
China-Taiwan Economic Relations

Both China and Taiwan have sustained rapid economic growth for more than three decades, and this growth has become ever more symbiotic over the years, despite political ups and downs.¹ By 2009 China's GDP was reported at \$4.9 trillion, or \$3,680 per capita, while Taiwan's GDP was \$370 billion—much smaller in absolute terms, but an impressive \$16,442 on a per capita basis given its modest population of 23 million (fewer than greater Chongqing alone).² For a decade and a half, Taiwan and China have ridden the same wave of globalization, a wave that has drawn them increasingly closer to one another. Since early in China's post-1978 reform period, Taiwanese entrepreneurs and capital, along with outsourcing by Taiwanese firms, have played an important role in seeding coastal China with manufacturing capabilities. Today, those early investments in China anchor powerful, global production chains stretching from Taiwan's Hsinchu Technology Park to Chinese factories in the south, east, and, increasingly, inland, to the retail electronics giants of North America and Europe.

This growing interdependence is manifest in all economic indicators, though not symmetrically. China is generally open to Taiwanese trade, in-

1. Authorities in Taiwan and Beijing have incompatible preferences with regard to the proper nomenclature for their respective polities, especially in discussions of cross-Taiwan Strait matters. The authors of the present volume are economists with insufficient expertise to comment on these toponymic concerns, and we therefore employ the vernacular terminology for these distinct economic entities most commonly understood by the American reading audience, without prejudice to political interpretations.

2. Measured in purchasing power parity terms, Taiwan's and China's respective per capita GDPs were \$29,829 and \$6,546 in 2009, according to the International Monetary Fund (IMF).

vestment, and labor, while Taiwan has been far more restrictive toward reciprocal flows from China. Two-way trade as a share of all trade and GDP had grown almost continuously since the 1980s from Taiwan to China, and since 2000 from China to Taiwan, before hitting the global financial crisis wall in 2008, from which trade is now recovering sharply. Direct investment from Taiwan to China has driven China's redevelopment since the early days of reform, though most of it was routed through Hong Kong and other locations. Direct investment from China to Taiwan, by contrast, has been severely limited by the unreadiness of both parties. But these limitations are under revision, and genuine two-way investment will likely grow significantly (though the balance of openness will favor Taiwanese outflows for some time). This is true for portfolio investment restrictions as well, giving investors from both sides the opportunity to invest in stocks, bonds, and other securities issued by the other. The movement of people across the Taiwan Strait has also expanded rapidly, though with a pronounced asymmetry: the number of Taiwanese citizens visiting or working in China dramatically surpasses the number of visitors and permanent residents from China in Taiwan. Normalization of long-stymied direct transportation links and tourism policies is broadening the base of two-way exchanges beyond business interests to civic groups and individuals.

The organic, bottom-up growth of economic interaction for more than 20 years occurred despite political tensions and obstacles to commerce. Recently, stepped-up ad hoc negotiations have accelerated the pace of economic integration and begun to formalize quasi-official mechanisms to undergird bilateral commerce. Arguably, the effectiveness of the ad hoc approach is already on the decline, and a more comprehensive approach to cross-strait economics is past due.

Such an approach is being undertaken in the form of an Economic Cooperation Framework Agreement that will soon lead to FTA-type talks. Chapter 2 of this study explores the ECFA and its likely economic implications. To set the scene for that analysis of the economic consequences of closer China-Taiwan economic relations, this chapter examines the status quo in terms of the flow of trade, investment, and people.

Trade: Data Problems, Economic Drivers, and Political Barriers

Trade in Goods

Taiwan-China trade in goods has swelled over the past decade as China assumed the leading role in final assembly in regional manufacturing production networks, foremost in information and communications technology. The exact values are obscured by politicized trade regimes that com-

pligate statistical recordkeeping, unilateral Taiwanese import bans on basic products from China, and the fact that Taiwan's exports to China largely consist of intermediate products then assembled and reexported to consumers in North America, Europe, and elsewhere. In other words, China runs a large trade deficit with Taiwan that is more than offset by a trade surplus with the United States and Europe, but, nonetheless, China's trade deficit with Taiwan would be smaller if it were not for protectionist Taiwanese policies.

The starting point for an analysis of cross-strait trade patterns is the aggregate direct trade numbers issued by statistical authorities, which illustrate the complicated trade relationship between China and Taiwan (figure 1.1). China's exports to Taiwan remained relatively low during the 1990s and gradually grew to around \$5 billion annually in the years preceding China's accession in 2001 to the World Trade Organization (WTO). Since then, annual exports have grown fivefold to around \$25 billion to \$30 billion in recent years despite import restrictions on the Taiwan side (see discussion on trade barriers below). The difference between Taiwan's reported imports and China's reported exports was 21 percent on average over 2000–2009. Whereas a certain variance in bilateral trade statistics is natural because of the use of different valuation concepts,³ this discrepancy is much more pronounced due to indirect trading through third locations. In the case of China and Taiwan, Hong Kong has evolved as a major transshipment location as a result of historical restrictions on direct trade, but also because of its status as the largest reexport hub in the region and as a doorway to the south China economy, where many Taiwanese manufacturing operations are located. These indirect flows inflate the natural discrepancy between cost, insurance, and freight (cif) and free on board (fob) shipping, as import numbers are tracked on a country-of-origin basis (which includes indirect flows) whereas export numbers often capture only the first and not the final destination of goods. Valuation effects related to indirect trade flows—such as reexport markups (the “value added” by the third location) or mispricing to evade taxes or circumvent quotas and other trade restrictions—can further increase these discrepancies.⁴

Whereas the discrepancy for China's exports to Taiwan is in the same range as with other trading partners,⁵ the discrepancy for trade flows in the other direction is more extreme. In the second half of the 1990s,

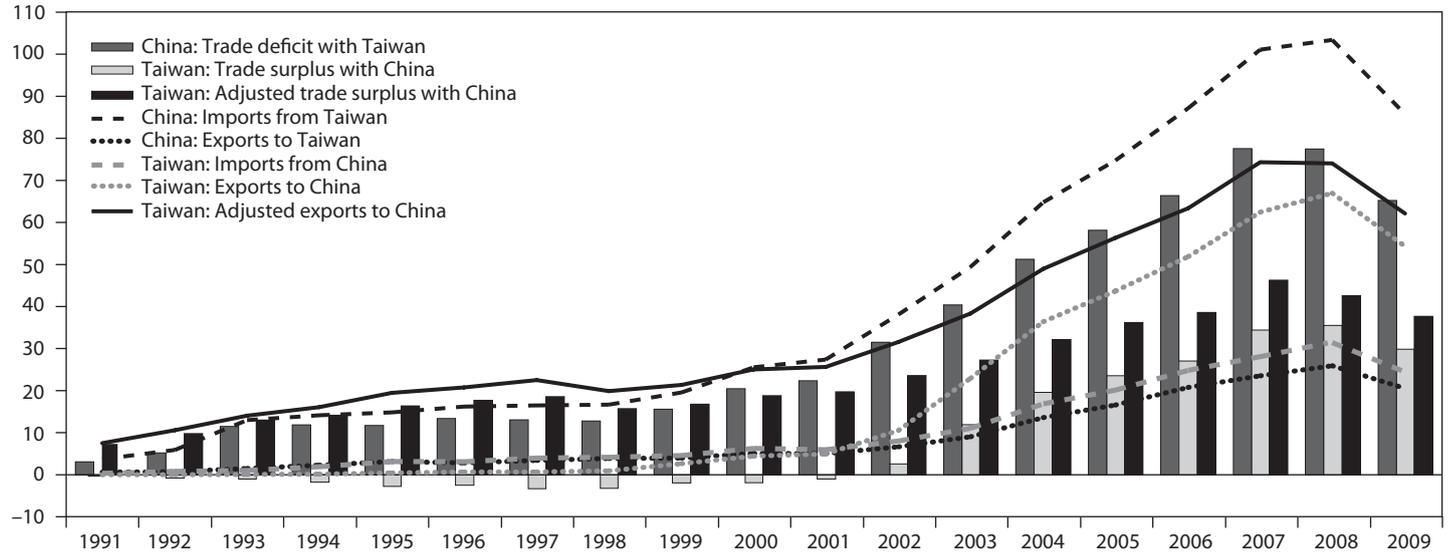
3. Export data are usually valued in fob prices (which means the price at which the exporter delivers a product past the ship's rails at the port of shipment), whereas import data are valued in cif prices (which is the fob price plus costs, freight, and insurance, or total costs associated with transport of the goods to the named port at destination).

4. For further elaboration on discrepancies in bilateral trade statistics, see Ferrantino and Wang (2008).

5. For example, the differential over the period between China's figures and partner data in the United States and Japan ranges from 20 to 29 percent.

Figure 1.1 Cross-strait merchandise trade, nominal and adjusted flows, 1991–2009

billions of US dollars



Note: Cost, insurance, and freight (cif) for imports and free on board (fob) for exports.

Sources: General Directorate of Customs, Taiwan; Bureau of Foreign Trade, Taiwan; China Customs, <http://english.customs.gov.cn>; Hong Kong Customs.

Box 1.1 Estimating Taiwan's exports to China

Taiwan's Mainland Affairs Council (MAC) and Board of Foreign Trade use the following formula to estimate the value of Taiwan's exports to China:

$$A + (B1 - B2)*80\% + C - r*A.$$

The variety of different trade flows built into this formula demonstrates the complicated nature of China-Taiwan economic relations. The first item is straightforward: explicit direct exports to China from Taiwan (*A*). Second, MAC takes what Taiwan says it exports to Hong Kong and subtracts what Hong Kong says it imports from Taiwan—the difference (less shipping) being Taiwan's exports being transhipped through Hong Kong to China (*B1 - B2*). The MAC formula actually just takes 80 percent of this amount, the remainder presumably being transhipped off somewhere else. To this is then added exports shipped indirectly but formally to China, so-called transit trade through Hong Kong (*C*). Finally, since the increase in explicit direct exports increasingly displaces that transit trade—except for shipments that go to Guangdong, for which Hong Kong is a natural first stop—a subtraction of 33 percent (the average ratio of Taiwanese exports to Guangdong to total exports to China) times explicit direct exports is made (*r*A*). The latter adjustment and the exclusion of one-fifth of the Hong Kong discrepancy are meant to avoid double counting.

Taiwan's direct shipments to China were prohibited, so recorded exports were virtually zero, whereas China's data recorded indirect imports through Hong Kong. Around 2000, the deviation between Taiwan's reported exports and China's reported imports was 500 percent and more. In the years that followed, direct shipping was gradually allowed, and in recent years the divergence has declined to around 60 percent. However, in 2009 the difference between China's reported imports and Taiwan's reported exports was still more than \$25 billion. The reason for this large discrepancy is twofold. Taiwan's statistics are not capturing the real extent of exports to China, as they are omitting indirect flows. On the other hand, China's figures overcount imports from Taiwan, as they appear to cumulate all of Taiwan's direct exports and all transit trade through Hong Kong and other third countries such as Japan, and do not adjust for the above-mentioned valuation effects.⁶ In order to approximate the real extent of Taiwan's exports to China, which lies somewhere in the middle of the two figures, we can use a formula from Taiwan's Mainland Affairs Council and Board of Foreign Trade (see box 1.1). The solid line and dark

6. According to estimates from the Hong Kong Census and Statistics Department, the average reexport markup rate for Taiwanese goods going to the mainland was about 8 to 11 percent during 2004–07, while the rate for Chinese goods to Taiwan was about 4 to 7 percent in the same period.

columns in figure 1.1 present these adjusted numbers for two-way trade between Taiwan and China alongside the nominal figures. Understandably, the discrepancies were quite significant in the 1990s but have since gradually narrowed.

Based on adjusted numbers, two-way trade has averaged 16 percent growth annually for the past decade, lifting the value of trade from \$30 billion in 2000 to \$105 billion in 2008, this after having roughly tripled in the preceding decade of the 1990s. In 2008, Taiwan's exports to China reached \$74 billion, accounting for 8 percent of total Chinese imports that year.⁷ In comparison, Taiwan's imports from China totaled \$30 billion, leaving a \$44 billion Taiwanese trade surplus. In 2009, bilateral trade crashed in line with the decline in global trade flows (to \$87 billion), but was back on track to previous highs with \$25 billion in the first quarter of 2010.⁸ While the absolute value of Taiwan's trade surplus with China has grown increasingly large over time, the ratio of Taiwan-China cross-strait exports to Taiwan beginning around the time of the two economies' WTO accession in December 2001. The ratio went from \$5 of Taiwanese exports to China for each \$1 of Chinese exports to Taiwan in 2001 to around \$3 to \$1 in 2008–09.

Although China's and Taiwan's trade statistics fall short of accurately capturing Taiwanese exports to China, we have to rely on these datasets for most of the following detailed analysis. The computable general equilibrium trade model we later use to compute various scenarios to assess the economic impact of cross-strait economic deepening adjusts for reexports via Hong Kong but no additional third countries, which has important implications for interpretation of the results.⁹

In the aggregate, is Taiwan's structural cross-strait trade surplus disadvantageous for China? From Taiwan's perspective, its exports to China reflect migration of final assembly that used to occur elsewhere—most notably in Taiwan itself—to China, which then generates reexports of final goods to other markets. Also, in the process of setting up the operations to facilitate those reexports, machinery and equipment exports have followed direct investment from Taiwan to China. And certainly given China's structural global trade surplus, Beijing should not be concerned about bilateral trade deficits. Figure 1.2 shows the net value of regional surpluses and deficits for China, and figure 1.3 shows the shift of US

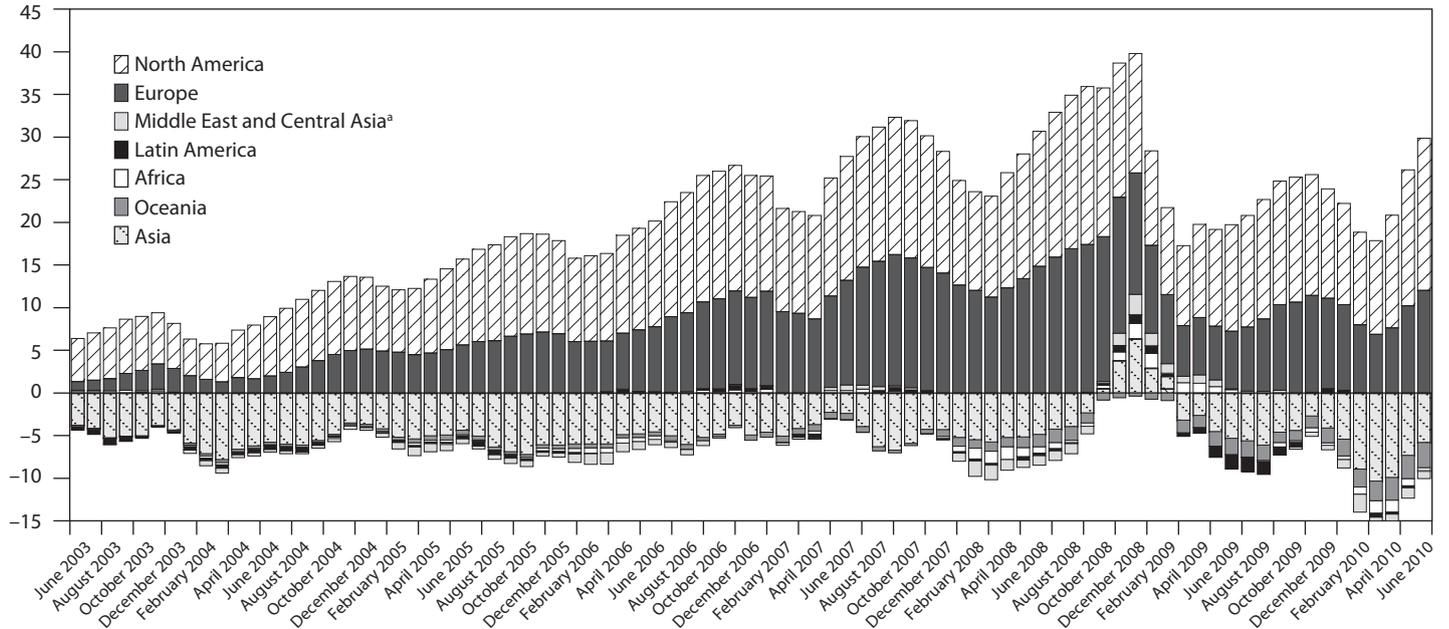
7. Estimate based on adjusted Taiwanese fob exports to China plus a 25 percent upward adjustment for transportation-related costs to make the number comparable to Chinese cif import statistics.

8. Nominal number from China Customs, <http://english.customs.gov.cn>.

9. For details on the model and interpretation of results, see explanations and comments in chapters 2 and 3.

Figure 1.2 China's trade balance by region, June 2003–June 2010 (monthly surplus or deficit; three-month moving average)

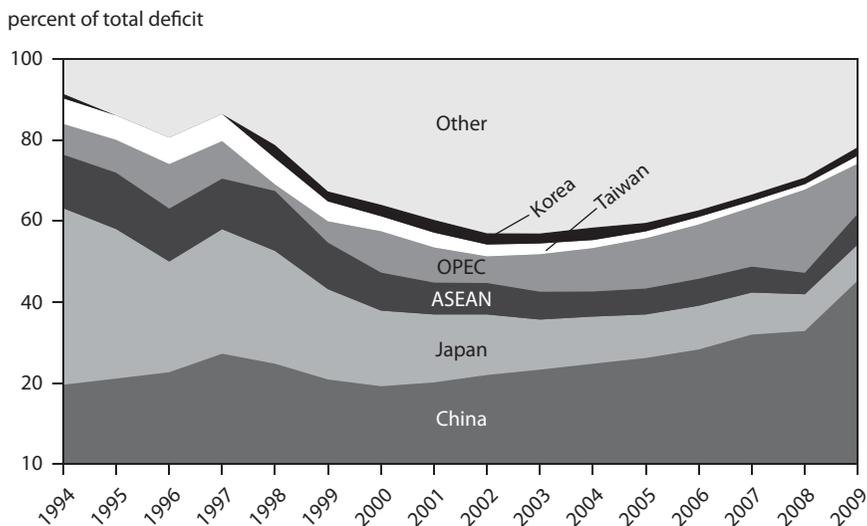
billions of US dollars



a. Includes Bahrain, Kuwait, Oman, Palestine, Israel, Qatar, Saudi Arabia, United Arab Emirates, Yemen, Iraq, Iran, Kazakhstan, Uzbekistan, Tajikistan, Kyrgyzstan, and Turkmenistan.

Source: China Customs, from CEIC.

Figure 1.3 Composition of US merchandise trade deficit, 1994–2009



ASEAN = Association of Southeast Asian Nations; OPEC = Organization of Petroleum Exporting Countries.

Source: US import and export merchandise trade statistics via US Trade Online.

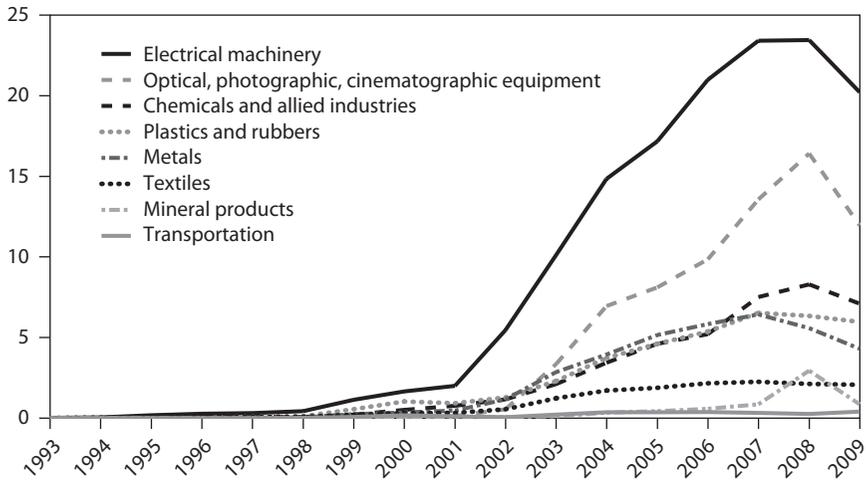
deficits from a range of Asian economies to a concentration in China over the past decade. However, China officially takes a different position. While acknowledging that direct investment from Taiwan and other origins benefits China and contributes to its export performance, officials have attributed this “serious imbalance” to restrictive trade policies and other measures taken by Taiwan exclusively against China. China further argues that these restrictions are not justifiable under WTO rules and norms and should be rescinded (WTO 2006). Notwithstanding this argument, China has (largely for political reasons) stopped short of formally challenging Taiwan’s barriers through the WTO or other fora.

China’s role as a final assembler in global manufacturing value chains became significant in the 1990s, with Taiwanese production of high-value intermediate goods going into those value chains. Indeed, Taiwanese firms in consumer electronics and other industries often were the pioneers in building China into this value chain role. Figure 1.4 shows that electrical machinery and optical equipment have dwarfed other Taiwanese exports such as chemicals, base metals, and plastics.¹⁰ In fact, just

10. As discussed further below, we employ Taiwan direct trade data for a description of China-Taiwan trade for the sake of consistency unless indicated otherwise. Due to restrictions on direct trade, the value of these data before 2000 is very limited. Mirror data for earlier years are available from China Customs, <http://english.customs.gov.cn>.

Figure 1.4 Taiwanese exports to China by category, 1993–2009

billions of US dollars



Source: Unadjusted flows, Bureau of Foreign Trade, Taiwan.

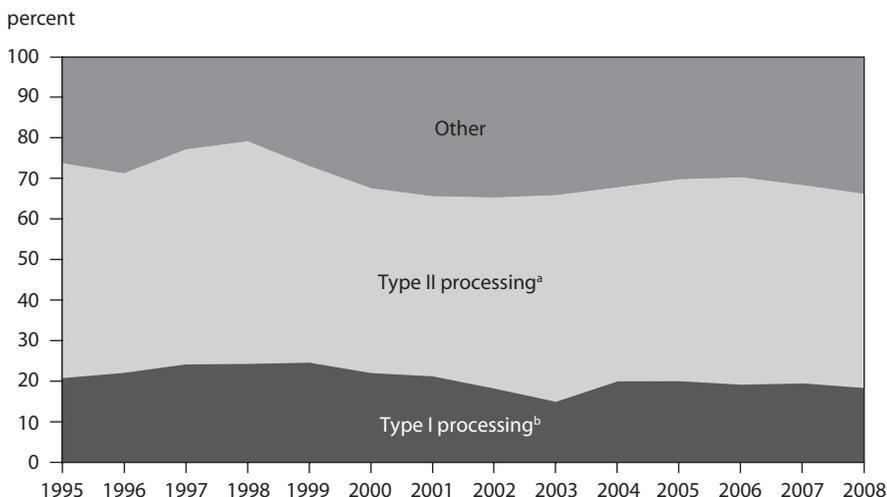
a handful of Taiwanese electronics-related manufacturers have a dominant role in Taiwan's relations with the mainland.¹¹

By 2009, 8 percent of China's imports originated from Taiwan. In manufactured processing trade (which includes most of China's high-tech exports), 82 percent of Chinese product value by 2006 came from foreign value added, not value created in China (Koopman, Wang, and Wei 2008). For example, 99 percent of China's computer exports arise from processing trade. And given that Taiwanese brands control 80 percent of the world laptop computer market, it is apparent that a high share of Taiwan's exports to China is bound for other markets. Mirror data from China Customs presented in figure 1.5 show that about 70 percent of China's imports from Taiwan are processing goods.¹² According to Chinese data, wholly foreign-owned or joint venture firms accounted for about 80 percent of China's imports from Taiwan in 2008, and many of

11. The authors thank reviewer Eric Ramstetter for pointing this out, noting that "nine of Taiwan's 10 largest manufacturers in 2006 were in these categories [electrical and optical machinery]: Hon Hai Precision, Quanta Computer, Asustek Computer, Taiwan Semiconductor, Compal Electronics, AU Optronics, Inventec Corp., Winstron Corp., and Chi Mei Corp. These firms alone accounted for sales of NT\$3.3 trillion in electronics-related industries or 24 percent of the sales of the largest 2,687 manufacturers in Taiwan."

12. While China's reported value of imports from Taiwan is likely overestimated (see our comments earlier in this section), the ratios shown in figures 1.5 and 1.7 should be close to reality, as both denominator and nominator are scaled up in the same way.

Figure 1.5 Composition of China's imports from Taiwan, 1995–2008



- a. Type II processing: ownership of traded components is transferred to a local firm.
- b. Type I processing trade: traded components remain the property of the foreign supplier.

Source: China Customs, <http://english.customs.gov.cn>.

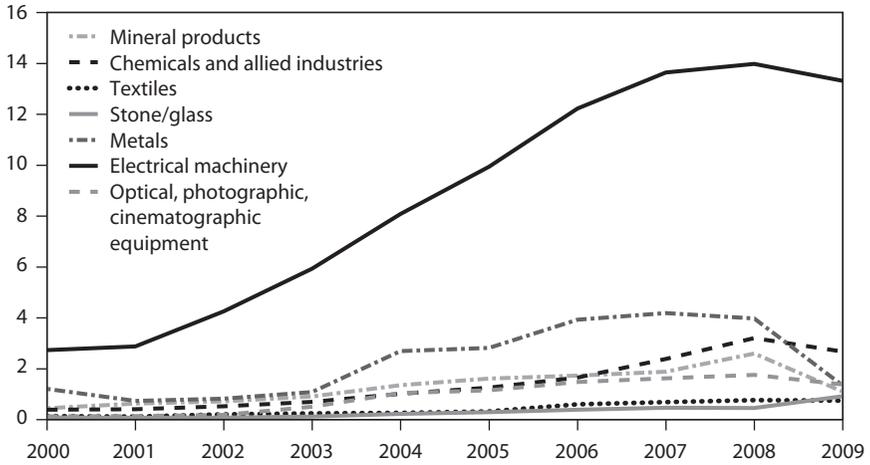
these are in fact Taiwanese firms.¹³ Of course, the same integration that was profitable enough to lure Taiwanese manufacturers despite political risks inflicted severe pain on Taiwan as global demand for “China’s” finished goods plummeted during the 2008–09 financial crisis, reducing Taiwanese exports by more than 40 percent year on year in December 2008 and January 2009 while Taiwanese imports from China fell by a much smaller percentage.

Taiwan’s imports from China have also grown significantly in recent years, doubling in share terms from 7 percent of total Taiwanese imports in 2002 to 14 percent in 2009, notwithstanding the unilateral prohibitions on many imports from China that are not applied to other economies (discussed below). Figure 1.6 provides a breakdown of Taiwan’s imports from China. Electrical machinery is the largest import category by value, by a considerable margin. A greater share of these imports is for final consumption in Taiwan and not for reexport, partly explaining why these imports have not grown at the rate that Taiwan’s exports to China have. The data from China Customs shown in figure 1.7 support this point. The share of processing trade in China’s exports to Taiwan is lower than in the other direction and declined from over 60 percent before China’s WTO accession to less than half in 2008. The share of these Chinese exports going to

13. China Customs data; statistics on trade by firm ownership.

Figure 1.6 Taiwanese imports from China by category, 2000–09

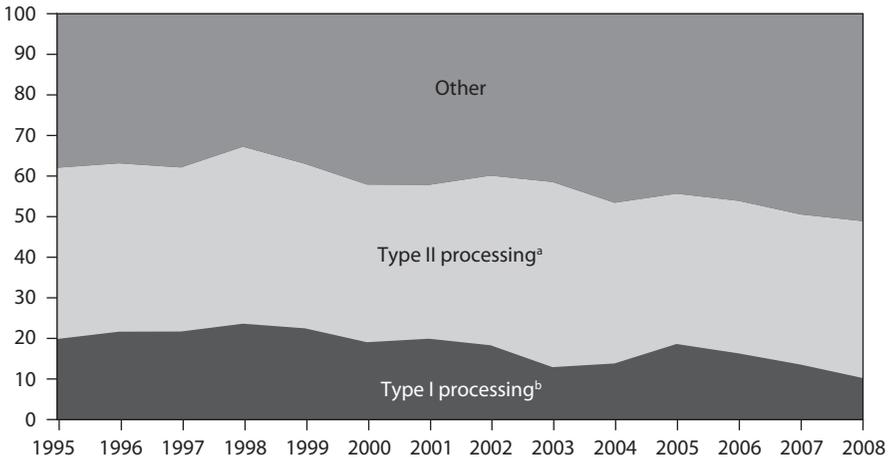
billions of US dollars



Source: UN Comtrade database, accessed through the World Bank’s World Integrated Trade Solution (WITS) software.

Figure 1.7 Composition of China’s exports to Taiwan, 1995–2008

percent

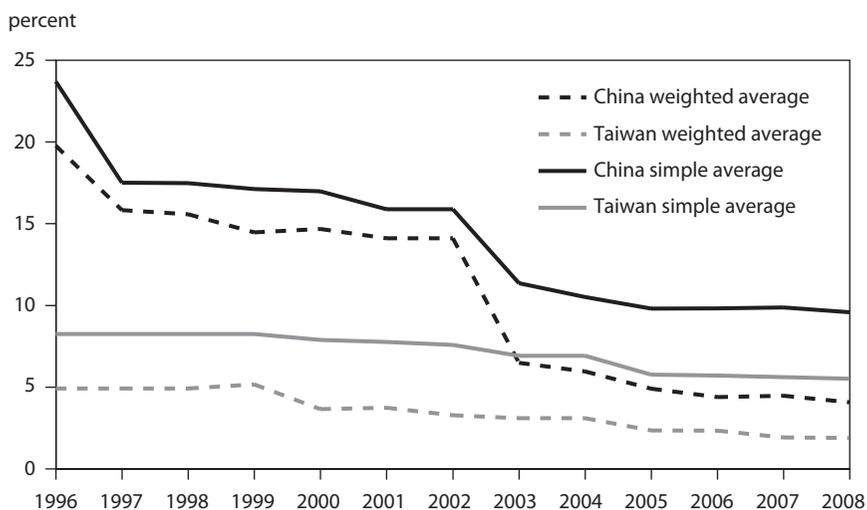


a. Type II processing: ownership of traded components is transferred to a local firm.

b. Type I processing trade: traded components remain the property of the foreign supplier.

Source: China Customs, <http://english.customs.gov.cn>.

Figure 1.8 China's and Taiwan's most favored nation tariff levels, 1996–2008



Notes: Missing values in single years were replaced with values of the previous year. For China, the value for 2002 is missing and the 2001 value is taken for that year. For Taiwan, the values for 1997, 1998, and 2004 are missing; the value for 1996 is used for 1997–98, and 2003 is used in lieu of 2004.

Source: UNCTAD, Trade Analysis and Information System (TRAINS) database, accessed through the World Bank's World Integrated Trade Solution (WITS) software.

wholly or partly foreign-owned firms was just 65 percent in 2008, compared to 80 percent for imports into China from Taiwan.

Cross-strait trade relations have not developed in a vacuum—over past decades both Taiwan and especially China have instituted broad economic policy reforms. This general liberalization has made the residual cross-strait abnormalities starker. Figure 1.8 shows the simple average and trade-weighted-average tariffs for the two since 1996, including the period of WTO accession. China's trade-weighted, most favored nation (MFN) tariff rate has come down from around 20 percent in 1996 to 4 percent today, and Taiwan's from 5 percent to 2 percent. Importantly, both economies are party to the WTO Information Technology Agreement, which stipulates free trade (zero tariffs) in components and products related to electronics, computing, and other industries central to the China-Taiwan trading relationship.¹⁴ As noted above, these MFN-level tariffs are generally applied to Taiwan by China, but not by Taiwan to goods from China.

14. For details see www.wto.org/english/tratop_e/inftec_e/itaintro_e.htm (accessed on September 15, 2010).

Another important driver of higher cross-strait goods trade was the relaxation of transportation sector controls. Until the late 1990s, Taiwan maintained a complete ban on direct transport and shipping links with China. Cargo had to go through third-party transshipment points such as Hong Kong, and shipping companies were not allowed to offer direct cross-strait services. These strict prohibitions were first relaxed in 1997, when Taiwan adopted “offshore shipping center” regulations that allowed limited direct shipping between Fujian province and Taiwan.¹⁵ In October 2001, Taiwan further relaxed rules and allowed imports from China into special processing zones and industrial parks through Kaohsiung port. In May 2004, two more ports in Taiwan and all ports in China were opened for direct shipping services.¹⁶ This greater freedom for direct shipment of goods is evident in the convergence of direct and indirect export statistics shown in figure 1.1. This convergence can be expected to further increase following an agreement in November 2008 allowing all ships from China and Taiwan to engage in direct shipping across the strait. Taiwan opened 11 ports under this accord, China 63.¹⁷ In November 2008 and April 2009, the parties signed agreements to normalize air transportation for passengers and goods, with daily flights. Taiwan committed itself to open eight destinations and China 21. Air cargo will run on a regular basis with two or three designated operators.¹⁸

Despite the progress made in tariff reduction and better transportation links for trade in goods, much remains to be normalized, let alone liberalized, in cross-strait trade. There remain a host of nontariff barriers negatively impacting commerce, the bulk of these imposed unilaterally by Taiwan. Most importantly, despite obligations under the WTO, Taiwan has a negative list in place that prohibits the import of more than 2,200 products from China. In 1993, Taiwan’s Bureau of Foreign Trade developed regulations for trade relations allowing unlimited exports but restricted imports.¹⁹ The bureau issued a “positive list” of goods allowed to be imported, which in 1996 was turned into a “negative list” of prohibited

15. “Offshore Shipping Centers” (境外航運中心), Ministry of Transportation and Communication, Taiwan, April 1997. Available (in Chinese) at <http://www.iot.gov.tw/public/data/7122111234871.pdf>.

16. “Measures to Make Cross-Strait Shipping Convenient”(海運便捷化措施), Mainland Affairs Council, Taiwan Executive Yuan, May 2004. www.mac.gov.tw/ct.asp?xItem=62187&ctNode=6227&mp=1 (accessed on September 15, 2010).

17. “Cross-Strait Sea Transport Agreement” (海峽兩岸海運協議), Association for Relations across the Taiwan Strait, November 4, 2008.

18. *Ibid.*, footnote 17; and “Supplement to Cross-Strait Air Transport Agreement” (海峽兩岸空運協議補充協議), Association for Relations across the Taiwan Strait, April 2009.

19. “Regulations Governing the Permission of Trade between Taiwan Area and Mainland Area” (台灣地區與大陸地區貿易許可辦法), Bureau of Foreign Trade, Taiwan, April 26, 1993.

Table 1.1 Taiwan's import prohibitions by category

Number	Taiwan	Code name	February 2009	January 2010	+/-
	commodity classification code				
1	50-63	Textiles	480	486	6
2	72-83	Metals	417	433	16
3	01-05	Animal products	284	316	32
4	06-15	Vegetables	282	282	0
5	16-24	Foodstuff	268	268	0
6	84-85	Electrical machinery	139	137	-2
7	28-38	Chemicals and allied industries	116	120	4
8	86-89	Transportation	95	95	0
9	68-71	Stone/glass	54	49	-5
10	90-97	Miscellaneous	29	29	0
11	39-40	Plastics and rubbers	15	15	0
12	25-27	Mineral products	9	9	0
13	44-49	Wood and wood products	6	5	-1
14	41-43	Raw hides, skins, etc.	0	0	0
15	64-67	Footwear	0	0	0
		Total	2,194	2,244	50

Source: Bureau of Foreign Trade, Taiwan, <http://fbfh.trade.gov.tw> (accessed on September 15, 2010).

items.²⁰ After its accession to the WTO, Taiwan reviewed its import regime and now has three lists to regulate imports from China: a positive list, a negative list, and a list with conditionally restricted goods, all of which are updated on a regular basis.²¹ Table 1.1 gives an overview of the distribution of prohibited items by category. The comparison over time also illustrates that Taiwan keeps extending the list of banned goods despite recent relaxations and the ECFA undertaking. New restrictions were most recently issued in the categories of textiles, metals, and animal products. Other categories such as glass and stone products saw a modest reduction of restrictions, but on net the negative list was extended by 50 products. In the early harvest agreement signed alongside the ECFA text in 2010, none

20. In the case of a positive list, products are not tradable unless expressly listed; in the case of a negative list, products are tradable unless listed. The latter is much more permissive, generally, than the former.

21. "Overview of Managing Imported Goods from China" (大陸物品進口管理概況), WTO Center of Taiwan, November 2003. www.wtocenter.org.tw/SmartKMS/do/www/listDocs-ByCategory?isMenu=true&categoryId=118. The most updated import regulation list is available at <http://fbfh.trade.gov.tw/rich/test/indexfhE.asp> (both websites accessed on September 15, 2010).

of the 267 project categories for which Taiwan committed to remove tariffs for China were from this lengthy banned list.

Although importers are rumored to bypass the negative list often by reporting imports under categories that are not banned, the restrictions are not compatible with Taiwan's WTO commitments and have a clear negative impact on imports in many categories. China has chosen not to challenge these barriers formally at the WTO so as to avoid underscoring Taiwan's independent status and also to avoid raising anxiety in Taiwan about economic pressure. However, in 2006 China's WTO representatives did include pointed comments in the occasional *Trade Policy Review of Taiwan* (known as "Chinese Taipei" in the WTO). These comments included the following (as summarized by the Trade Policy Review Body chairperson):

China was concerned over problems relating to the WTO nondiscrimination principle. Chinese Taipei practiced trade-restrictive policies against China in many areas, which had limited the potential for cross-strait trade and economic cooperation. Chinese Taipei had maintained import prohibitions on 2,237 [sic; accurate at the time] tariff lines of products from China without WTO-consistent justification. Access for China's services providers was virtually blocked in many ways, and Chinese companies found it impossible to invest in Chinese Taipei. This was not conducive to the development of cross-strait trade and economic relations; it was not only against the interests of businesses and consumers in Chinese Taipei, but also had a negative impact on business investment in China. As a result, the economic growth of Chinese Taipei had been greatly impaired. China urged Chinese Taipei to . . . take steps to correct these trade policies and practices, which were inconsistent with WTO rules, so as to promote trade liberalization (and facilitation) across the strait. (WTO 2006, 12, paragraph 59)

Taiwan has argued that its WTO obligations do not apply to China in the same way because China was not a WTO member when they were negotiated. (China and Taiwan negotiated accession and entered the WTO in parallel.) But WTO obligations, however arrived at, are multilateralized and applied to all members on an MFN basis, unless a specific exception is registered at accession, which Taiwan did not do. In addition to its list of prohibited imports from China and its residual restrictions on transport links, Taiwan has maintained special restrictions on Chinese investment, services, and the physical movement of people for employment and personal travel, as described below. The lack of normal government-to-government contact has further frustrated a variety of commercial activities dependent on consultation and communication between regulators and overseers.

For its part, China maintains a more limited set of restrictions on Taiwanese commerce. Beijing does not impose restrictions on Taiwanese goods imports different from those applied to other WTO members. However, it has declined to issue licenses for Taiwanese services sector firms to conduct business, most notably in the financial services industry, on the grounds that such firms could not be adequately regulated due

to the lack of normal regulator-to-regulator communication between governments on each side of the strait. With the advent of WTO+ FTAs between China and other economies, China now applies lower rates of import duty to goods from some other WTO members than from Taiwan. While this is neither unusual in the world today nor necessarily noncompliant with WTO obligations, it adds an element of distortion for Taiwan and has been the main argument employed by President Ma Ying-jeou's government in making the case for a formal arrangement to achieve deeper economic integration.

Trade in Services

Our description of China-Taiwan trade has thus far focused on trade in goods. However for an advanced economy like Taiwan, the opportunity for services trade with China is extremely important. Comprehensive data on trade in services between China and Taiwan are not available, but we can describe the aggregate services trade situation for the two and draw a general assessment of bilateral flows based on available and circumstantial information.

Taiwan's balance of payments data indicate a services trade deficit throughout 1984–2009. Services exports grew faster than imports in all these years, though starting from a very low base. As table 1.2 and figure 1.9 show, growth was highest in the late 1980s, with average annual rates at 24 percent for exports and 20.5 percent for imports. This growth has slowed over time, falling to 3.9 percent annually for exports and a negative number for imports in 2004–09. As a share of total exports and imports, services exports increased from 7.5 percent in 1984 to 13.3 percent in 2009, while services imports declined from 20 percent of all imports in 1984 to 14.8 percent in 2009 (figure 1.9).

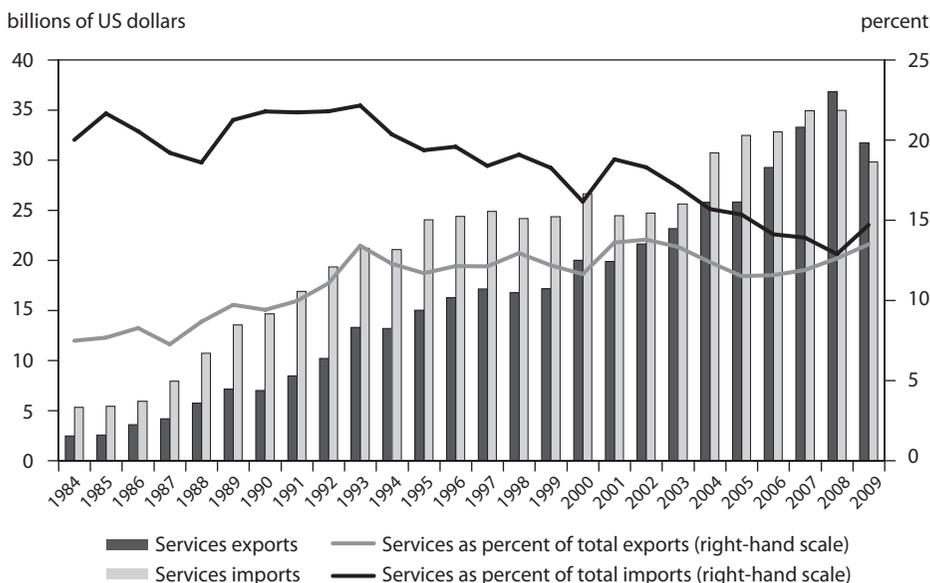
Taiwan's balance of payments data break down trade in services, and figure 1.10 tracks the trade balance of subsectors over time. In business services, Taiwan has built a growing surplus over two decades, while for most other services Taiwan is near balance or in deficit (royalty and licensing fees being the biggest “import” for Taiwan today, a healthy reflection of the development of its high-tech industries). Looking forward, Taiwan considers the development of its services industries to be key to maintaining its prosperity and competitiveness. Sectors earmarked for strategic attention include finance, logistics/distribution, information and media, medical and healthcare services, education, tourism, research and development, environmental services, and engineering. Taiwan is thinking specifically about future demand from China for consumer and business services and Taiwan's ability to sustain comparative advantage in these industries, which do not rely on large-scale capital-intensive assets or abundant low-cost labor—two endowments Taiwan conspicuously lacks.

Table 1.2 Growth of Taiwan's services exports and imports with the world
(percent)

Period	Exports	Imports
1984–89	23.76	20.50
1989–94	13.10	9.20
1994–99	5.48	3.00
1999–2004	8.50	4.80
2004–09	3.90	–0.50

Source: Balance of payments data from the Central Bank of Taiwan.

Figure 1.9 Taiwan's trade in services with the world, 1984–2009

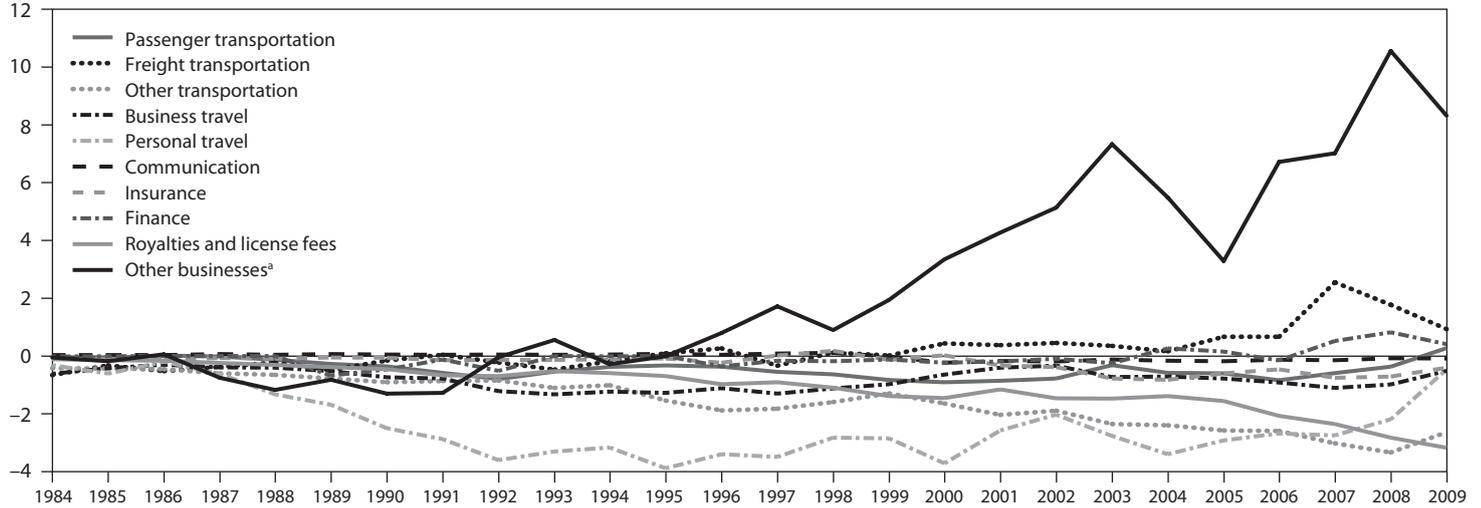


Source: Central Bank of Taiwan.

The development of China's trade in services reflects the different phases of the country's integration into the global economy. In the 1980s and first half of the 1990s, China's trade in services was generally low and mostly balanced, with a slight surplus in earlier years (figure 1.11). After 1995, the growth of services imports outpaced the export side and China turned into a net importer of services. This shift was mostly related to a strong growth in imports of services related to China's integration into regional production chains such as transport and various business services.

Figure 1.10 Balance of Taiwan's services trade with the world by sector, 1984–2009

billions of US dollars

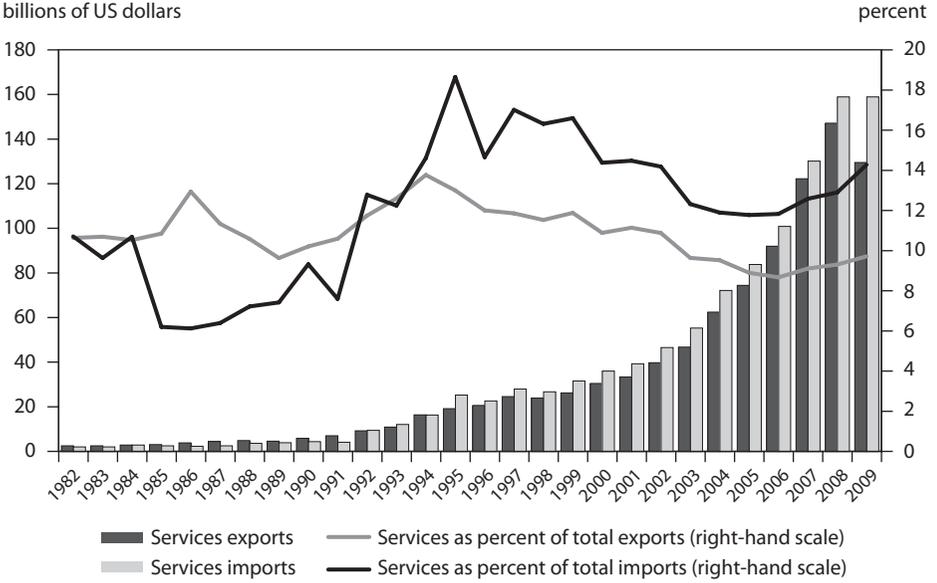


a. Other business services include accounting, advertising, legal services, agricultural processing, business consulting, merchant services, operating/leasing services, technical services, waste treatment, research and development, etc.

Note: The figure does not include all categories.

Source: Central Bank of Taiwan.

Figure 1.11 China's trade in services with the world, 1982–2009

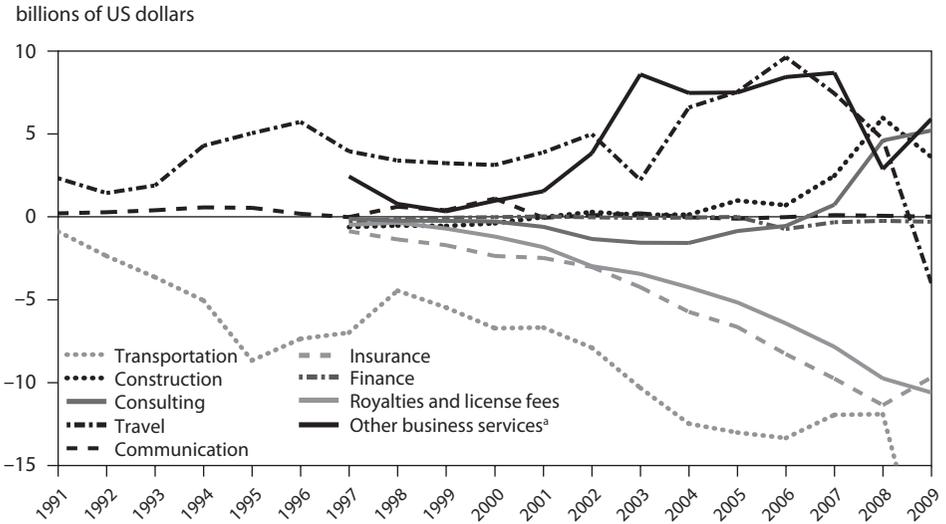


Source: State Administration of Foreign Exchange, China.

After 2001, the annual growth of services imports averaged 22 percent and services exports 24 percent, compared to 24 percent and 18 percent in the previous decade. However, this increase was not enough to keep pace with the growth in merchandise trade; hence the share of services in China's total trade fell. Since 2006, these patterns have been reversing again and services trade is expected to grow in importance to China in the years ahead. The services sector accounted for 43 percent of China's GDP in 2009 but has averaged 17 percent annual growth since 2005, faster than the other sectors of the economy. Efforts to rebalance the economy and shift investment away from polluting and capital-intensive manufacturing to labor-intensive activities is expected to further boost the role of the services sector in the economy (He and Kuijs 2007).

The services trade balance from China's balance of payments statistics (figure 1.12) reveals the most important trends. China has long been a major net importer of transportation services, a deficit that widened after WTO accession in 2001. Other major deficit items on the balance sheet are insurance services and fees related to intellectual property rights. On the net export side, China's strongest position has long been tourism. Since 2001, business services have also grown into a major net export category. In recent years, construction, consulting, and information technology services emerged as major net export sectors. In 2008, China's Ministry of Commerce (MOFCOM) issued a report that contains several data

Figure 1.12 Balance of China's services trade with the world by sector, 1991–2009



a. Other business services include accounting, advertising, legal services, agricultural processing, business consulting, merchant services, operating/leasing services, technical services, waste treatment, research and development, etc.

Note: The figure does not include all categories.

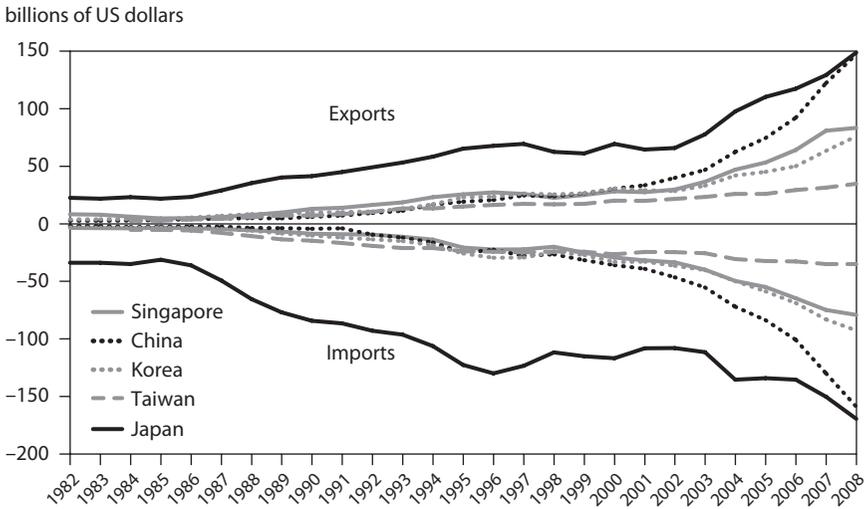
Source: State Administration of Foreign Exchange, China.

points on the regional distribution of China's services trade.²² According to MOFCOM, Hong Kong, the United States, European Union (EU), Japan, and the countries of the Association of Southeast Asian Nations (ASEAN) account for around 70 percent of China's total services trade. Not surprisingly, Hong Kong alone accounted for around 20 percent of the total trade value. Hong Kong also was the trading partner with the largest surplus, whereas the largest deficits occurred with the European Union, Australia, and Japan.

While services make up more than 70 percent of Taiwan's GDP, Taiwan's weight in global services trade is relatively low. Services trade growth by local peers was strong enough to overshadow Taiwan (figure 1.13). China, on the other hand, already is an important market in global services trade given the overall size of the economy. In 2009, it ranked fifth in global services exports and fourth in imports, surpassed only by

22. MOFCOM, "An Overview of the Development of China's Trade in Services in 2007." <http://tradeinservices.mofcom.gov.cn/en/c/2008-11-17/62284.shtml> (accessed on September 15, 2010).

Figure 1.13 Trade in services of countries in East Asia with the world, 1982–2008



Source: International Monetary Fund.

the United States, Germany, and the United Kingdom.²³ In East Asia, Japan leads in global services exports and imports value, though China nearly passed that position in 2008. Given the size of its economy and the current growth trajectory of its services sector, China will most likely soon be the most important market for services trade in East Asia.

With regard to bilateral services trade, neither China nor Taiwan publishes reliable statistics.²⁴ However, we can surmise that China’s services exports to Taiwan are extremely low, given that services trade often includes direct investment flows and movement of people, or direct shipping, and until recently Taiwan has been largely closed to investment and labor from China (discussed further below).²⁵ In fact in the WTO’s *Trade Policy Review of Taiwan*, China complained that at most only one of 160 services subsectors had been opened by Taiwan to Chinese investment,

23. See the WTO’s annual report on trade services via the Chung Hua Institution of Economic Research. <http://taiwan.wtcenter.org.tw/WTOissueindex.asp?id=18> (accessed on September 15, 2010).

24. MOFCOM’s 2008 services trade report (see footnote 22) mentions that China’s services trade in 2006–07 was strongest with Taiwan in tourism, transportation, and insurance services, but does not provide specific data.

25. Establishment of such a commercial presence is not the only way to generate a services export: services can be sent abroad by phone or computer, consumed “for export” by visitors like tourists and business travelers, or delivered by a temporary visitor.

and that even that sector (real estate) was not practical due to restrictions on visitation by mainland citizens.²⁶ For other WTO members, meanwhile, Taiwan provided at least partial opening in 120 of these subsectors. But with the growth of direct trade links, tourism, and especially the recent opening of Taiwan to mainland investment generally, China's services exports to Taiwan are likely to grow, while the major impediment in Taiwan will continue to be national security concerns.²⁷

Taiwan's services export offerings to China have also been curtailed by cross-strait abnormalities, but to a smaller degree. Some services sectors that Taiwan considers to be promising and important—notably financial services—have been restricted by Beijing out of reciprocity and also for want of direct channels for handling regulatory oversight. Taiwan had restricted transportation and shipping services exports to China unilaterally, although these were diverted to Hong Kong and Japan instead, and hence cross-strait normalization may not mean growth (though liberalization *would*, by fostering faster GDP growth). In a variety of nonfinancial business services including consulting, technical advisory, and technology licensing, Taiwan has enjoyed strong exports to China for some time, as these services exports have been necessary to support the Taiwanese firms that have migrated production to China.²⁸

As of 2010, extensive Taiwan opening to inbound direct investment from China is taking place under memoranda of understanding (MOUs) signed in ad hoc cross-strait meetings since 2008. These agreements will open many Taiwanese sectors to investment from China, and address financial services in particular. Banking and the trust investment sector are in line for opening to investment from qualified Chinese institutional investors (as they have been to other foreign investors, like Standard Chartered Bank and Citibank). For example, two Chinese fund management services firms—China AMC and China International Fund Management—have completed registration procedures and are preparing to trade shares in Taiwan.²⁹

26. Very significantly, this presents a real challenge to econometrically modeling the effects of deeper China-Taiwan trade integration in the years ahead, because zero values of past trade do not lend themselves to growth in economic models, and the nonquantitative (nontariff) barriers constraining services trade are more difficult to operationalize in a model. See chapter 2 and appendix A for further discussion.

27. In general, services imports are much more sensitive from a national security standpoint than goods imports as they require foreign direct investment and people on the ground, and reach into areas that are highly relevant for national security, such as finance, information technology, communication, infrastructure, and transportation.

28. See MOFCOM's 2008 services trade report (footnote 22).

29. Jingying Ma, "Finance Industry Is Not Included in the Second Round of ECFA Negotiation" (金融业未纳入ECFA第二轮协商), Caing News, March 31, 2010. <http://finance.caing.com/2010-03-31/100130861.html> (accessed on September 15, 2010).

Direct Investment and Portfolio Holdings

The integration of production chains across the Taiwan Strait is also evident from the patterns of foreign direct investment (FDI) between the two sides. China has experienced growing inflows of direct investment from Taiwan since the 1980s, mostly for greenfield manufacturing facilities. China's direct investment in Taiwan was virtually zero until recently: except in a handful of cases since 2002, Taiwan did not permit investment from China, ostensibly on national security grounds. As with trade statistics, the real extent of FDI flows between China and Taiwan is obscured by the extensive use of third economies as intermediate jurisdictions. Recent changes in Taiwan's inward investment rules and the increasing motivation and readiness of China's firms to invest abroad will likely bolster the mainland's FDI flows to Taiwan in the near future. Compared to direct investment, levels of cross-border portfolio investment holdings have been very low on both sides until recently but are expected to grow rapidly on the back of regulatory changes for portfolio investment in general and cross-strait investment in particular.

Direct Investment from Taiwan to China

Direct investment in China by Taiwanese firms was explicitly prohibited until 1992 and still is tightly controlled today by Taiwan, but the reality is that flows have mushroomed for more than two decades. As early as the late 1980s, Taiwanese firms started to shift manufacturing operations to China from Taiwan and elsewhere in Asia, as China had set up export processing zones with favorable conditions for foreign investors and had a natural comparative advantage for labor-intensive industries in which sparsely populated Taiwan was unable to maintain cost competitiveness.³⁰ While foreign exchange controls on capital account transactions were lifted in 1987, investment flows to China remained tightly restricted, while investment via third country locations such as Hong Kong was not.

In his study of China-Taiwan relations, *Untying the Knot: Making Peace in the Taiwan Strait*, Richard Bush points out that it was not just the attraction of production costs in China that motivated Taiwan's firms, but an upward inflection in Taiwanese production costs as well (Bush 2005, 24). Through the 1980s, real wages in Taiwan rose an average of 7 to 8 percent annually, and easy steps to stay ahead of the cost curve with productivity-enhancing investments in technology had already been taken.³¹ By the mid-1980s

30. On the growing allure of China for manufacturers in this period, see Rosen (1998). The potential of the domestic Chinese market was the focus of many investors, but for the majority of Taiwanese firms the allure was China as an export platform to serve the rest of the world.

31. Authors' calculations based on data from Taiwan's General Directorate of Budget, Accounting and Statistics.

there were strong US perceptions that Taiwan was building an unnatural amount of US dollar foreign exchange reserves as a result of an intentional policy of currency undervaluation. At the time, Washington was coordinating with Japan to revalue the yen, and from 1985 onward Taiwan commenced to permit appreciation of its currency. Already in those years Taiwan had identified South Korea as a peer competitor, and while Taiwan conceded some adjustment on its exchange rates, Korea conceded less so, adding more competitive pressure that motivated Taiwanese firms to seek out cost structures less prone to competitive concerns abroad. In this way, exchange rate pressure from the United States helped to hasten the migration of Taiwanese firms to the mainland. Similarly, in the years ahead US pressure on Taiwan's shortcomings in the protection of intellectual property rights would impel movement across the strait in search of a "blind eye."

Thus, indirect Taiwanese investment in China grew bigger and in 1992 authorities responded to that reality and formalized oversight and administration through the *Act Governing Relations between Peoples of the Taiwan Area and China Area* (Article 35). New regulations virtually encouraged the indirect investment option, but required firms to register and seek approval from Taiwan's Ministry of Economic Affairs (MOEA) for any existing or new investment in China.³² This change allowed Taiwanese firms to legally invest in China. However, the regulations also specified several conditional rules for outbound investment—for example, that a firm's investment in China not exceed 40 percent of its net worth—in order to prevent a "hollowing out" of economic activity in Taiwan. Taiwan's approval process for direct investing in China remain burdensome, while the regulatory requirements for investing in other countries are relatively simple—in most cases firms just need to register with the MOEA Investment Commission.³³ Because of these discrepancies, firms often circumvented the China approval process through the MOEA and registered their projects

32. *Act Governing Relations between Peoples of the Taiwan Area and China Area* (臺灣地區與大陸地區人民關係條例), Ministry of the Interior, Taiwan, April 2, 2002. www.mac.gov.tw/public/MMO/RPIR/book367.pdf (accessed on September 15, 2010).

33. Outbound investment is governed by multiple regulations. The most important rules for outbound FDI to the mainland are summarized in the "Regulations Governing the Approval of Investment or Technical Cooperation in Mainland China." <http://law.moj.gov.tw/LawClass/LawContent.aspx?pcode=Q0040001> (accessed on September 15, 2010). Approval from the MOEA Investment Commission is needed for large investment and reporting is needed for small projects. A project will be suspended if it is not approved or reported. Investment into Hong Kong and Macau only requires approval from the MOEA (not its Investment Commission) for large projects and reporting for smaller projects. No sanctions for nonreporting are mentioned. www.moeaic.gov.tw/system_external/ctrl?PRO=LawsLoad&id=6 (accessed on September 15, 2010). Investment in other foreign countries only requires reporting to the MOEA's Investment Commission. Again, no sanctions are mentioned. www.moeaic.gov.tw/system_external/ctrl?PRO=LawsLoad&id=49 (accessed on September 15, 2010).

as FDI to Hong Kong, Singapore, and, later, Caribbean tax havens. As in goods trade, the role of these entrepôts complicates data assessment, obscures the true value of FDI flows, and makes analysis of disaggregated investment details more difficult.

The starting point for estimates of aggregate Taiwan FDI to China is the MOEA's data on approved outbound FDI (table 1.3, columns 2–4). These data are compiled by the MOEA based on reporting requirements for firms seeking investment approvals, and include a breakdown of approved outward FDI by country, including indirect flows to China (column 3). Since 2002, China has accounted for more than two-thirds of Taiwan's approved annual outbound FDI. However for a number of reasons these official approval figures are not accurately capturing the reality of FDI outflows. First, Taiwanese firms frequently shifted investment out of Taiwan without going through registration, especially in earlier years when outward FDI approval procedures were most burdensome and investment to China prohibited.³⁴ When the firms did report, they reported anticipated, not realized, values. As a result, these data show occasional spikes during periods of stricter enforcement by Taiwan, or when statisticians chose to adjust estimates to better reflect unregistered outflows (1993, 1997, and 2002).³⁵ Second, these data capture only the first destination of outward investment, and many firms used locations with lower regulatory barriers as switchyards for their China investments. The stark differences between Taiwan's approved numbers and data on contracted FDI from Taiwan as reported by Beijing (column 5) reinforce the evidence of underreporting by Taiwanese businesses to their home authorities. Taiwanese analysts typically assume that the majority of Taiwan investment flowing to Hong Kong, Singapore, and Caribbean tax havens (column 4) in reality went to China.³⁶ And of course this means reinvested earnings might not be captured in the data. And third, Taiwan's data on approved investment is not very useful for mapping out actual flows because the data consistently diverge from *utilized* FDI—frequently to an extreme degree, as many negotiated projects are not ultimately carried out for commercial or regulatory reasons.

Taiwanese authorities do not collect and report utilized outbound FDI as opposed to that which is approved, so one must determine an accurate

34. There is a wide variety of techniques used to surreptitiously shift money abroad for such purposes. For instance, firms can underinvoice for transactions overseas in order to leave cash abroad that would otherwise come home.

35. There are compounding factors for 1993 and 2002: 1993 saw an uptick in FDI to China generally as investor confidence redoubled after the political turmoil of the Tiananmen Square demonstrations and crackdowns around the country in 1989; 2002 saw a direct investment surge as a result of China's accession to the WTO in late 2001.

36. Chen (2004) reports that the Central Bank attributed 80 percent of the tax haven flows to China investment at that time.

Table 1.3 Dimensions of Taiwanese outward foreign direct investment, 1988–2009 (annual flow in millions of US dollars)

Year	Total approved outward FDI from Taiwan to world ^a	Approved indirect outward FDI to China ^b	Approved outward FDI to tax havens, Hong Kong, and Singapore ^c	Contracted inward FDI to China from Taiwan ^d	Actual total outward FDI from Taiwan to world ^e	Utilized inward FDI to China from Taiwan ^f	Actual equity investment in greenfield projects and M&A deals ^g
1988	219	—	19	—	4,121	—	—
1989	931	—	87	—	6,951	—	—
1990	1,552	—	426	—	5,243	—	—
1991	1,830	174	523	—	2,055	—	—
1992	1,134	247	305	—	1,967	—	—
1993*	4,829	3,168	425	—	2,611	—	—
1994	2,579	962	966	—	2,640	—	—
1995	2,450	1,093	614	5,849	2,983	3,162	—
1996	3,395	1,229	1,316	5,141	3,843	3,475	—
1997*	7,228	4,334	1,552	2,814	5,243	3,289	—
1998*	5,331	2,035	2,153	2,982	3,836	2,915	—
1999	4,522	1,253	1,926	3,374	4,420	2,599	—
2000	7,684	2,607	3,086	4,042	6,701	2,297	—
2001	7,176	2,784	2,550	6,914	5,480	2,980	—
2002*	10,093	6,723	1,938	6,741	4,886	3,971	—
2003*	11,667	7,699	2,694	8,558	5,682	3,377	8,172
2004	10,323	6,941	2,204	9,306	7,145	3,117	12,417
2005	8,454	6,007	1,471	10,358	6,028	2,152	7,559
2006	11,958	7,642	2,903	11,336	7,399	2,136	5,598
2007	16,441	9,971	3,082	—	11,107	1,774	6,791
2008	15,158	10,691	2,721	—	10,287	1,899	5,490
2009	10,148	7,143	1,075	—	5,876	1,881	8,058
Cumulative	145,102	82,703	34,037	77,415	116,504	41,023	54,086

* = years with adjusted volume

— = not available

FDI = foreign direct investment; M&A = merger and acquisition.

- Taiwan Ministry of Economic Affairs (MOEA); sum of approved FDI to China and other countries.
- Taiwan MOEA.
- Taiwan MOEA.
- Taiwan Ministry of Commerce.
- Taiwan's central bank based on balance of payments data.
- Taiwan Ministry of Commerce.
- Authors' compilation based on Thomson ONE and fDIIntelligence.

figure for aggregate Taiwan-to-China FDI using other proxies. The Central Bank of China—Taiwan’s central bank—provides an estimate of actual FDI outflows from Taiwan “to the world” in its annual balance of payments statistics, which have been compiled according to IMF standards in recent years (table 1.3, column 6).³⁷ There are a number of options for estimating the share of these global flows going to China. One can use the numbers for utilized FDI entering China with a stated Taiwan origin, as reported by China’s Ministry of Commerce (MOFCOM, column 7). This number is significantly lower than the Taiwanese MOEA’s *approved* outward FDI, and lower than MOFCOM’s contracted inward FDI, and certainly underestimates actual Taiwan investment (for example, it does not capture all Taiwanese FDI fed through Hong Kong and other locations). In addition to these official numbers, the value of Taiwanese investment can be approximated from public announcements of greenfield projects and cross-border acquisitions (column 8). This methodology is also imperfect, since it describes equity capital only, omits reinvested earnings and other capital flows, and considers only the nationality of the investing company and not the origin of capital (which is probably why in some years it is higher than total outflows recorded in Taiwan’s balance of payments figures).

We use these various data points to assemble a best guess for actual direct investment outflows from Taiwan to China. Due to the shortcomings of MOEA data, we start with Taiwan’s balance of payments data as a reference point. From the late 1980s through the 1990s, outbound Taiwanese investment was overwhelmingly focused on China, and we assume that 80 to 90 percent of annual balance of payments outflows ended up in China. This is true for the years surrounding WTO accession and China’s integration into regional manufacturing networks as well. More recently, Taiwanese firms have diversified into a greater range of markets and segments, for example in a downstream presence in US, Japanese, and EU consumer markets or other low-cost manufacturing locations in Asia such as Vietnam. Thus, the share of China-as-destination is likely to have come down to 60 to 80 percent of total outflows in recent years from 80 to 90 percent in earlier years, depending on the trends and larger-scale projects in each respective year.

In early 2003, Taiwan’s central bank reported that firms had \$67 billion invested in China—roughly 87 percent of Taiwan’s year-end 2002 outbound FDI stock of \$77 billion. Adding 60 to 80 percent of actual annual outflows recorded in the balance of payments in 2003–08, and applying the same ratio for asset revaluation as for all FDI stock in this period, we arrive at a range of \$130 billion to \$150 billion for total Taiwanese outward FDI stock in China at year-end 2008, or around 80 percent of Taiwan’s total

37. Balance of payments data from Taiwan’s central bank, www.cbc.gov.tw/ct.asp?xItem=2070&ctNode=512&mp=2 (accessed on September 15, 2010).

overseas FDI stock of \$175 billion. The imprecise nature of these projections notwithstanding, it is fair to say that Taiwan is far and away the largest foreign investor in China. According to our estimates, Taiwan accounted for around 15 to 17 percent of China's inward FDI stock in 2008. In 2009, this stock probably rose by at least \$8 billion, which can be surmised from deal reports. According to Taiwanese government estimates, around 70,000 Taiwanese firms were invested in China by the end of 2009.³⁸ Looking forward, these flows are likely to remain large as additional restrictions on direct investment are removed.³⁹ In the first months of 2010, Taiwanese investments in China were running above past trends.⁴⁰

These aggregate uncertainties cast a shadow on the breakdown of flows by industry and subregion, which can be approached using MOEA data. These approved numbers are not reliable in terms of value, for the reasons stated above, but taken together with commercial databases on greenfield and merger and acquisition (M&A) investments by industry, they can be used to get an idea of the patterns and inflections in investment.

The composition of approved Taiwanese FDI to China by sector clearly shows that manufacturing dominates Taiwan's investment activity in the mainland, accounting for around 90 percent of the total (figure 1.14), although this share has come down to 80 percent in more recent years as a result of expanding investment activity in services sectors. The evolution of manufacturing FDI by subsector echoes the evolving economic relationship as seen in the trade data (table 1.4). In the early 1990s, investment was well distributed across industries, with a focus on traditional labor-intensive sectors including food, electrical components, plastics, and apparel. In subsequent years, investment shifted to computers, optical equipment, and other electronics, reflecting China's integration into these manufacturing value chains as the final assembly point. As outbound Taiwanese investment moved further up the sophistication curve to semi-conductors and other higher value-added manufacturing, capital intensity per project increased. This is evident in the sharp increase in average approved investment project value in the MOEA data (figure 1.15).

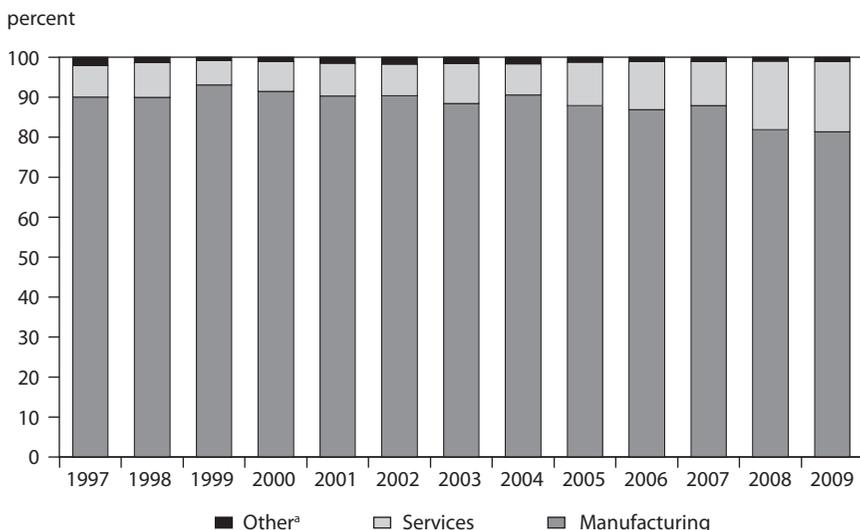
In the most recent period (2005–09), the strongest Taiwan-to-China investment growth momentum is seen in wholesale and retail trade (figure 1.16). Electronics and information technology remain the top investment sectors in the period by value, but with comparably modest growth rates, and computers and optical products see declining investment flows. Tai-

38. President Ma in an interview with the *Wall Street Journal* on December 15, 2009. <http://online.wsj.com/article/SB10001424052748703514404574588863008012766.html> (accessed on September 15, 2010).

39. On July 17, 2008, for instance, Taiwan's Executive Yuan increased the limit on China-bound investment for Taiwanese companies from 40 to 60 percent of net assets.

40. MOEA, "Statistics Summary," February 2010. www.moeaic.gov.tw/system_external/en_home.html (accessed on September 15, 2010).

Figure 1.14 Taiwanese foreign direct investment into China by sector, 1997–2009



a. Includes agriculture, mining, utilities, and construction.

Source: Ministry of Economic Affairs, Taiwan, approved direct investment.

wan’s China profile is evolving beyond high-tech assembly to consumer and business services, in pursuit of downstream market share instead of just manufacturing for reexport. This new emphasis on China as the consumer market of the near future rather than assembly point to serve traditional Organization for Economic Cooperation and Development (OECD) markets predated the global financial crisis of 2008–09, which brought so much attention to the rise of the Chinese consumer and the decline of US trend consumption growth. However, the crisis certainly amplified the sense of urgency for this investment-focus shift in Taiwan.

Figure 1.17 depicts the evolving 1991–2009 Taiwan-to-China investment pattern by province. In the early 1990s, Guangdong and Fujian dominated due to family ties, export processing zones, and other policies favorable to Taiwanese investors, as well as the suitability of these locales for Taiwan’s small and medium-size light manufacturing (Guangdong and Fujian are both known as light manufacturing hubs). The rise of Taiwanese investment in Jiangsu Province since the 1990s has resulted from investments in the capital-intensive semiconductor industry and computer sector, both of which are clustered in the adjoining provinces of Shanghai—Zhejiang and Jiangsu. In 2008, the MOEA approved more Taiwanese investment to Jiangsu than the next three provinces—Guangdong, Shanghai, and Zhejiang—together. Shanghai’s share has also grown rapidly since 2000, surpassing Guangdong in 2008.

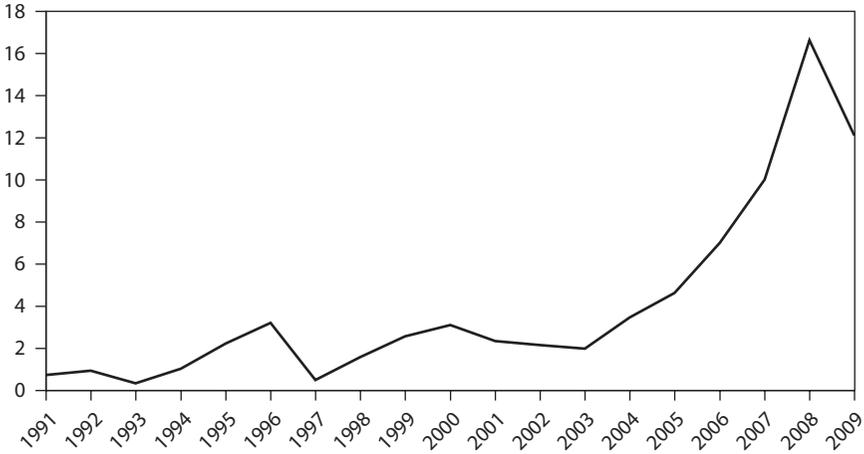
Table 1.4 Top 10 Chinese industries targeted by Taiwanese foreign direct investment, 1991–2009 (millions of US dollars)

	1991–95		1996–2000		2001–05		2006–09	
	Industry	Amount	Industry	Amount	Industry	Amount	Industry	Amount
1	Food	546	Computers, electronics, and optical products	1,741	Computers, electronics, and optical products	4,916	Electronic parts and components	7,898
2	Electrical equipment	416	Electronic parts and components	1,220	Electronic parts and components	4,836	Computers, electronics and optical products	5,963
3	Plastic products	388	Electrical equipment	1,107	Electrical equipment	2,791	Electrical equipment	3,240
4	Fabricated metal products	384	Fabricated metal products	787	Fabricated metal products	2,418	Wholesale and retail trade	1,967
5	Other manufacturing	334	Plastic products	721	Chemical material	1,617	Plastic products	1,661
6	Nonmetallic mineral products	325	Nonmetallic mineral products	625	Plastic products	1,441	Machinery and equipment	1,587
7	Leather, fur, and related products	314	Food	506	Nonmetallic mineral products	1,374	Basic metal	1,518
8	Textile mills	282	Machinery and equipment	493	Machinery and equipment	1,311	Fabricated metal products	1,266
9	Computers, electronics, and optical products	269	Textile mills	461	Wholesale and retail trade	897	Chemical material	1,197
10	Electronic parts and components	260	Chemical material	425	Textile mills	822	Nonmetallic mineral products	1,036

Source: Ministry of Economic Affairs, Taiwan, approved direct investment.

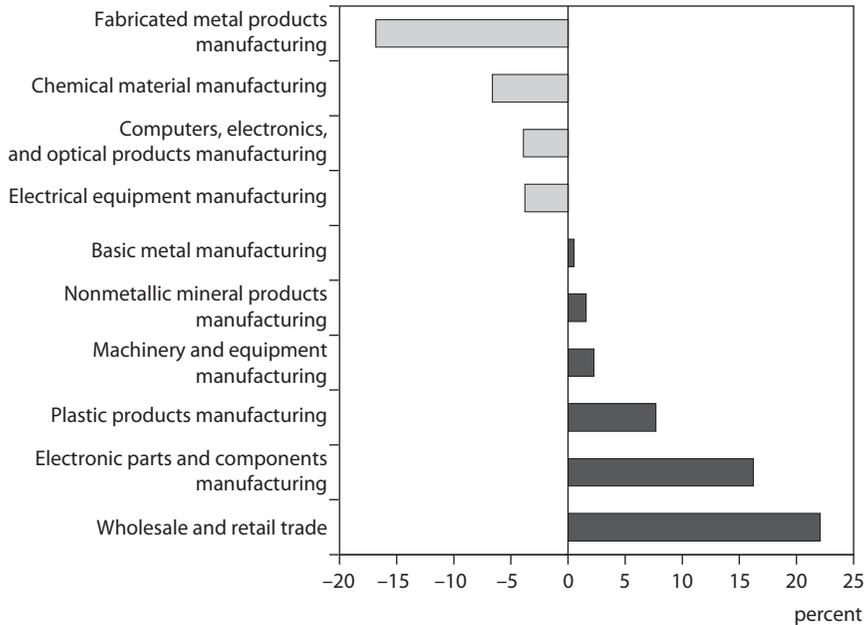
Figure 1.15 Average size of approved Taiwanese foreign direct investment into China, 1991–2009

billions of US dollars



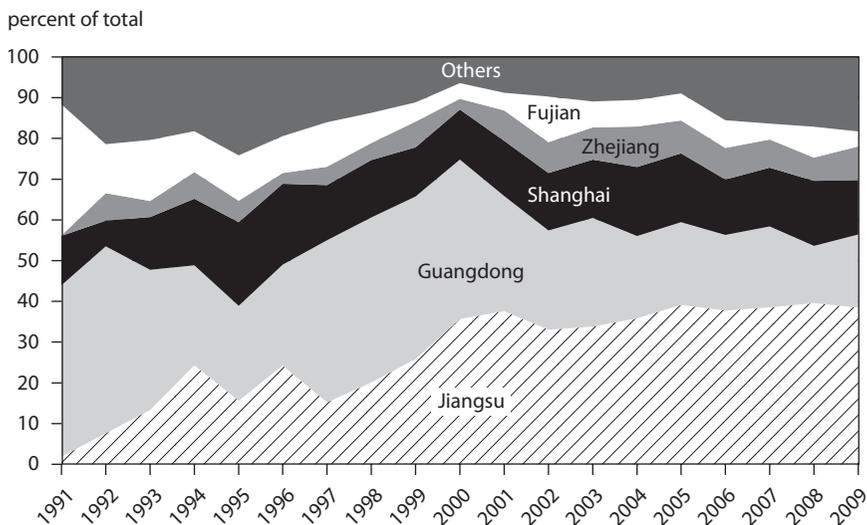
Source: Ministry of Economic Affairs, Taiwan, approved direct investment.

Figure 1.16 Growth of approved Taiwanese outward foreign direct investment into China by industry, 2005–09



Source: Ministry of Economic Affairs, Taiwan, approved outward foreign direct investment.

Figure 1.17 Taiwanese outbound foreign direct investment into China by province, 1991–2009



Source: Ministry of Economic Affairs, Taiwan, approved outbound foreign direct investment.

Figure 1.18 shows the leaders in approved Taiwanese investment to China through 2009 by industry, and within each industry the provincial distribution within China. Jiangsu was the major recipient of FDI in all of the key industries, most importantly electronic parts (43 percent of the total), computer electronics (34 percent), and electrical equipment (43 percent). With manufacturing bases including Kunshan and Suzhou, Jiangsu has a leading role in the computer and electronics clusters. The increasing importance of Shanghai, on the other hand, is related to services sector competence, as shown in figure 1.19. By 2009, Shanghai accounted for 32 percent of Taiwan’s approved investment in wholesale and retail trade in China, 58 percent in financial and insurance services, and 56 percent in scientific and technical services.

Direct Investment from China to Taiwan

Direct investment flows from China to Taiwan are easier to discuss—because so little has been permitted so far. Under Taiwan’s 1992 *Act Governing Relations between Peoples of the Taiwan Area and China Area*, investment from China to Taiwan was treated more prohibitively than outbound investment to China.⁴¹ The treatment of outbound investment

41. Op. cit. footnote 32.

Figure 1.18 Regional breakdown of Taiwanese foreign direct investment to China, top manufacturing sectors, end 2009

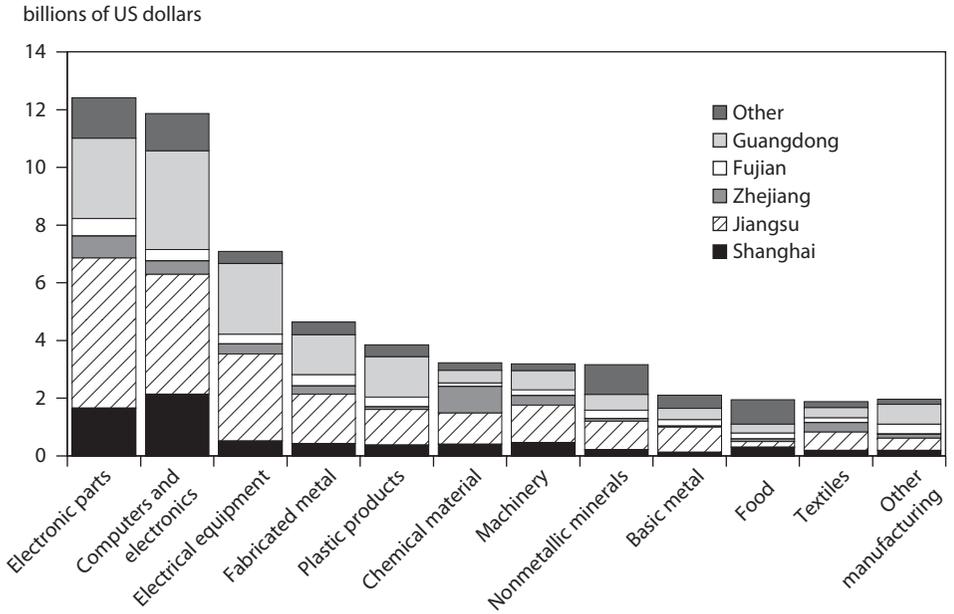
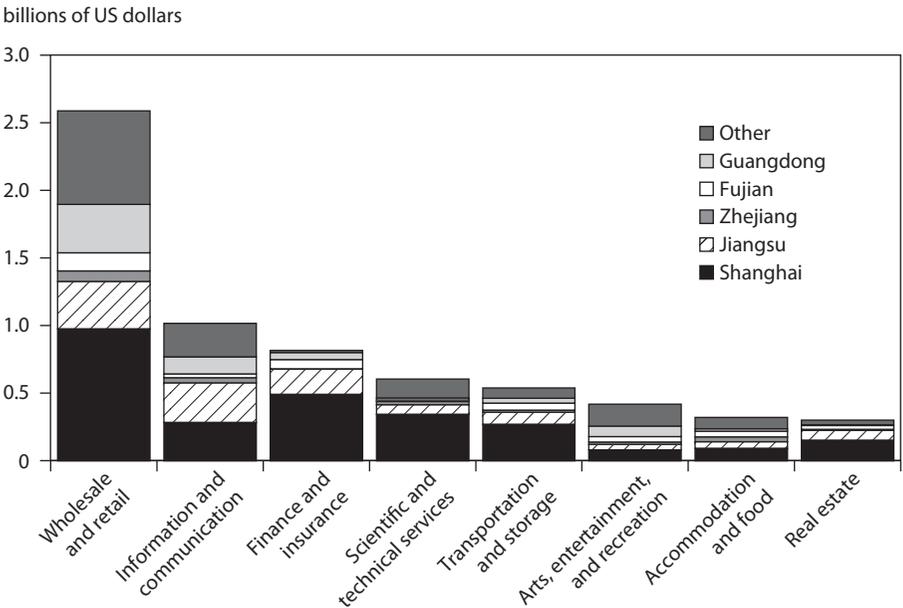


Figure 1.19 Regional breakdown of Taiwanese foreign direct investment to China, top services sectors, end 2009



Source: Ministry of Economic Affairs, Taiwan, approved outbound foreign direct investment.

(Article 35) begins affirmatively: “Any individual, juristic person, organization, or other institution of the Taiwan Area permitted by the Ministry of Economic Affairs may make any investment or have any technology cooperation in [the] China Area,” before restrictions and (somewhat onerous) procedures are elaborated. For inbound investment from China (Article 40–1), the presumption is negative: “Unless permitted by the competent authorities and having established in the Taiwan Area a branch or liaison office, no profit-seeking enterprise of [the] China Area may engage in any business activities in Taiwan.” While Taiwan investment through third parties into China became the common practice and is also acknowledged by regulators, under Article 73 the use of third parties by Chinese firms to invest in Taiwan is explicitly included in the restrictions: “[A]ny individual, juristic person, organization, or other institution of [the] China Area, or any company it invests in [in] any third area may not engage in any investment activity in the Taiwan Area,” unless expressly approved.

This lack of reciprocity imposed little on Beijing in 1992, because China’s outbound FDI at the time was extremely limited and tightly controlled by Beijing administratively. Beijing sought to conserve foreign exchange reserves as a buffer against balance of payments pressures or other eventualities, and a closed capital account and strict licensing to convert renminbi for liquid currencies made it difficult to go abroad. Further, Taiwan was a less interesting target during the 1990s for firms from China that *did* go abroad, which were state-owned giants interested in natural resources.

By 2002 Taiwan had amended its inward FDI regulations to comply with WTO commitments. The revised regulations replaced the blanket China prohibition with allowance in principle for mainland investors to enter real estate and designated services industries, with case-by-case approval by Taiwan authorities.⁴² However, these changes did not lead to a significant increase in FDI from China and only a handful of projects were recorded prior to 2008, mostly in retail and business services.⁴³ In addition to being involved with a low number of direct Chinese greenfield and M&A projects in Taiwan, Taiwanese regulators also were involved in several international M&A transactions in which a Chinese buyer acquired a globally operated firm with assets in Taiwan, such as Lenovo’s acquisition of IBM’s personal computer unit.

With Ma Ying-jeou’s March 2008 election to the presidency in Taiwan the investment picture began to change. Making good on campaign

42. Item 69, *Act Governing Relations between Peoples of the Taiwan Area and China Area* (臺灣地區與大陸地區人民關係條例) (see footnote 32).

43. Summary of cross-border investment transactions between China and Taiwan in the period of 2003 to 2009, derived from subscription databases fDiMarkets (<http://fdimarkets.com>) and Thomson ONE (<http://banker.thomsonib.com>).

pledges to improve cross-strait economic relations, Taiwan reached agreement on expanding charter air services, triggering a wave of investment in Taiwan by China's airlines to set up required business infrastructure. In the summer of 2008, several policies supportive of Chinese investment in Taiwan were announced. In late June limited local currency convertibility for the new Taiwan dollar and the Chinese renminbi at Taiwan banks was announced, and in July cross-strait market access to the securities industry was widened. Additional normalization of transport links was agreed upon in the fall, paving the way for additional direct investment in support of sea transport and delivery services. The biggest development came in June 2009 with an agreement to ease the process for mainland firms to set up branches and offices in Taiwan, opening 192 sectors to Chinese investors—64 in manufacturing, 117 in services, and 11 in infrastructure. A regulatory cap on Chinese investors was raised from 20 percent to 30 percent of ownership.⁴⁴

These changes in Taiwan complemented general outward investment liberalization taking place in China under the rubric of “go global,” as commercial pressures on firms in China to invest abroad rose (Rosen and Hanemann 2009). In May 2009, the MOFCOM issued regulations specifically governing outward FDI to Taiwan, encouraging such investment as long as it did not harm national security interests, which principally meant special scrutiny by Beijing to ensure that investment overtures by Chinese firms did not provoke anxieties in Taiwan and a backlash against momentum for broader cross-strait economic liberalization.⁴⁵

By the second half of 2009, actual investment flows from China to Taiwan confirmed that these changes were concrete and not just a rhetorical false start. Deal-tracking services reflect at least 15 greenfield investment overtures from China to Taiwan from May through December 2009 in the computer (Lenovo), automotive (SAIC), financial services (CMB), civil aviation, and other sectors, as well as a number of acquisition deals. The volume of inward mainland FDI approved by the MOEA spiked from virtually zero to over \$30 million in both December 2009 and January 2010 (figure 1.20). Although these are small numbers (and not all of this “approved” investment will necessarily become “utilized”), this is a major change in the cross-strait context, and now that the “seal is broken” the annual value of China-to-Taiwan investment will likely rise significantly.

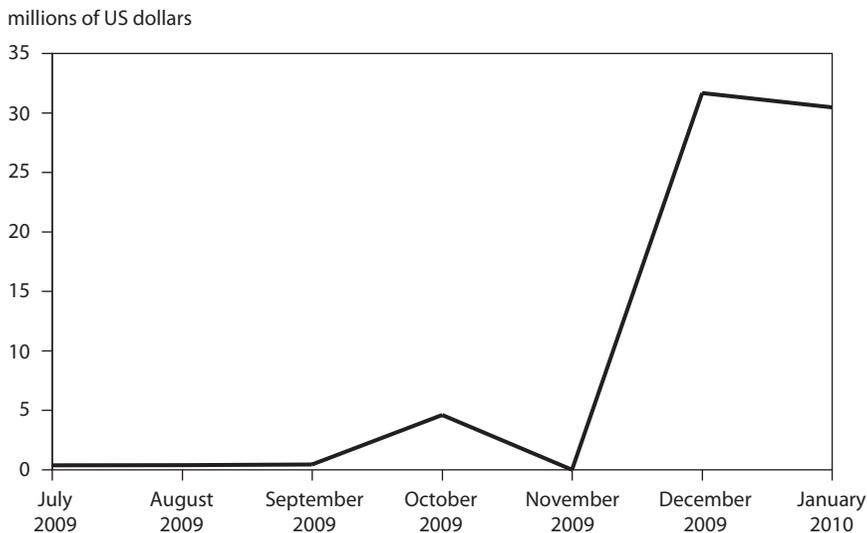
44. “Regulations on Investment Permission for Mainland Investors”

(大陸地區人民來臺投資許可辦法), Ministry of Economic Affairs, Taiwan, June 30, 2009. Earlier drafts intended to raise the percentage to 50 percent. Available at: http://www.moeaic.gov.tw/system_external/ctrl?PRO=LawsLoad&id=64.

45. “Notice on Mainland Enterprise to Invest and Set Up Legal Entity in Taiwan”

(关于大陆企业赴台湾地区投资或设立非企业法人有关事项的通知), Ministry of Commerce, People's Republic of China, May 17, 2009. Available at http://www.china.com.cn/policy/txt/2009-05/17/content_17788032.htm.

Figure 1.20 Approved foreign direct investment from China into Taiwan, monthly values, July 2009–January 2010



Source: Taiwan, Ministry of Economic Affairs Investment Commission.

Given that Taiwan's international investment position recorded total FDI stock of only \$45.5 billion in 2008, with an average annual inflow of \$5 billion over the past five years, China's marginal addition could soon be economically important.

Portfolio Investment

Cross-border portfolio investment flows are an additional element of normal economic exchange. Portfolio investment is ownership of equity or debt securities in pursuit of a financial return, rather than as a manager or owner of a business for its own sake.⁴⁶ Direct cross-holdings of debt and equity securities by China and Taiwan are at an early stage, as both sides have restricted the other's portfolio investment activity until recently. This is changing as a result of the ad hoc steps taken in 2008–09 to liberalize cross-strait economic relations, and direct holdings are likely to increase significantly in the years ahead.

As of end-2008, Taiwan reported global portfolio assets of \$189 billion and liabilities to foreigners of \$111 billion in its international investment

46. According to the OECD's 2008 "Benchmark Definition of Foreign Direct Investment," the line between portfolio and direct investment equity stakes is generally drawn at 10 percent of total shares. Holdings below this threshold are classified as portfolio investment; a "controlling" stake of more than 10 percent is considered as direct investment.

position (IIP).⁴⁷ In 1990–2003, Taiwan used a qualified foreign institutional investor (QFII) system to introduce international capital into domestic financial markets in a conservative manner. After abolishing these QFII constraints in 2003, international capital flowed in more copiously—the stock of \$40 billion doubled in the first year and then doubled again by the end of 2006, topping out at \$208 billion in 2007 before falling by almost half again by the end of crisis year 2008 due to valuation effects and withdrawals. But investment from China was excluded from this flow, and uncertainties about Taiwan’s relations with Beijing tempered investor enthusiasm, since the political risk associated with Taiwanese firms reliant on China-related income streams remained higher than in other economies.

With few exceptions, China still maintains a closed capital account and has taken a cautious approach to embracing portfolio capital flows. By end-2008, China held \$252 billion in portfolio assets abroad and had sold \$161 billion of portfolio liabilities to foreigners. Though these figures are slightly larger than those for Taiwan, the fact that China’s population is 50 times larger and its economy 13 times bigger demonstrates how timid Beijing has been on this front. China studied Taiwan’s use of the QFII system carefully in designing its own window on the otherwise closed capital account for portfolio investors, which it started to open in 2002. By 2006, Beijing permitted limited domestic portfolio investment firms to go out, in the other direction, under a corresponding qualified domestic institutional investor (QDII) program. To this were added licenses for state wealth managers, including the China Investment Corporation (China’s sovereign wealth fund) and the National Social Security Fund, to invest pools of foreign exchange in diversified portfolios abroad, partly to help Beijing deal with its investment challenges regarding foreign exchange reserve management. But as with Taiwan’s outbound flows, China’s new forays in portfolio investment abroad could not flow across the Taiwan Strait until recently.

In June 2008, Taiwan relaxed quotas on Taiwanese fund investment in China’s stock exchanges.⁴⁸ In August 2008, Taiwan started the liberalization of portfolio investment inflows from China, and in December 2008 passed a law that lifted the long-standing ban on investment from China in Taiwan’s securities and futures.⁴⁹ In January 2010, a cross-strait bank-

47. International investment position data from Taiwan’s Central Bank, www.cbc.gov.tw/public/Data/961517174971.pdf (accessed on September 15, 2010).

48. “Modification of Cross-Strait Securities Investment” (調整兩岸證券投資方案), Financial Supervisory Commission, Taiwan Executive Yuan, June 26, 2008. Available at <http://www.mac.gov.tw/ct.asp?xItem=44258&ctNode=5613&mp=1>

49. “Regulations Governing Securities Investment and Futures Trading in Taiwan by Mainland Area Investors” (大陸地區投資人來臺從事證券投資及期貨交易管理辦法), Financial Supervisory Commission, Taiwan Executive Yuan, December 4, 2008. Available at <http://law.moj.gov.tw/LawClass/LawContent.aspx?Pcode=G0400147>

ing, insurance, and securities MOU (signed in November 2009) took effect and Taiwan's Financial Supervisory Commission issued implementing regulations for China's QDIIs to enter Taiwan's financial markets.⁵⁰ In the initial stage the cap on Taiwanese securities market positions for these firms is \$500 million. As of mid-2010, two funds—China AMC and China International Fund Management—have finished the registration processes and are preparing to start trading in Taiwan. While this ceiling is modest and several sectors are off limits, the quotas and coverage are likely to expand in the future. In the meantime, Taiwan is proceeding cautiously. China-controlled stakes are capped at 10 percent for important sectors, including public utilities and natural gas. The limit for shipping services is 8 percent. For the financial industry, the limit for each QDII is 5 percent, and 10 percent for all QDIIs.

Flows of People

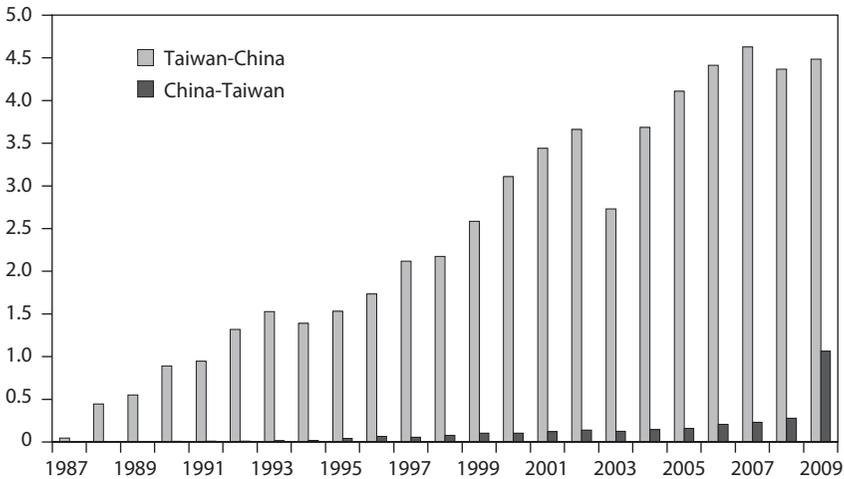
After trade and investment, the third factor that moves between economies in the normal course of exchange is people, and this too has been abnormal in the cross-strait context in the past. The movement of business travelers, expatriates, and tourists ordinarily follows bilateral trade and investment patterns closely. Whereas the number of Taiwanese business travelers and expatriates in China has grown steadily since the late 1980s, the number of visitors from China has been strictly limited by Taiwan. Taiwan's limits on visitation and residency paralleled trade and investment restrictions and reinforced them: for instance, the limited cases of investment opening to China that Taiwan had permitted (in real estate) were effectively nullified by travel prohibitions. The recent opening of Taiwan to investment from China described in the preceding section would be meaningless without relaxation of travel and residency restrictions, and likewise the regularization of transportation links is a prerequisite to meaningful investment flows. The total number of mainlanders traveling to Taiwan for business and tourism is expected to grow significantly and serve as a major source of economic growth for Taiwan.⁵¹

50. He Qian Xu, "MOU Took Effect and Mainland Investor Entered Taiwan" (MOU生效 陆资登台上路), *Caing News*, January 18, 2010. <http://overseas.caing.com/2010-01-18/100109188.html> (accessed on September 15, 2010).

51. The economic significance of Chinese tourists traveling to Taiwan is so great in fact that Beijing has used the threat of calling off tour groups to Taiwanese cities that lean toward the opposition Democratic Progressive Party as a tool of statecraft to punish perceived provocations. See Romberg (2009, 1–2). Such targeted commercial sanctions are precisely the kind of political pressure that skeptics of economic deepening in Taiwan are worried about.

Figure 1.21 Number of annual cross-strait visitors, 1987–2009

million individual entries



Source: Taiwan Affairs Office of the State Council.

Business Travel and Tourism⁵²

Figure 1.21 illustrates that the cross-strait flow of visitors has been asymmetric: visits by Taiwanese citizens to China grew from fewer than 1 million entries annually in 1990 to more than 4.5 million in 2007. This increase was largely driven by Taiwanese businessmen traveling temporarily to set up and manage production facilities, and mirrored the phases of economic engagement described above. The two-decade uptick correlates with flows of goods and investment from Taiwan to China. Temporary dips occurred in 2003 as a result of the SARS epidemic and in 2008 as a result of the global financial crisis, but otherwise the growth in the number of Taiwanese citizens traveling to China has been nearly constant.

Travel by Chinese citizens to Taiwan has remained limited to date, though it increased from trivial numbers in the late 1990s to about 250,000 in 2008, as both business and tourist travel were opened slightly. In 1995, Taiwan started allowing group business visits for attending exhibitions and trade shows. As of 2005 individual business visits were permitted, and Taiwanese firms can now issue invitations to Chinese businesses for stays of less than three months.⁵³ In 2002, Taiwan initiated group tourist

52. Tourism as an industry was reflected in the services trade discussion; here we are interested in openness to the movement of people for whatever reason.

53. "Regulations on Mainland Business Visitors in Taiwan"

(大陸地區人民來臺從事商務活動許可辦法), Ministry of the Interior, Taiwan, February 1, 2005. Available at http://law.moj.gov.tw/LawClass/Law_Content.aspx?pcode=D0080144

visas, and since 2008 individual tourist visas have been permitted.⁵⁴ This new visa policy along with relaxation of rules for passenger traffic across the strait has led to an explosion of visitors: in 2009, the number quadrupled compared to previous years and surpassed the 1 million mark for the first time (figure 1.21).

As with trade and investment, the cross-strait flow of people was distorted by Taiwan's prohibition on direct transportation links. After 1949, passenger travel between Taiwan and China was prohibited, necessitating transit through Hong Kong or other entrepôts, despite the reality of rising trade and investment over the past two decades. Indirect charter flights for holidays and other special events were permitted as of 2003, and in July 2008 direct flights between the mainland and Taiwan were allowed on weekends. In November 2008 and April 2009, the two sides signed new air transportation agreements to normalize flight traffic and allow direct daily flights.⁵⁵

Labor and Permanent Residency

While initially the cross-border flow of people from Taiwan to China was mostly short-term business visits, direct employment and residence of Taiwanese professionals in China became important by the late 1990s. With the increasing integration of China into Taiwan-driven production chains there was urgency to position skilled Taiwan professionals as expatriates in China, especially in the information and communication technology industry and other export-processing sectors. Key skills were in short supply in China at the time, and the mainland suffered from a brain drain of specialists. There are no official statistics available on how many Taiwanese citizens currently live and work in China, but unofficial estimates range from 400,000 to more than 1 million.⁵⁶

While Taiwanese expatriates were mostly able to live and work in China, Taiwan's *Act Governing Relations between Peoples of the Taiwan Area*

54. "Regulations on Mainland Tourists in Taiwan" (大陸地區人民來臺從事觀光活動許可辦法), Ministry of the Interior, Taiwan, January 1, 2002; "Agreement on Mainland Tourists in Taiwan" (海峽兩岸關於大陸居民赴臺灣旅遊協議), Association for Relations across the Taiwan Strait, June 13, 2008. Available at <http://law.moj.gov.tw/LawClass/LawContent.aspx?pcode=D0080141>.

55. "Cross-Strait Air Transport Agreement" (海峽兩岸空運協議), Association for Relations across the Taiwan Strait, November 4, 2008. Available at <http://law.moj.gov.tw/LawClass/LawContent.aspx?PCODE=Q0070009>; "Supplement to Cross-Strait Air Transport Agreement" (海峽兩岸空運協議補充協議), Association for Relations across the Taiwan Strait, April 2009. Available at <http://www.mac.gov.tw/public/Data/04269514771.pdf>.

56. Media and even government officials from both sides often refer to an estimated 1 million Taiwanese citizens—or 5 percent of the total population—that currently live and work in China. But to our knowledge there is no statistical evidence that confirms this number.

and China Area in 1992 restricted employment of mainland Chinese in Taiwan, with partial exceptions for spouses and short-term workers in a limited range of industries. According to Taiwanese immigration data, around 300,000 mainland Chinese were granted residency by end-2009, which compares to around 400,000 nonmainland foreign residents.⁵⁷ Whereas more than 80 percent of those non-Chinese foreign residents are allowed to work—among them many blue-collar workers from Southeast Asian countries—those from China with permanent residency in Taiwan are not. The great majority of them—160,000 by end-2009 according to official statistics—are women married to Taiwanese men. Until recently, spouses from China were permitted to work only if they married into low-income families or in other cases of “special needs.”⁵⁸

In 1998, Taiwan introduced permits for professionals from China with special skills to apply for work visas, but the number issued under the program has remained minimal.⁵⁹ These rules were expanded in January 2002 to allow information technology professionals from China to apply for short- and long-term work visas in research and development and technical cooperation to overcome an acute shortage of talent in these fields. However, the number of workers under this program has remained very small as well: about 3,500 short-term visas had been issued by 2008, and the annual number of long-term visas has never exceeded 30. Since 2003, multinational corporations with large operations in Taiwan have been permitted to internally transfer employees from China to work in Taiwan for up to three years. In 2003–08, around 3,400 employees were transferred under this allowance.⁶⁰

In his first year in office, President Ma submitted amendments to normalize work opportunities for mainland-born spouses and to permit greater latitude for Chinese students to live and study in Taiwan. Despite

57. Data from Taiwan National Immigration Agency. www.immigration.gov.tw/aspcode/info9811.asp (accessed on September 15, 2010); and www.immigration.gov.tw/immigration/FileSystem/Statistics/05%20Foreign%20990407.xls.

58. *Act Governing Relations between Peoples of the Taiwan Area and China Area* (臺灣地區與大陸地區人民關係條例) (see footnote 32), before the July 2009 revision.

59. “Rules Governing Permits for Professional Personnel from Mainland China Engaging in Professional Activities in Taiwan” (大陸地區專業人士來臺從事專業活動許可辦法), Ministry of the Interior, Taiwan, June 19, 1998 (first version for Chinese professionals with special skills). Available at <http://law.moj.gov.tw/LawClass/LawContent.aspx?pcode=Q0020006>

60. “Regulations on Inviting Mainland Employees to Work in Taiwan by Multinational Companies with Large-scale Business in Taiwan’s Free Trade Zone” (在台灣自由貿易區內營業達一定規模之跨國企業邀請大陸地區雇員來台從事商務活動的許可辦法), (Ministry of the Interior, Taiwan, May 16, 2003. Available at <http://www.immigration.gov.tw/aspcode/searchmenu.asp?directoryid=910>; “Regulations on Internal Transfer of Mainland Employees in Multinational Enterprises” (跨國企業內部調動之大陸地區人民申請來臺服務許可辦法), revised on August 20, 2007. Available at <http://law.moj.gov.tw/LawClass/LawContent.aspx?pcode=Q0040007>.

controversy, this revision to Article 17 of the act passed the legislature on June 9, 2009.⁶¹ Yet the issue of labor pressure from China remains a political lightning rod in Taiwan, and most parties still compete with one another to be more populist in promising to shield Taiwan from labor pressures originating across the strait.

Conclusions

This chapter has described the existing trade and economic relationship between China and Taiwan in order to set the stage for analyzing the implications of deepening that relationship. Before turning to that analysis in the following chapters, we can form a number of conclusions about the status quo in cross-strait economic relations that are useful in thinking about the future.

First, there is no economic status quo in this relationship either for China-Taiwan economic relations narrowly or for the regional or global context surrounding them. Whereas in the political context maintaining the status quo is the mainstay of agreement between Beijing, Taipei, and Washington, in the economic sphere everything is constantly changing and there is no status quo. It is common to hear people talk about economic change in cross-strait affairs as though it were an option to be embraced or rejected. That is an illusion. In terms of trade flows, direct investment and portfolio investment, and flows of people, cross-strait economic fundamentals are changing profoundly every day. In terms of Taiwan's export dependence on China, and final consumption in China as a share of those exports, the fundamentals are changing as well. The gap in technological capabilities between Taiwan and China is narrowing rapidly. Polls on public sentiment regarding economic interests and the importance of transcending past tensions also demonstrate significant changes.

The changes are just as stark in the multilateral context surrounding the cross-strait relationship. Economic agreements between China and most other economies in Asia are altering the relative costs of trade barriers between China and Taiwan. The ASEAN-China FTA has lowered China's tariffs to below MFN levels, and a host of other agreements are also altering tariff and nontariff barrier conditions. Value chains knit through Asia and across the Pacific are constantly reconfigured to reflect changing efficiencies and political risk realities, as long-standing political resistance to economic integration with China at the hub give way to the logic and durability of China's economic rise. The bottom line is that standing still is not an option, and much of what is being debated in cross-strait integration negotiations is already happening.

61. Article 17 states that "Any person who is permitted to have a spouse residency or long-term residency in the Taiwan Area in accordance with the provisions of Paragraphs 1, 3 or 4 of the preceding Article may work in the Taiwan Area during the residency period."

Second, the trend of growing economic gains in Taiwan from its relationship with emerging China, while impressive, leaves mounting concerns about the risks to Taiwan's prosperity from incomplete normalization with China. The existing and future disparities for Taiwan in economic relations with China are a serious concern in terms of economic outlook. Chapter 2 models and projects the implications of these disparities compared to scenarios in which they are resolved. But even before undertaking that formal exercise we can state that the existing relationship has given rise to doubts about Taiwan's economic development prospects and strategy. In trade, investment, and people flows, Taiwan is becoming more dependent on China, not less, and the absence of normalized economic interaction therefore presents a greater risk going forward. Taiwan's strategy to be a well-regulated gateway to continental China stalled due to ambiguities about its economic integration and tensions over political risk that could erode the value of operations in Taiwan in the future.

Third, neither the quantity nor the quality of Taiwan's future economic relations with China can be assured through evolutionary and cyclical ad hoc processes, even though, per the first point above, much is changing in the cross-strait economic relationship in that very fashion. These processes as we have known them are inherently cyclical because they start and stop with election cycles in Taiwan and leadership cycles in China, and are affected by election cycles in the United States as well. The ad hoc approach has been dribbling forth for almost two decades already, and yet cross-strait opening has been surpassed by shorter-lived plurilateral undertakings. Chapter 2 will define in more detail the forward agenda for more comprehensive normalization and liberalization of China-Taiwan economic relations, but based on just assessing the relationship to date one can surmise that the "occasionalism" that has characterized the approach to date is not sufficient to maintain a cross-strait relationship that is win-win over the long term.

Fourth, most of the adjustments needed to deepen cross-strait economic relations will have to come from Taiwan's side, though the corollary is that Taiwan stands therefore to reap more of the economic benefits. Our discussion of the structure of current relations has shown that China is largely in compliance with MFN-level WTO obligations to Taiwan, while Taiwan unilaterally imposes a broad range of barriers to trade in goods and services uniquely on China. These barriers need to be dismantled in order to normalize the relationship. Similarly, China is wide open to Taiwanese investment, which represents the largest single source of FDI in China, but Taiwan until recently has been almost entirely off limits to investment from China. This too will need to change in the course of deepening.

The chapters that follow will model the likely results of dismantling these barriers. But trade theory and experience make it clear why the work of liberalization and its subsequent benefits will fall disproportionately to Taiwan. Because Taiwan is largely WTO-compliant with practically every other member of the world trading community, its China-

specific barriers have not so much protected Taiwanese business as marginally raised the costs to them, as well as to Taiwan's consumers. Our modeling in the following chapters confirms that Taiwan will gain from dismantling these barriers, not from increased net exports but from the domestic welfare benefits of increased imports and the structural adjustment and dynamic effects that follow.

Fifth, while many of the residual distortions in China-Taiwan economic relations ultimately are economic in nature, they are maintained by Taiwan ostensibly for national security reasons. Some of these—like limits on foreign control of public utilities—are typical in most other economies and are likely to remain. But many are not security oriented or have long since ceased to play a clear security role. The United States has debated for decades whether “national economic security” should stand along “national security” as a justification for blocking foreign investment and has consistently decided that the answer is no. The most important reason for that stance is that admitting national economic security as a basis for selectively excluding foreign investment and trade, especially in a democracy, is an open invitation to constant demands for protectionism by special interests that elected officials will find nearly impossible to repel. In the case at hand, China's behavior has already shown that for a small economy like Taiwan, national economic security can be a real concern, and a real source of vulnerability. Taiwan will need a filter to separate legitimate economic security concerns that could undermine the island's interests from special interests masquerading as security concerns.

Admitting that national economic security concerns are legitimate does not answer the question of whether defensive, protectionist measures are really a more effective response than proactive engagement and economic deepening. Not only can protectionist barriers masquerading as security fail to enhance national security, they can diminish it by threatening Taiwan's long-term competitiveness and economic success. However sympathetic one is to Taiwan's security imperative, one can just as easily argue that the island's security concerns are too important to be commingled in a stew of mixed, largely self-interested commercial motives.

Sixth, cross-strait opening is not a recipe for Taiwan's competitiveness but just a step to prevent the erosion of existing strengths. After all, by deepening economic relations, Taiwan is simply matching what its ASEAN and other regional competitors have done. Taiwan has done well despite cross-strait abnormalities for two reasons. First, China has tolerated the asymmetry. But second, Taiwan has produced comparative advantage in high-tech industries, which has paid the bills. The converse to this is that while optimizing cross-strait economic relations will support Taiwan's welfare, it is no more of sole importance on the upside than it was a detriment in the past. Improving cross-strait economic relations only provides a level playing field; what Taiwan does on that playing field to generate value is the

hard question, and is largely separate from discussions between Taiwan and Beijing.

China's comparative advantage is relatively easy to ensure: low-cost labor, economies of scale and scope, and substantial room to improve the country's still-widespread relative impoverishment will propel China at high GDP growth for the next decade and beyond.⁶² For Taiwan, comparative advantage can flow only from a highly sophisticated interaction of excellence in government policy and regulation, creativity and innovation by a highly educated population, and savvy risk taking in the corporate sector. While the unresolved risks to cross-strait trade and investment could diminish the likelihood that the highly mobile factors of high-skilled professionals and corporate capital will stay put and take their risks in Taiwan, resolving those risks (even perfectly, which is not in the cards) is just the first step to sufficiently reinvigorate the business environment and incentive structure in Taiwan to compete with the likes of Shanghai, Hong Kong, Tokyo, Osaka, and Singapore.

This conclusion draws only from our review of extant cross-strait conditions—it does not summarize the overall findings of this study. In particular, conclusions related to other parties, including the United States and the rest of Asia, as well as to regional trade dynamics, must await the forward-looking analysis in the following two chapters. We now turn to that analysis, defining and exploring the implications of cross-strait deepening for China and Taiwan in chapter 2, and extending that to an analysis of regional considerations in chapter 3.

62. We do not mean to be blithe: obviously, the disruption and adjustment that are a daily matter of course in China impose a grueling price on hundreds of millions of less well-off Chinese—the vast bulk of the population—whose fortunes are not secured. The challenges of policymaking in a transitional, unique economic context are epic, and the risks of social and political unrest are acute. Our point is that in growth accounting terms, the components needed to sustain growth are not in short supply.

