EXECUTIVE SUMMARY

MODELS OF DEVELOPMENT

Revised and Expanded Edition

A Comparative Study of Economic Growth in South Korea and Taiwan

Edited by
LAWRENCE J. LAU

Foreword by
LAWRENCE R. KLEIN

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—— *Executive Summary* ——

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Foreword

South Korea and Taiwan have continued to make unusual economic progress since the original publication of this study, and the favorable comments that I made in the foreword to the first edition have not changed in a fundamental way. These two economies are outstanding in the sense that they are very promising cases for elevation from developing-country status to developed-country status. In fact, many people who are familiar with the use of the concepts "developing" and "developed" already assume that these two economies are, in fact, developed.

There are some interesting pieces of information that lead one to this conclusion, apart from observation of such achievements as high output/income levels, strong international trade accounts, and the excellent quality of their manufactured goods. Both countries are selling world-class goods in sophisticated lines in international markets.

Their strong positions in world trade were formerly associated with favorable currency exchange rates, which were essentially pegged to the U.S. dollar. During the past few years, both the New Taiwan dollar and the South Korean won have been allowed to appreciate, just as the currencies of "members of the club" would have done in similar circumstances. It is true that the respective central banks and treasuries moved very cautiously toward currency appreciation, and it is also true that they were talked into this action by the United States; nevertheless the currencies did appreciate, and both countries continue to enjoy healthy export-led growth. Both took the requisite steps and realized substantial rises in the value of their currencies against the U.S. dollar —approximately 40 percent in the case of the New Taiwan dollar and 25 percent in the case of the South Korean won. Both countries have performed better with appreciating currencies than their leaders thought was possible.

In the face of increased competitiveness from the United States, Western Europe, Japan, and Australia, as well as from the other newly industrialized economies, both countries continue to realize significant trade surpluses, service their debts, show strong real growth, and hold domestic prices to steady trend paths. These achievements exhibit a kind of economic maturity. They will find it ever harder to grow through exporting alone.

Although their prices are rising along a moderately increasing growth path, it does not appear that Taiwan and South Korea are approaching a condition of accelerating inflation. But times have changed. Work forces in these countries put in a very strong effort at low wages in order to gain a foothold in international commerce through competitive pricing. It is only natural that workers now demand much better wages so that they can better enjoy the fruits of their labor. Wage increases are now higher, and the only way that prices can be kept at competitive levels is to have strong productivity gains. There is, therefore, a real challenge to worker effort and ingenuity, together with entrepreneurial guidance, to overcome the rising exchange value of their currencies and continue to sell manufactured goods in world markets. During the first few years of meeting the challenge under the new conditions, these two countries have been wonderfully successful, and there is every reason to believe that success will continue.

Taiwan and South Korea have been pressured by the United States to liberalize trading policies, to import more U.S. goods, and to look more than in the past toward domestic economic expansion. South Korea attained a measure of high international economic status through its sponsorship of the Asian Games in 1986 and the Olympics in 1988. Taiwan has repeatedly been called upon by the United States to contribute, along with other "advanced" countries, toward the resolution of the LDC debt problem. South Korea has been paying off its foreign debt ahead of schedule. It is their mature responses to these extraordinary requests and pressures that, more than anything else, place these two economies in the most advanced international classification.

Taiwan and South Korea are following the Japanese economic route in many respects, and the similarities are also striking in the case of education. We educators have come to appreciate the high level of achievement of the scholars from Taiwan and South Korea; both countries operate impressive educational establishments domestically. The performance of their students in international competition and in absolute levels of scholarly achievement is quite impressive. Scholarly achievement played a very positive role in elevating Japan to the world's highest economic status, and I can perceive the same forces at work in Taiwan and South Korea. In many respects, the student flow that I personally encounter at the higher education level in American universities reminds me of the similar performance of Japanese students during the 1950s and 1960s.

The fact that a second edition of this book is called for is indicative of the point that world readers in the field of economics are deeply interested in the two success stories being analyzed in the present study. There is a great desire to know as much as possible, in subtle detail, of the factors that made possible the economic achievements of Taiwan and South Korea. Many third world and centrally planned economies want to emulate these two cases.

Lawrence R. Klein
Nobel Laureate in Economics

Preface

We are very pleased to publish this executive summary of the revised and expanded edition of *Models of Development*. In South Korea, Taiwan, and throughout the world, significant changes have occurred since the first edition of the book was published in 1986 that make this an important publication.

In the past four decades, Pacific Basin countries have compiled extraordinary records of economic performance. The experience of the "four tigers"—Hong Kong, Singapore, South Korea, and Taiwan—provides a sharp contrast to the stagnation or decline experienced in many other developing countries. Of the four, South Korea and Taiwan have political, demographic, and geographic qualities that are more representative of third world countries in general and thus provide better examples for other developing countries. The particular focus of this book is on economic policies that can be adopted in other social and political settings.

We are confident that this edition will have the same broad appeal of the first edition and that the experiences of South Korea and Taiwan will be of interest in many other countries. Indeed, the first edition has been translated into Spanish and into Chinese in both the People's Republic of China and the Republic of China on Taiwan.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
September 1990

Summary of Conclusions

In the past four decades, the "four tigers"—as Hong Kong, Singapore, Taiwan, and South Korea are known—have compiled extraordinary records of economic performance. Of these countries, South Korea and Taiwan have demographic, political, and socioeconomic qualities that are more representative of third world countries in general. This work focuses on the economic successes of those two countries and on the economic policies responsible for their successes.

1. The economic success of Taiwan and South Korea is attributable to three essential factors:

   - reliance on private enterprise
   - establishment of the rule of law in the economic sphere
   - the existence of domestic and international competition

   The simultaneous presence of these three factors is important: reliance on private enterprise without competition, for example, may lead to private monopolies, with their associated inefficiencies.

2. In important policy and policy-related areas Taiwan and South Korea had some key similarities, as well as some differences:

   - Both Taiwan and South Korea featured export promotion as the cornerstone of economic growth.
   - Both adopted realistic interest rate policies. South Korea, however, was not as successful as Taiwan in mobilizing domestic savings for investment; foreign capital provided

an important source of investment funds. In the 1980s, however, the South Korean savings rate increased significantly and exceeded investment, and the current account went from a deficit to a surplus position.

- Both countries had fiscal budget surpluses and maintained realistic exchange rates.

- South Korea's currency was subject to more frequent devaluation, and Taiwan had more stability in prices and growth of real GDP.

3. The philosophies behind the development strategies of the two countries were different in important ways. One striking difference is in their fundamentally different views on the role of government.

   - The South Korean government took a very active role in controlling market forces, while the government of Taiwan tended to rely more on the workings of the free market.

   - Both countries implemented a variety of economic controls, but government influence over economic affairs was much more overt and pervasive in South Korea, where the economic planning structure was larger, more centralized, and more elaborate.

4. One outcome of the difference in development strategy is that South Korea generally has a higher level of industrial concentration—fewer firms per industry—than Taiwan.

   - In Taiwan the most important factor in the prevalence of small businesses and low industrial concentration was the absence of a policy to encourage large enterprises and the government's willingness to let market forces take their course after securing conditions conducive to economic growth.

   - In South Korea, however, the government consciously encouraged large businesses—and high industrial concentration—at the expense of small. Credit, for example, was subsidized and allocated to large enterprises; tax incentives and disincentives in favor of large enterprises were common.

5. Taiwan's free-market orientation has produced a more equitable distribution of income than exists in South Korea. Taiwan's more equitable distribution stems from six factors:

   - land reform, which improved land distribution and encouraged increased productivity
   - high employment, which increased labor's share of income
   - an increasing level of education, which helped reduce income inequality
   - tax policies aimed at redistribution
   - social welfare, health, and education spending designed to benefit lower-income groups
   - a small average business size, which eased entry and limited excessive profits

6. In the 1980s, both economies saw increased economic liberalization and democratization. Prospects for continued growth in both countries remain good. The unrest both are experiencing is similar to what Japan experienced in the 1960s. The only dark cloud on the horizon is the rampant speculation on the stock exchanges and property markets. As we go to press in September 1990, the Taiwan Stock Exchange Average Index has lost 70 percent of its value since the beginning of the calendar year.

An Overview of *Models of Development*

In any international comparison of economic performance during the past quarter century, four countries—Hong Kong, Singapore, Taiwan, and South Korea—invariably stand out. While their economies still lag behind Japan and the industrialized West in real income and real consumption per capita, in terms of other dynamic indicators they rank far ahead of all economies—including Japan and the industrialized West. All four excel in growth rates of real income and real consumption per capita, in low inflation and unemployment rates, and in most noneconomic, social welfare indicators such as life expectancy and literacy. In fact, Hong Kong, Singapore, Taiwan, and South Korea have done so well in the past two decades they are often collectively referred to as the "four tigers," "four little dragons," or the "gang of four."

Why are they so successful when other developing countries are still struggling to maintain bare subsistence? With growth rates ranging between 8 and 10 percent per year over the past quarter century, luck alone cannot have been responsible for their *high and sustained* rates of economic growth. It is obvious that Hong Kong, Singapore, Taiwan, and South Korea must all be doing something right. Of course, each of the four countries has a unique history; faces a unique constellation of economic, political, social, and environmental forces; and has a unique set of resources at its command. Identifying the factors important in their success and weighing each component's relative contribution is a complicated task.

An analysis of each country individually, however, does not go far enough. One major reason to analyze the factors that have contributed to the economic successes of Hong Kong, Singapore, Taiwan, and South Korea is our desire to see what factors they have *in common*. Were initial conditions in the four countries comparable? Are their economic policies similar? Are their institutional environments alike? And most important, what successful policies, if any, may be found in all of them?

The ultimate purpose is to ascertain whether any general principles can be induced from the successful experiences of these four countries. Are some factors more important and others less so? To what extent have certain economic policies been the engines of growth? Which policies have been most pivotal in the development process? Are certain institutional environments more conducive to economic growth?

Even if these general principles can be found, however, the problem of transferability remains. Will the same strategies work in other developing countries? If similar economic policies are adopted elsewhere, will the same success follow? Or are the policies unique in their benefits to these economies? These questions are difficult but crucial.

The experiences of the city-states of Hong Kong and Singapore, which are substantially dependent on unique geographies and histories, are largely irrelevant for the majority of developing countries. By contrast, both Taiwan and South Korea had initial conditions similar to those of most other developing countries, and their natural resources and endowments were even poorer than most. Their experiences are thus likely to be more relevant for other countries than the experiences of Hong Kong and Singapore.

Taiwan's Success Story, 1965–1981

Ramon H. Myers describes and analyzes Taiwan's economic growth between 1965 and 1981. Among other issues, he discusses the development of Taiwan's financial institutions, the country's economic planning structure and strategies, the stability of the economy, and changes in income distribution. Taiwan's economy averaged 9.4 percent real growth per year in gross national product (GNP) between 1965 and 1981. Many factors contributed to this remarkable growth: Partly as a legacy of the

Japanese occupation from 1895 to 1945, Taiwan had a relatively modern infrastructure in the form of roads, railways, harbors, and the like to build on. Throughout the 1950s and early 1960s, Taiwan also received substantial economic and military aid from the United States, which helped create the stable economic and political conditions that enabled the economy to thrive. Even after direct U.S. aid ceased in 1965, the United States continued to contribute to the Taiwanese economy through trade, direct investment, technology transfer, and the education and training of advanced students. Taiwan was also fortunate enough to enter the world market at a time of rapid trade expansion. By all accounts, however, two economic policies, which were innovative at the time, played a decisive role in transforming Taiwan from an agrarian backwater to a thriving industrial society. These two policies were promotion of exports and liberalization of interest rates.

In the 1950s and early 1960s the prevailing wisdom was that, in order to grow, developing countries needed to adopt an import-substitution strategy, that is, to produce domestically (under protection if necessary) goods that had been imported. But instead, Taiwan's economic planners chose to promote exports, setting an exchange rate close to the market-clearing rate and reducing or removing import tariffs and quotas on producer goods. As a result, Taiwan's exports soared—from US$449.7 million in 1965 to US$22,611.2 million in 1981, a phenomenal increase. With it the economy prospered.

Again defying the conventional wisdom of the day, Taiwan's economic planners in the early 1960s set interest rates at close to market-clearing rates, which, moreover, yielded a positive real rate of return to savings depositors. As a result, the ensuing two decades in Taiwan saw a huge increase in the ratio of savings to income. For example, gross national savings as a percentage of GNP went from roughly 20 percent in 1965 to 35 percent in 1973, dropping slightly to 31 percent in 1981. As the 1965 figure suggests, the people of Taiwan seemingly have a cultural predilection for saving, so the rate of savings has always been relatively high once a minimum threshold level of per capita real income has been reached. But the country's realistic interest-rate policies pushed the rate of savings up even further. In fact, domestic savings alone was able to provide virtually all of the huge pool of investable funds that was so crucial to Taiwan's capital accumulation and growth.

These twin strategies of export promotion and realistic interest rates caused not only dramatic economic growth in Taiwan, but also a tremendous improvement in the living standards of the average citizen. The people of Taiwan became much better fed, better educated, and better housed. They also enjoyed, contrary to the predictions of most economic development theories, an income distribution that was among the most equitable in the world. The degree of income inequality among households in Taiwan decreased as the country's economic growth soared.

Myers cites a number of factors that contributed to this surprising trend. First, land reform in the late 1940s and early 1950s promoted income growth among rural households by improving land distribution and encouraging increased productivity. Second, the high rate of employment between 1965 and 1981 increased labor's share of income and narrowed the gap between the wages of skilled and unskilled labor. Third, the increasing average level of education in Taiwan helped reduce income inequality. Myers reports, for example, that the proportion of students enrolled in post–high school educational institutions grew from 4.5 percent to 20.1 percent of all students over the fifteen-year span from the mid-1960s to the early 1980s. This trend brought about a corresponding increase in labor's share of income.

Fourth, Myers notes that Taiwan's government implemented a number of taxation policies aimed at redistribution. For example, it levied higher excise taxes and tariffs on luxury goods and instituted estate and gift tax laws. Fifth, the government designed its social welfare, health care, and education expenditures principally to benefit lower- income groups. Finally, the small average size of businesses in Taiwan made it easier for entrepreneurs to get started and put a ceiling on the profits of any single enterprise. Both phenomena had the effect of reducing the concentration of income.

South Korea's Success Story, 1965–1981

Sung Yeung Kwack addresses many of the same topics discussed by Myers, but in relation to South Korea. He examines in detail prices, exchange rates and monetary policy, the development of financial markets, investment, savings and rates of return, South Korea's foreign economic relations, and the country's income distribution. In a number of respects, South Korea's success story strongly resembles Taiwan's. South Korea began the 1960s in a very underdeveloped condition. The country was poor and politically unstable and had few apparent resources. South Korea's economic planners also opted to pursue export promotion, rather than import substitution. Like Taiwan, the country had the benefit of entering the world market at an auspicious time, enjoyed a legacy of Japanese-built roads and harbors (but also suffered the destructions of the Korean War), and was the recipient of substantial economic and military aid from the United States. South Korea's economy also grew very rapidly, averaging 8.7 percent real growth per year in GNP between 1965 and 1981.

Like their counterparts in Taiwan, South Korean economic planners also aimed to mobilize domestic savings by setting realistic interest rates and maintaining positive real rates of return for savers. Although successful, South Korea was not as successful as Taiwan in this regard; foreign capital provided a very important source of investable funds for the country, especially in the late 1960s and again in the late 1970s and early 1980s. The proportion of foreign capital in total capital formation remained high. In 1979 it was 21.6 percent; in 1980, 32.4 percent; and in 1981, 30.4 percent. Kwack highlights two factors responsible for this high ratio: interest payments and oil prices.

First, interest payments on foreign debts—including remittances of profits to foreign investors—grew rapidly over the period. Amounts skyrocketed during the 1970s (from US$75 million in 1970 to US$3,689 million in 1981). Second, oil prices rose sharply in the 1970s, and oil imports increased at the same time, resulting in huge import bills.

The rate of domestic savings in South Korea vacillated between the late 1960s and early 1980s. On the whole it rose, but it never quite matched Taiwan's rate. The proportion of private-sector savings to total savings was 38.1 percent in 1965 and 47.1 percent in 1971; it reached a high of 71.6 percent in 1977. Corporations played a more significant role than households in the formation of private savings.

Economic growth in South Korea produced significant improvements in the living standards of South Koreans. They ate better and lived longer and more comfortably in the 1980s than they did in the

1960s. Unlike Taiwan, however, income inequality did not improve—by some measures it even worsened slightly.

Comparison of Taiwan and South Korea, 1965–1981

Myers and Kwack reveal additional similarities between Taiwan and South Korea. First, both countries, on the eve of their economic take-offs, had similar initial conditions and endowments. Both countries experienced successful land reforms. Both economies were and still are poor in natural resources. Both faced military threats from aggressive adversaries—across the Taiwan Strait in one case and across the thirty-eighth parallel in the other—and thus had to devote a large fraction of their national budgets to defense. Second, both economies had institutional environments conducive to economic growth. Both Taiwan and South Korea enjoyed considerable political and social stability, at least most of the time, coupled with economic mobility. Their governments were also strongly committed to economic development as a national goal. And there were effective and efficient mechanisms for social decision making. The combination of these factors meant that over long periods of time consistent and continuous policies were maintained to provide a favorable and low-risk climate for investments, both domestic and foreign.

Third, Taiwan and South Korea had broadly similar economic policies. We have already identified the replacement of import substitution with export promotion and the maintenance of a realistic interest rate as central policies both shared. Other common policies include the maintenance of a realistic exchange rate and fiscal budget surpluses (most of the time). Through these policies, the two economies were able to exploit their comparative advantages by developing labor-intensive manufacturing industries oriented toward the world market. These industries were established with the investable funds provided by the high volume of private savings generated by a realistic nominal rate of interest and, by developing country standards, a relatively low inflation rate.

Despite their similarities in both performance and policy, the economies of Taiwan and South Korea also had some important differences. The most striking difference, as noted above, was in income distribution.

In South Korea, income became quite concentrated—as most development theories predict. Taiwan, however, provided an important counterexample: despite the very high rates of growth and capital formation, income distribution became much more equal between 1965 and 1981. In other words, lower-income groups in Taiwan have received disproportionate benefits from economic growth. As a result, the improvement in their standard of living, as reflected in the rate of growth of their per capita real consumption, was greater than that of comparable lower-income groups in South Korea. Indeed, Taiwan's experience has been constantly used as an example for developing countries of how to achieve *both* growth and equity. Taiwan's success in this regard was undoubtedly due at least partly to the fact that the nation's leaders explicitly aimed to enhance the "people's livelihood," that is, the standard of living of the average citizen, under their ideology of the "Three Principles of the People."

A second major difference between Taiwan and South Korea had to do with the stability of the growth rates of real gross domestic product (GDP) and inflation. Despite comparable average growth rates, Taiwan's growth between 1965 and 1981 was on average more stable than South Korea's. Because of differences in the monetary policies pursued by their respective central banks, Taiwan also performed consistently better than South Korea in maintaining price stability.

A third major difference between Taiwan and South Korea had to do with the management of their respective international financial positions. South Korea had to devalue its currency several times between the mid-1960s and the early 1980s, while Taiwan was able to maintain its exchange rate within a narrow band of approximately 10 percent during the same years. Moreover, despite the existence of similar foreign-exchange regulations in both countries, Taiwan's official exchange rate was very close to the equilibrium rate most of the time. The black market exchange rate in Taiwan was virtually the same as the official rate. These factors produced much more stability in Taiwan in sectors of the economy affected by international financial transactions.

It is noteworthy that South Korea relied heavily on international borrowing to finance its investments, while Taiwan used international borrowing only sparingly, relying principally on domestic savings. Taiwan, as a result, had a much lower foreign debt burden than South

Korea. As with price stability, the difference in the international financial positions of the two economies can be attributed to differences in the objectives pursued and policies adopted by their respective central banks.

A fourth major difference between Taiwan and South Korea lay in the degree of industrial concentration in each country. By the early 1980s the South Korean economy became dominated by the large conglomerates, known as *chaebols*, patterned after the *zaibatsus* of Japan. The ten largest industrial groups in South Korea produced 75 percent of the country's GDP. By contrast, Taiwan had literally hundreds of thousands of independent enterprises, all competing with one another. The largest industrial enterprises in Taiwan did not come close to the size of those in South Korea. It is debatable whether a high degree of concentration is advantageous for economic growth. It is easy to see, however, that industrial concentration must have contributed to the considerably greater income inequality in South Korea.

The difference in industrial concentration resulted partly from efforts by South Korea's economic planners to achieve economies of scale. The South Korean government also took a very active role in controlling market forces. The government of Taiwan, in contrast, tended to rely relatively more on the workings of the free market. The difference, however, is only a matter of degree: by the standards of the advanced industrialized western economies, both governments may be regarded as interventionist.

Tibor Scitovsky provides a detailed comparison of how the two economies developed. He discusses at some length the philosophies behind Taiwan's and South Korea's economic development, relating these philosophies to the average size of businesses and the degree of income inequality in each country. As discussed earlier, Taiwan and South Korea pursued quite similar economic development strategies. The philosophies guiding the strategies were different in some important ways, however, and their outcomes have been unique.

The fundamental difference between Taiwanese and South Koreans development philosophies, Scitovsky argues, lies in their views on the role government should play. Specifically, the government's efforts to control private enterprise were more considerable in South Korea than in Taiwan. Taiwan certainly implemented a variety of economic controls, but these tended to be more selective and less intrusive than in South

Korea. Where South Korea tended to vigorously enforce an elaborate roster of economic "dos and don'ts," Taiwan aimed instead to create an economic environment conducive to growth.

The result of this stance in Taiwan was to foster the proliferation of small businesses and to keep the businesses relatively small. Taiwan's monetary policy, for example, had some important indirect effects on the development of small businesses. Because the credit market was relatively open, it was relatively easy for a small business to obtain financing and so to get started. Moreover, realistic interest rates limited the profits of business enterprises, resulting in slower rates of growth of individual firms and thus helping to keep very large firms from crowding out small ones.

The presence of many small firms was also encouraged by factors such as Taiwan's public ownership of monopoly-prone industries (electric power for example), and the establishment of industrial parks and districts, which provided a variety of advantages for start-up firms. But the most important factor in the preservation of many small businesses in Taiwan was the absence of policies encouraging the growth of large enterprises and the government's willingness to let market forces take their course once conditions conducive to economic growth were obtained.

The advantages of having a large number of small businesses are many. Scitovsky emphasizes that small firms are more adaptable to changing conditions than big ones. Moreover, small businesses help to keep the market competitive and the entrepreneurial spirit alive. Most important, though, the plethora of small businesses in Taiwan played a very significant role in reducing income inequality in the country.

South Korea's story is very different in this regard from Taiwan's. South Korea tended to have far fewer small businesses, and a considerably less equitable income distribution. Government influence over economic affairs was much more overt and detailed in South Korea than in Taiwan, with the economic planning structure larger, more centralized, and more elaborate. The factors that encouraged small businesses in Taiwan did not operate in South Korea. First, credit was much less "naturally" allocated through the open market, but was instead more "rationed." The criterion qualifying borrowers for low-cost credit was much more precisely defined in South Korea. The concessionary or subsidy component of the cost of credit was, in addition, several percentage points higher in South Korea than in Taiwan. Borrowing from abroad was prohibited unless expressly authorized by the government. Moreover, firms that did not "go along" with government strictures in South Korea reportedly had a very difficult time getting loans. This was an especially harsh sanction given the extent to which businesses relied on bank loans in South Korea.

The same philosophy dominated in the area of tax incentives. For example, South Korea provided lower rates of profit taxes and substantial depreciation and wastage allowances in order to promote export and investment in targeted industries. On the disincentive side, the tax returns of wayward firms tended to be very carefully scrutinized.

These policies helped to give rise to larger-sized firms in South Korea than in Taiwan. Firms that "went along," Scitovsky notes, made huge profits and expanded accordingly. Start-ups had a difficult time competing with the large, government-favored firms, and many simply died aborning for lack of credit. In turn, the lower number of firms in South Korea made government control of business easier, reinforcing the process. These factors tended to work against income equality, and accounted for some of the gap between Taiwan and South Korea in this important measure of social welfare.

The Economy of Taiwan in the 1980s

1981 marked a critical turning point for the world economy. The price of oil finally stopped its once seemingly inexorable rise and began a steep decline in both nominal and real terms over the next several years. In the earlier part of this decade, however, many of the advanced industrial countries were still just beginning to come out of their recessions. Most developing countries, especially those in Latin America, were burdened by their external debts, and the once promising economic prospects of Argentina, Brazil, and Mexico turned into nightmares. Against this backdrop, the growth of world trade slowed and protectionist sentiments rose worldwide.

Nevertheless, Taiwan was able to continue remarkable economic growth during this period. The effects of the second oil shock were allowed to pass through to the economy immediately, resulting in a one-time increase in the price level, which then stabilized. Inflation remained at a low level through the rest of the 1980s. Exports continued to grow rapidly, and Taiwan began to run a string of large trade surpluses. By the end of the 1980s, Taiwan amassed official foreign-exchange reserves of US$75 billion, ranking behind only Japan.* The currency was pegged to the U.S. dollar in the early 1980s, but, persistent large trade surpluses and pressure from trading partners, especially the United States, led to a steady appreciation of the New Taiwan dollar beginning in late 1985. By 1989, the New Taiwan dollar has appreciated more than 40 percent against the U.S. dollar (approximately from 40 NT$ per US$ to 25 NT$ per US$). Despite the massive increases in foreign-exchange reserves, and consequently in the domestic money supply, the central bank was successful in holding the rate of inflation to a very low level.

The 1980s also saw a sea change in the political landscape of Taiwan, with potentially important ramifications on the economy: martial law was lifted, bans on new political parties and newspapers were removed, and citizens were allowed to visit mainland China for the first time in forty years. With increasing democratization amidst a relaxed political atmosphere, demands by labor and other interest groups became far more numerous and vociferous. Work stoppages, strikes, and demonstrations became commonplace: Taiwan has yet to develop an effective and orderly mechanism for resolving socially divisive issues without resorting to the streets.

Liberalization of the economy, especially in international trade and financial markets, has been proceeding apace since the mid-1980s. Restrictions on imports are now minimal, with the exception of agricultural products. Tariff rates have been drastically reduced. Capital flows, both inward and outward, have also been liberalized. Plans for the privatization of the government-owned banks have been approved,

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*The comparison with Japan is a little misleading, however, because Taiwan nationals were not permitted to hold foreign assets without government approval prior to 1987. Thus, the official foreign reserves held by the Central Bank of China in Taipei represented the total amount of foreign assets held by the Taiwan nationals. By contrast, private Japanese holdings of foreign assets are many times the official foreign reserves held by the Japanese government through the Bank of Japan.

but privatization and deregulation of financial institutions without the corresponding financial discipline can be disastrous. Taiwan must be careful to avoid repeating the costly savings and loan association debacle of the United States.

All in all, Lawrence J. Lau concludes that the prospects for continued economic growth are bright. This does not mean, however, that there will be no problems, or that they can be easily solved; it only means that the government leaders of Taiwan have demonstrated the ability to make the necessary changes that conditions demand. The environmental and labor strife will eventually pass with the evolution of a social consensus on how to deal with them. If there is a dark cloud on the horizon, it would be the rampant speculation on the Taiwan stock exchange. The price level of the stock market has risen to unsustainable heights, with price-to-earnings ratios exceeding 200 for some shares: it is a bubble waiting to burst. When it does, it is hoped that the whole economy will not be brought down with it.

The Economy of South Korea in the 1980s

The 1980s also saw major changes in the direction of the South Korean economy. The recovery from the recession and inflation of 1980 and 1981 was achieved through a combination of tight fiscal and monetary policies. As a result, the rate of inflation declined from the more than 20 percent per year of 1980 and 1981 to the low single-digit levels of the mid-1980s. Despite the tight fiscal and monetary policies, economic growth during this period remained robust. Part of the reason for continued growth lay with the continual devaluation of the South Korean won in real terms in the early 1980s. The lower world price of oil and international interest rates also helped. Moreover, beginning in the mid-1980s, the significant appreciation of the Japanese yen vis-à-vis the U.S. dollar and the South Korean won helped divert demand from Japan to South Korea and was partially responsible for the strong performance of the South Korean economy.

In the 1980s, the "Big is Beautiful" philosophy was reevaluated by the South Korean government and gradually supplanted. Greater efforts were made to ease entry in various industries in order to promote competition in both domestic and export markets by South Korean firms. The commercial banks, which played such an important role in financing the growth of the large South Korean conglomerates, were denationalized and the financial market was gradually deregulated. Imports were liberalized through the elimination of restrictions and the reduction of tariffs. Income distribution and social welfare assumed greater importance as objectives of government policy, especially under President Roh Tae Woo.

In the mid-1980s two important milestone events occurred. First, the South Korean current account turned from a chronic deficit position into a surplus position. Second, the domestic savings rate rose significantly and for the first time since the Korean War exceeded the investment rate. The process of transformation from a net international debtor to a net creditor has thus begun for South Korea.

With the increasing democratization of South Korea, however, labor has become much more restive and demanding. Industrial strikes became increasingly common and bitter in the late 1980s. In addition, Sung Yeung Kwack identifies three other major economic issues facing the South Korean economy today: How to counter protectionist sentiments abroad so as to maintain the continued growth of exports. How to further increase competition at home and thereby improve the distribution of income as well as economic efficiency. And finally, how to reduce the debt-to-equity ratio of South Korean firms and thereby increase their long-term viability and competitiveness.

Concluding Remarks

Looking back at the past quarter century, can one identify the reasons behind the success of Taiwan and South Korea? Lawrence J. Lau examines this important question in the final chapter and finds that there was significant saving, capital accumulation, and growth of the labor force in both economies. In other countries, however, similarly high rates of investment did not lead the economies to take off. Thus one has to look elsewhere for the cause. The replacement of import substitution with export promotion, together with the maintenance of realistic interest rates, deserves a great deal of credit (South Korea was not as faithful as Taiwan in adhering to the latter policy). Nevertheless, many other countries, such as Brazil and Mexico, also tried export promotion, and some succeeded for a while, but most failed to take off into sustained growth. There have also been claims that the authoritarian nature of the governments of Taiwan and South Korea was responsible for their successes. There is doubtless a considerable advantage in having a government that can make effective decisions for society in an expeditious manner, but the world's economic "basket cases" are often governed by authoritarian regimes.

Lau identifies the three essential factors common to the success of both Taiwan and South Korea as, first, reliance on private enterprise; second, establishment of the rule of law in the economic sphere; and third, the existence of domestic and international competition. Moreover, all three factors must be present simultaneously. Private enterprise without competition will result in private monopolies with possibly far worse consequences for allocative efficiency than public monopolies. It is only because of real or potential competition that private entrepreneurs must strive for efficiency in order to make a profit. The rule of law then guarantees that the fruits of their efficiency will not be arbitrarily taken away from them, either directly by the government or indirectly by other enterprises with special privileges or good government connections.

What are the prospects for future growth in Taiwan and South Korea? Despite the many current problems, such as the environment, labor, and the even bigger issues of working out an orderly mechanism for resolving social conflicts and achieving a consensus on social policies, Lau remains optimistic. Most of the people in Taiwan and South Korea are pragmatists. They will soon realize that confrontation and noncooperation work against everyone's interests and that accommodation and cooperation are "positive-sum" strategies. In this regard the Japanese development experience provides hope. Although the Japanese management–labor relationship is widely admired today, industrial peace is actually a relatively recent phenomenon in Japan. As late as the early 1960s, the Japanese industrial scene was marked by long and frequently bitter strikes, not unlike those now seen in the two economies, especially in South Korea. Today, however, they all seem distant and largely forgotten.

In addition, the high level of human capital in both economies will help raise their technological levels—Taiwan and South Korea have the highest postsecondary school enrollment rates in the world. Both will be upgrading their industries as labor costs and exchange rates keep climbing. Already, labor costs in Taiwan are no longer low compared with other newly industrialized economies (NIEs) and would-be NIEs, and they are creeping higher in South Korea. Major restructuring of the industries has already begun, especially in Taiwan.

In many other aspects, the two economies remain different. Taiwan continues to have better control over inflation than South Korea. The New Taiwan dollar has been allowed to appreciate much more than the South Korean won. South Korea is once again looking at a devaluation of the won as a way of maintaining international competitiveness. At the same time, there also seems to be some convergence in their economic policies. South Korea has begun to pay more attention to income distribution and social welfare, and Taiwan has begun to pursue a more active industrial policy through government funding of major R&D projects.

Where can Taiwan and South Korea go from here? The two economies should attempt to find their own ways that take into account their respective histories and cultures. The social welfare states of Western Europe, such as the Scandinavian countries, West Germany, and the United Kingdom, do not provide a good model for emulation. When workers have no incentive to work, consumers have no incentive to save, entrepreneurs have no incentive to be efficient, and investors have no incentive to invest, and more generally, when people do not have the incentive to take responsibility for their own well-being, the economy and the society will be in serious trouble. Japan does not provide a good model either. Although there is no question that, as measured in U.S. dollars, Japan has a higher per capita income than the United States, most Japanese people will readily acknowledge that their standard of living has a long way to go to achieve parity with that of the Americans. This situation has been brought about by severe distortions in the allocation of resources in the Japanese economy; distortions that cannot be easily corrected because of the vested interests built up over so many years. These distortions are manifested in prices of food, housing, and other consumer goods that are extremely high relative to prices in the rest of the world. It is important for Taiwan and South Korea to avoid the same distortions. A real danger is that they will end up like today's Japan, with a high per capita nominal income but a low real standard of living for the average citizen.

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