

**Building a Global Competitive Mechanism:  
A Political Economy View from Taiwan's  
Perspective**

Dr. Rong-I Wu

**Keynote Speech**



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## Introduction

In a market of free competition, the fit survives and the unfit is weeded out—those who adapt live. The key strategy for business operations is to survive.

In a globalized market, enterprises compete head to head with not just rivals in the home country, but also with competitors from abroad. Global competition requires companies to enhance constantly their product competitiveness. In this regard, it is not only business strategy that matters, but competitive environment built by government also plays a pivotal role, with respect to all aspects of policies—taxation, labour, capital formation, human resources, and technology, etc as well as national business legal framework.

International business environment is constantly changing. Businesses are always adjusting their strategies reactively or proactively, just as in government policy making. In other words, government infrastructure of legal system for business operations must remain competitive globally in order to help business sectors to face challenges from international competition. In an open economy, business, capital or

talents may opt to eschew a country that lacks such competitive environment. Therefore, most countries find it necessary to be flexible and adaptable to build and improve their business infrastructure.

## Development Experiences

In a world of globalization, competition in international market is increasingly severe. In particular, with the promotion of the World Trade Organization (WTO), national markets are increasingly opening up with tariffs and other trade barriers gradually dismantled, which has benefited member countries as well as many other developing countries by creating massive job opportunities and enhancing living standards.

Yet, increasing market access has varying degrees of impact on nations in tandem with their development stages. For developing as well as developed nations, some domestic industries bear the full front of liberalization and are rather vulnerable to foreign competition. In spite of the benefits of market liberalization, some nations are prone to sustain resistant policies toward market opening in order to protect domestic industries.

What is at issue is whether national industries can compete in the global market. It requires well devised government policies to foster a good business environment and enhance international competitiveness of domestic industries.

## Building a Global Competitive Mechanism

A Fraser Institute's report, *Economic Freedom of the World: 2007 Annual Report*, indicates that countries with more economic freedom grow more rapidly and achieve higher level of per capita GDP. Their people are richer and unemployment lower. They also enjoy higher political rights and civil liberties. Yet, why are so many countries still reluctant or slow to adopt more liberal economic policies and open their markets? It would be worthwhile to look into aspects of political economy to gain some insight. The key factor may rely on whether a competitive mechanism has been built into the economic and political system of a country.

## Political and Economic Institutions in the 21st Century

Regimes of political economy in the 21st century may roughly fall into two categories—capitalist free economy and socialist planned system. Since the disintegration of the former Soviet Union and communist East European bloc in early 1990's, North Korea and Cuba are the only two remaining socialist countries. Socialist market economy with Chinese characteristics is the official term for the economic system of the People's Republic of China. Vietnam retains its own socialist title while in fact

having taken market economy policies by and large.

A comparison of the two systems may be useful for the following discussion. Capitalist economy is democratic politically and free and competitive economically honoring private property rights, while socialist system is autocratic politically and central planning economically with state-owned properties.

In essence, there are competitive mechanisms of various extents politically and economically in the capitalist system, while they could be missing in the socialist regime. History has witnessed the triumph of capitalist free democracy over socialism, especially in the competition process with an open global environment. This is the reason why we can only find very few countries with socialist or reformed socialist market economy in the 21 century.

Such competitive mechanism is embodied in the system of profit-seeking enterprises and free consumer choices on the economic side and casting the ballot with free will on the political side. Through competitive process, businesses that live up to consumers' expectations will survive while political powers change hands alternately between parties.

The core of effectively competitive market or free election is a set of rules for fair games to bind participants. Legislative bodies, law enforcement agencies and judicial authorities are all indispensable for effective implementation of such competitive mechanisms.

A fair and free competitive market in a democratic nation is particularly important in capitalist economies. However, the majority of countries which became independent after World War II are still on a learning curve when it comes to the operation of parliament, enforcement capability of administration and independence of jurisdiction. As evidenced in the *Economic Freedom of the World: 2007 Annual Report*, nations with less economic freedom also have lower levels of economic development, political rights and civil liberties.

With a competitive mechanism in place, business is required to adapt in strategy to external conditions to ensure competitiveness. Being too slow in responding and adapting, they risk making losses and going bust. On the political front, similar selection works through free elections. Political parties are motivated to meet voters' demands to stay in power, and hence adaptability is equally necessary. Yet, representative democracy is intrigued with interests in conflict and there is no guarantee that policies will always be globally competitive. Government in democracy is circumvented by such structure and slowness in decision-making relative to efficiency and flexibility of the private sector.

A Government's flexibility in adjusting policies will affect its country's attractiveness to foreign capital, talents and technologies. Therefore, a government's capability to cultivate a globally competitive business environment is very crucial.

To sum up, a government's adaptability to global competition conditions as reflected in improvement of investment environment determines its performance in economic development. What is at work is

the functioning of a competitive mechanism, which in turn is via price signals in economics and democratic free elections in politics. How well it functions depends on the degree of economic and political freedom.

## Political Economy in Taiwan

Taiwan's rapid economic development over the past decades helped it to establish a reputation as one of the four Asian Tigers and a good example for other developing countries. Economic growth in Taiwan during 1951-2000 marked a recorded high average rate of more than 8 percent which would be difficult to find a comparable country since World War II. Except for two oil crises in 1971-80, the average inflation rate was less than 3 percent. Unemployment rate, which is often the most difficult policy target for developing countries, was only around 2 percent in 1951-2000. Taiwan's economic performance, nevertheless, was lagging behind some Asian developing countries in recent years, in particular during the governing period under Democratic Progress Party in 2000-2008. Critics were quick to blame on government's failure to provide businesses with satisfactory investment environment. In particular, it is often argued that Taiwan was not opening its market to China. Some criticisms, especially from opposition parties (such as KMT), have attributed it to the failure of government policies of Democratic Progress Party (DPP). A brief history of economic and

political development in Taiwan after World War II may be useful to understand the reason why.

## I

Taiwan was under one party rule of KMT during 1945-2000. KMT implemented Martial Law in 1949 until it was lifted in 1987, the longest martial law in history. Therefore, political control in Taiwan during this period was undoubtedly very strict. However, economic policies were rather market- and development-oriented. In particular, US aid programs started to implement in 1951 which included not only economic planning but also technical assistance with development advisors. U.S. Aid officials and advisors assisted Taiwan government to plan and implement market oriented development programs. The core of these programs can be represented by the promulgation of a series of laws to promote investment by domestic entrepreneurs as well as foreign capitalists since the 1950s. They composed crucial factors of rapid industrialization in Taiwan as follows:

- a. Statute for Investment by Foreign Nationals; promulgated on July 14, 1954.
- b. Statute for Encouragement of Investment; promulgated on September 10, 1960.
- c. Statute for Establishment and Management of Export Processing Zones; promulgated on January 30, 1965.
- d. Statute for Establishment and Management of Science-Based

Industrial Parks; promulgated on July 27, 1979.

These laws are called “special statutes” to exclude general laws and to provide a favorable investment environment to attract and promote investment. They helped simplifying bureaucratic procedures and approaches to economic reality. Tax burden was effectively exempted and preferential financing and credit allowances were provided to investors. The purposes of these laws and regulations are to provide incentives to boost investment. Amendments to these laws were constantly made in response to changes of economic and international environment. In addition, Taiwan also extended welcoming arms to foreign direct investment, especially from USA, Japan and Europe. Foreign direct investment not only brought into Taiwan capital but also management, technology and marketing skills. They made a great contribution to export oriented industrialization during the early period of economic development in Taiwan.

Such development strategies have sustained not only high economic growth but also rapid export expansion with huge trade surpluses and accumulation of foreign reserves. At the same time, political movement of opposition started to spread quickly through the course of various elections. Therefore, opposition activities were growing rapidly and thus demand more political freedom. Under strong pressure for more political freedom as well as economic liberalization, the ruling government finally granted the official status of the first opposition party—Democratic Progress Party in 1986. Government also decided to lift the Martial Law and deregulated foreign exchange controls in the next year. These two

policy changes had profound implications for afterward development of Taiwan in economic and political arena.

In the political aspect, the lift of martial law opened the possibility of changes in law and the viability of opposition parties. Consequently, DPP succeeded to win presidential election for the first time in 2000, and again in 2004. In economic aspect, the deregulation of foreign exchange controls opens the door for implementing flexible exchange system and free movement of capital by enterprises and individuals. This is evidently a very important step leading to economic freedom in the capitalist system.

Since government of National Party retreated to Taiwan in 1949, Martial Law was put into effect until it was lifted in 1987. Any private and public contact between Taiwan and China was strictly prohibited during the martial law period. Afterwards, domestic and international development in the region pressured government in Taiwan to start pondering on adjusting cross-strait relations. Thus, government launched the “visiting relatives in China” program in 1987. This is a small but very important step to further openness of Taiwan-China trade and other economic interactions later.

### Further Political and Economic Liberalization

As mentioned in the above, we can see that Taiwan had taken several

important policy adjustments in the second half of the 1980s. An opposition party arose and further political liberalization realized, hence a peaceful turnover of government from 50 years of KMT rule to the opposition party–DPP through popular elections. In 2008, KMT won back the presidential election peacefully. DPP became opposition party again. Now, Taiwan is regarded as one with high political and civil freedom comparable to US and European countries, according to *FREEDOM IN THE WORLD 2007*.

In spite of a political system as free as other advanced democracies, Taiwan has been through a turmoil period of democratization since the changeover of political powers in 2000 and is still learning to adjust. A strong opposition party is essential to successful functioning of democratic system. However, it is not an easy task for multi-party political system to achieve proper development goals. As democratic process continues to evolve, we can expect the system to become increasingly mature.

In conjunction with the lift of martial law in July 15, 1987, foreign exchange controls were also relaxed gradually. Each adult person could transmit abroad as much as \$5 million without having to file applications each year. Enterprises can apply even more foreign exchange transmissions according to their investment projects. The purpose of this relaxation of foreign exchange controls is to reduce the pressure of appreciation on NT Dollars from rapid accumulation of foreign exchange reserves. Trade surpluses were rising since the mid-1970s and experienced rapid increases since 1981. It was US\$1.4 billion in 1981 and

jumped remarkably to US\$18.7 billion in 1987. The ratio of surpluses to GNP rose from 2.9% to 20.3% during the same period. Continuous and rapid increases of trade surpluses have contributed to the fast accumulation of foreign reserves, which rose quickly from US\$7.2 billion in 1981 to US\$76.8 billion in 1987.

### Exchange Rate Adjustment

In order to restrain inflation caused by monetary oversupply from rapid increases of foreign exchange reserves, the Central Bank started to adjust New Taiwan Dollar exchange rate against the US Dollar. The exchange rate rose rapidly from 39.85 in 1985 to 25.40 in 1992, up 57% within a short period of seven years. Such big revaluation of NT Dollar has imposed a great impact on Taiwan's export industries and economic development.

Another important factor during the period was a significant increase of wage rate which seriously affected international competitiveness of labor-intensive export industries. The increasing demand for manpower due to economic growth led to the continuous decline in unemployment rate which decreased from 2.9% in 1985 to 1.5% in 1992. Wage level was pushed up incessantly during the period in 1986-1992. The average wage rate of manufacturing industries grew more than 10% per annum during the same period. Continuous rise in wage means workers were able to share the fruit of economic development and therefore the problem of

income disparity did not worsen. However, wage increases also imply the rise of cost of production.

Exports from Taiwan were mainly in labor-intensive products before the 1980s. Substantial rise of NT Dollars and rapid increase of wages had adverse effect on competitiveness of labor-intensive products in international market. One reason is that wage accounted for a relatively larger proportion of the cost of production for such goods. Fast increases of wages would surely push up the production cost rapidly. Moreover, as wages were paid in local currency, and major machinery and raw materials producing labor-intensive products were supplied domestically, the value from exporting labor-intensive products was substantially declining when converted into NT Dollar. In other words, Taiwan's traditional labor-intensive products had consequently lost their international competitiveness.

Facing this new economic environment, manufacturers had to adjust in order to accommodate the new development, otherwise, they would perish. In fact, our manufacturing firms had made various necessary adjustments such as using more machinery to replace labor. This is the so-called process of technological transformation. Because of gradual increases of wages causing the rise of labor cost, it was natural for manufacturers to use fewer workers and instead switch to the use of machines. Higher exchange rate of NT Dollar allowed them to import machinery with relatively lower cost. Such adjustment has become the main strategy of Taiwan's industries.

A big transformation of the production structures can be witnessed

from changes in Taiwan's industrial structures since the 1980s. It can also be observed by a fast change in the product structure of exports in the period. Major export products were in the category of labor-intensive goods such as garment, shoes, toys, etc. before 1980. However, the importance of the above-mentioned labor-intensive products was greatly decreasing in recent years. In contrast, machinery and electrical machinery equipment have become the major export products. Taking the year 1995 for example, the proportion of machinery and electrical machinery equipment was 43.7% of total exports. Export growth was as high as 29.2%, a visible result from technological transformation in Taiwan. Today, electronic products become the most important export component which accounted for about 25% in total exports.

### Outward Investments

Another aspect of manufacturers' adjustment was outward investment, especially to the countries where abundant labor supply and relatively cheap labor were available. At the beginning, the destinations were mainly in the region of South East Asian countries where many Taiwanese businesses had long-term relations. China replaced ASEAN to become the popular place for Taiwan's investment, especially after the regulations on China-Taiwan interactions were relaxed and Taiwan's government approved indirect trade and investment since the beginning of the 1990s. Now, China accounts for about 70% of Taiwan's outward

investment. More than 40% of Taiwan's exports are shipped to China (Hong Kong included) which revealed a very high dependent ratio of Taiwan's foreign trade.

Here, we have to point out that Taiwan's government did not make the policy to encourage or approve outward investment by local business people in the early period of development. On the contrary, attracting foreign direct investment was the most important policy, as we have discussed previously. Therefore, the amount of Taiwan's outward investment was very limited until the 1980s, when restrictions on outward investments were lifted because of deregulation of foreign exchange controls and the lowering of pressure on appreciation of NT Dollar. Now, Taiwan has become one of the important countries to invest abroad, especially to neighbouring developing countries. Based on official data, approved outward investment from Taiwan amounted to US\$65 billion in 1991-2007. This clearly underestimates the actual figures, in particular, of investment to China. According to estimation of a US Congress report, Taiwan's investment in China reached US\$280 billion which accounted for above 50% of total Chinese FDI. This is undoubtedly a very important contribution to Chinese economic development, especially those concerned with export sectors. On the other hand, Taiwan's domestic capital formation was seriously affected, thus leading to high unemployment rate and low economic growth, especially since 2000.

Taiwan in a unique status—China factor

Taiwan is faced with fierce international competition as other nations. Unlike most other nations, Taiwan also faces military threat and diplomatic sabotage from China. Taiwan's businesses and people have had to overcome extra challenges to survive international competition.

After the Plaza Accord in 1985, the Taiwan Dollar appreciated drastically from TWD 40 to 25 per USD in a short period of time. Taiwan's businesses must adjust accordingly and started investing abroad. Of course, government support and assistance is very important and helpful during the process of adjustment.

As mentioned above, Taiwan's economy relies on China to an unprecedented level, alarmingly. Therefore, China's future development has profound implications for Taiwan. So it is important for me to comment on future development of China.

In light of China's rapid economic growth over the past decades, commentators were eager to predict that the Chinese economy will soon surpass Japan to become the world's superpower next only to the U.S. Some are more reserved and cautious. They predicted China's eventual collapse at some point of time. The two contrasting scenarios reveal that China either is a promising land of business opportunities or potential trap of high risk for ever concentrating investments.

If history is any guidance, then the development of world political economy indicates that capitalist free economies as represented by the U.S. are in the mainstream. Socialist countries that barely breathe

currently have remained politically authoritarian and backward in economy. China's model of "socialist market economy" has proven quite astonishing, or so far. It is still a question mark if China can successfully transform its economy while retaining its political clench.

The significant downside of China's economic development has been well demonstrated recently. Pessimists argue that China has been turned into capital heaven of the political elites. Corruption and bribes are rampant. Social tensions are heightened when income distribution is rapidly worsening. Crises are virtually lurking in many corners of the society. On the other hand, under the autocratic regime, the political elites are prone to hold on to their own interest and shy away from any meaningful political reform deemed so urgent and necessary for smooth transition. Nevertheless, China is forced to open up its market continually in order to create job opportunities and narrow income gaps, especially those between urban and rural population. Yet, China also continues to suppress free expression of media and crackdown on dissidents violating human rights. Critics have accurately pointed out that China has been caught in the trap of transition. Such is the possibility of collapse that one should not casually dismiss.

### Concluding Remarks

Rapid globalization has produced complicated impacts to countries all over the world, for both developed and developing countries. However, no one, including private enterprises or national government,

can avoid severe competition. Therefore, how to face the challenges of global competition in order to survive become the most important tasks. The government role is to provide a competitive business environment for enterprises.

Taiwan's experience of development during past decades had demonstrated its capability of quick adjustment and high flexibility facing various challenges including economic transformation and political development. The uniqueness in situation of Taiwan is its relations with big neighboring country—PRC, which is characterized by a totalitarian political regime with a so-called social market system. Thus, its huge market size with very high growth rate provides attractive but risky business opportunities many business people and governments could not ignore. Taiwan is no exception. However, China on the one hand uses economic incentive to lure Taiwan's investment, and on the other hand, deploys thousands of missiles targeting Taiwan and sabotages Taiwan's participation in international communities. As a democratic country, Taiwan finds it very difficult to reach consensus on economic and political strategies toward PRC. Whether Taiwan can maintain its performance in economic and political development in the future depends on people's resolutions as well as international perceptions on Chinese threat.