to more imports that would destroy domestic industries and lead to more unemployment.

None of those fears really happened. The inflation rate did not pick up. Domestic industry continued to be very strong. Exports grew very rapidly, and the whole economy flourished.

Taiwan's exports grew very rapidly in the 1960s, but from a very small base. They really didn't make a big impression on policy makers around the world until the late 1960s or even the early 1970s. And by then people began to take notice and say, “What did Taiwan do? This small island that was very poor, why are they so successful? What did they do 10 years earlier?” And people began to look back at Taiwan's example and say, maybe there's some lessons here for us.

Taiwan was quickly followed by Hong Kong, South Korea, Singapore – which all did very well, and that was very instructive for policy makers around the world, and really led the reform effort, in terms of trade policy around the world, during the 1960s and 1970s.

Chad Bown: Today, when you hear stories or policy advice for countries thinking about export-led growth as a development strategy, it's often told as if the policy needs to be a radical shift toward free trade.

But for the Taiwan story, that really does not seem accurate.

Doug Irwin: It's also interesting, as you pointed out, that Taiwan didn't fully embrace free trade. So that meant that Taiwan's reforms were very pragmatic and that pragmatism could be an example for other countries as well.

You didn't have to buy into an extreme free trade ideology. You would just take these practical steps that would move towards greater integration in the world economy. You still had some tariffs in place, you could still have some subsidies, but economic performance improved dramatically by taking those steps.

What that meant was that other countries could look back at Taiwan and say, "Look at what they did! It was very successful for them, maybe we should consider doing that!"

Or in a crisis, a country could look back at Taiwan and say, "Well, they faced a similar situation and did this policy, and that it worked out pretty well – maybe we ought to give that a try as well."

Chad Bown: Doug, thank you very much.

Doug Irwin: Thank you for having me.

GOODBYE FOR NOW

Chad Bown: And that is all for *Trade Talks*.

A huge thanks to Doug Irwin, my colleague here at the Peterson Institute, and an economics professor at Dartmouth College.

Do read his new paper titled "How economic ideas led to Taiwan's shift to export promotion in the 1950s."

Thanks to Melina Kolb, our supervising producer. Thanks, as always, to Collin Warren, our audio guy.

And a special thanks this week to Washington DC's crew of leaf blowers. You probably heard them. It's nice to have them back and contributing some audio content to the podcast.

Do follow us on Twitter, and in fact we would be super grateful if you would Tweet out this episode. We are on @Trade__Talks. That's not one but two underscores @Trade__Talks.

<insert super funny double underscore joke here> . [redacted]