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Warm Economic Ties; Cool Political Relations

Prospects for Cross-Strait Economic Integration after SARS and WTO

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Taiwan firms have pushed into the China market over the past 20 years despite government restrictions and political tensions. Restrictions have slowed the process of exchange and rendered transactions relatively inefficient, and yet capital, goods, and knowhow have continued to move across the Strait. Entrepreneurs have incorporated in Hong Kong or increasingly free ports like the Cayman Islands and British Virgin Islands in order to bypass the rules. In some cases, major investments are phased in over time to avoid restrictions. Trade via Hong Kong and creative transits via Japanese offshore islands have allowed trade to expand significantly across the Strait, even in the absence of direct links.

In assessing recent economic integration trends, it is important to distinguish between major factors that are ultimately driving integration from minor ones that may grab headlines while influencing developments only at the margins. Major drivers of integration include the business climate in China, the level of regional and global openness to cross-border trade and investment, and the complementary nature of the Taiwan and PRC economies. Minor influences include political rhetoric and positioning, as well as policies on direct trade and investment that influence the speed and efficiency of transactions, but do not prevent them via indirect channels. Between these two extremes, other factors involve policies that permit trade and investment in newly opened sectors such as services, and the flow of goods, people, and capital from the PRC into Taiwan, which has been more restricted.

Relocation to China has made sense as costs of manufacturing have risen in Taiwan. Taiwan's ability to provide capital, middle-range technology, and managerial expertise fits well with the PRC's lower-cost environment and need for capital. Geographic proximity, cultural affinity, and a common language have further facilitated contact. New market openings in China are also creating incentives for increased trade and investment as Taiwan firms position themselves for a piece of the domestic market. Growing Taiwan investment in the PRC and trade across the Strait is part of the wider dynamic of East Asian liberalization and globalization. Competition intensified significantly in East Asia in the 1990s with the quadrupling of foreign direct investment (FDI) into the region, further liberalization of trade and investment barriers, and the subsequent cross-border specialization occurring in the region, as evidenced by the rapid growth in the trade of intermediate goods. China has been central to this process because of its abilities to attract inward FDI and to lower its trade barriers, becoming not only the largest export market for Taiwan, but also for Japan and South Korea.

Integration to Date

The bulk of cross-Strait trade continues to be processing-related; most trade still supports the export of final product to key global markets such as the United States. Trade remains weighted in favor of goods and capital flowing from Taiwan to the PRC, but with WTO-mandated tariff and trade barrier reductions, 2002 witnessed a 32 percent jump in PRC exports to Taiwan, followed by a further jump of 46 percent in the first quarter of 2003 (see chart on page 6). Many analysts expect this gap to close over the next few years as other trade restrictions are liberalized. Top trade products include machinery and mechanical appliances and parts, electrical machinery and parts, chemicals, plastics, base metals (especially iron, steel, and copper), and textiles.

Taiwan investment in the PRC has followed the traditional "boom-and-bust" business cycles in China, and Taiwan's share of total foreign investment in the PRC has remained fairly constant. Investment contracted in the late 1980s and then rose to all time highs in the early 1990s. Investment contracted again in the late 1990s following the Asian financial crisis and general slowdown in China. Since 2000, investment contracted by Taiwan firms in the PRC has been growing in tandem with the overall rise in investment as the business climate has improved. By the end of 2002, Taiwan had committed a total stock of $55.5 billion in investment in the PRC, according to PRC statistics. Contracted investment may actually be as high as $100 billion, taking into account investment by Taiwan firms via offshore companies in Hong Kong and the free ports, which is not typically calculated as Taiwan investment in either PRC or Taiwan statistics. When these indirect investments are included, an estimated 50 percent of Taiwan's outbound FDI is now invested in the PRC. Despite the concentration of Taiwan's outward FDI in China, it represents a very small percentage of total investment in Taiwan. Since the mid-1990s, Taiwanese firms have expanded from low-value manufacturing investment in metals, minerals, textiles, footwear, and toys to new ventures in electronics and information technology (IT) components, medical equipment, food and beverage processing, petrochemicals and plastics, and retail. Financial services firms are now positioning for entry.

There were important areas of progress in 2002 and 2003 despite the Taiwan government's increasing caution on commercial cooperation due to the growing reliance of Taiwan firms on the PRC market. In addition to the growth in cross-Strait trade and investment discussed earlier, Beijing and Taipei successfully arranged six flights to transport passengers from the PRC to Taiwan to celebrate the Chinese New Year in February 2003, and then negotiated to allow Taiwan carriers to fly across China's airspace during the Iraq War. The governments approved China Airlines' investment in China Eastern's air cargo operations, as well as a joint oil exploration plan for China National Offshore Oil Corporation (CNOOC) and China Petroleum Corporation. New regulations permit Taiwan business associations in the PRC to follow long-term cooperation between the China Council for the Promotion of International Trade (CCPIT) and the China External Trade

Development Council (CETRA), paving the way for both organizations to look toward formally opening offices in Taiwan and the PRC respectively.

SARS and the Taiwan Election

The SARS epidemic generated real concern, but also allowed the Chen administration to divert attention from the failure to realize its 2000 campaign promise to establish direct links. SARS created a brief, but real, crisis of confidence in both the PRC and Taiwan. Service and transportation industries were especially hard hit. As for the longer-term impact, the key variables influencing business decisions appeared to be uncertainty and the risk of delay (i.e. the risk of quarantine for travelers). Both sides appear much better situated to handle a future outbreak and, provided the situation remains relatively stable, can expect to recover investment confidence. At the margins however, there will likely be increased attention to due diligence, risk management, and the uncertainties of locating businesses in parts of China's interior that are far from quality health care for principals and families.

At the height of the epidemic, Taiwan officials closed down the mini-links for direct travel and trade via Taiwan's outer islands. The move was a quick response to contain the disease, but given the small volume, it also provided an important symbolic opportunity to distance Taiwan from the PRC. In light of other political rhetoric at the time, such a move appeared to be part of a larger strategy to detract from Taiwan's own bungled handling of the outbreak by drawing attention to the PRC's initial reckless handling of the disease. It also played up the dangers of contact and helped to de-emphasize direct links as a priority as other issues took precedence. Chen could also plausibly blame the PRC for the failure to realize direct links, diluting the prominence of failing to move forward on ties as a campaign issue. China is likely to back off in turn, given that realization of direct links is much more of a priority for firms in Taiwan as they try to increase efficiencies.

The upcoming presidential election campaign in Taiwan makes any bold policy shifts difficult until after May 2004. The Chen Administration's need to play to its independence minded base with the announcement of an effective KMT-PFP alliance, combined with shifting public opinion to go slowly with Beijing, has moderated the need to move forward on cross-Strait integration. Over the longer term, however, the issue will remain and rear its head again. The China-Hong Kong Closer Economic Cooperation Agreement announced in late June 2003 promises reduced tariffs and preferential access in services for "Hong Kong firms." While terms are still being interpreted, these new policies appear to offer incentives to trade and invest via Hong Kong that could create further pressure on the Taiwan government to negotiate direct links as well as preferential treatment for Taiwan firms in order to retain competitiveness.

WTO: Economics and Politics

The greatest value of WTO membership for the PRC and Taiwan is economic. Commitments made by both PRC and Taiwan have set them on a path of further liberalization in relation to each other as well as to the rest of the global trading community. Falling tariffs and non-tariff barriers and new openings in services (logistics, telecom, financial services, retail), especially in the PRC, offer new opportunities for further commercial exchange across the Strait. Tariffs for products covered under the Information Technology Agreement (ITA) fall to zero over a five-year schedule, further facilitating trade.

In services, Taiwan firms may face obstacles in the large capital contributions new PRC legislation requires for firms to incorporate and expand in banking, insurance, telecommunications, and potentially distribution services. Taiwan also still faces overall problems with liberalization of its market and how to handle applications of PRC firms.

The ongoing cat and mouse game between Beijing and Taipei regarding Taiwan's official position continues to play out in international fora. Taiwan's efforts to politicize its WTO seat and move for a WHO seat, and to change the name of the Taiwan passport to read "Taiwan" under the "Republic of China" have created tensions that have distracted attention from the real issues at hand regarding responsibilities of both the PRC and Taiwan to implement WTO commitments, contribute to the Doha Round, and prepare their health systems for a possible resurgence of SARS this fall and winter. From press accounts, senior staff in the WTO and the WHO have consumed a fair amount of time navigating the politics between the two sides.

The most important factors to watch will be how effectively the PRC and Taiwan implement their WTO commitments, how both parties participate in the Doha round, and how apparently growing protectionist forces both in the United States and Asia affect cross-Strait trade. Trade pressure in Northeast Asia has been growing as evidenced by the rise in antidumping actions brought by Asian firms against Asian firms over the past two years. Issues may also arise with regard to reciprocity if PRC firms are not granted the same access in Taiwan as Taiwan firms enjoy in the PRC or vice versa; witness the strong emotional reaction in Taiwan's Legislative Yuan during the recent cross-Strait beer spat.

Most of the arguments supporting a U.S.-Taiwan Free Trade Agreement (FTA) are framed in political terms. There is real concern that the effects of a U.S.-Taiwan FTA could be more trade-distorting than enhancing due to the integration currently underway across the Strait. Negotiating an FTA before Taiwan has even cut its teeth on the WTO could very well divert attention away from Taiwan's implementation of its existing commitments.

Ultimately, commercial interests will drive integration. As much as public and policy attention tends to get wrapped up in political concerns, the core issues for Taiwan firms in the period ahead will be how to tie themselves effectively to the growth of China both as a base for manufacturing and, more importantly, as a growing market for their products and services. Despite increased rhetoric that is likely to continue through the Taiwan presidential election campaign, Taiwan firms, like their counterparts, in other markets will continue to pursue opportunities in the China market. China will set the tone on future cross-Strait commercial trends as far as the types of openings and conditions it offers and as firms assess these risks and opportunities on a commercial basis. At the margins, Taiwan will set the tone on government-to-government cooperation and the extent to which business transactions are direct.

This paper reflects the personal views of the author. It does not reflect an expression of views by the U.S.-China Business Council or the Atlantic Council of the United States. Presented to a Cross-Strait Seminar at the Atlantic Council on June 18, 2003.

Taiwan's Direct Investment in the PRC, 1989–2002

Year	*Number of Projects*			*Contracted Investment ($ million)*			*Utilized Investment ($ million)*		
	Taiwan	*Total PRC*	*% Share*	*Taiwan*	*Total PRC*	*% Share*	*Taiwan*	*Total PRC*	*% Share*
1989	539	5,779	9.33	431.69	5,599.76	7.71	154.79	3,392.57	4.56
1990	1,103	7,273	15.17	889.97	6,596.11	13.49	222.40	3,487.11	6.38
1991	1,735	12,978	13.37	1,388.52	11,976.82	11.59	466.41	4,366.34	10.68
1992	6,430	48,764	13.19	5,543.35	58,123.51	9.54	1,050.50	11,007.51	9.54
1993	10,948	83,437	13.12	9,964.87	111,435.66	8.94	3,138.59	27,514.95	11.41
1994	6,247	47,549	13.14	5,394.88	82,679.77	6.53	3,391.04	33,766.50	10.04
1995	4,847	37,011	13.01	5,849.07	91,281.53	6.41	3,161.55	37,520.53	8.43
1996	3,184	24,556	12.97	5,140.98	73,276.42	7.02	3,474.84	41,725.52	8.33
1997	3,014	21,001	14.35	2,814.49	51,003.53	5.52	3,289.39	45,257.04	7.27
1998	2,970	19,799	15.00	2,981.68	52,102.05	5.72	2,915.21	45,462.75	6.41
1999	2,499	16,918	14.77	3,374.44	41,223.02	8.19	2,598.70	40,318.71	6.45
2000	3,108	22,347	13.91	4,041.89	62,379.52	6.48	2,296.28	40,714.81	5.64
2001	4,214	26,140	16.12	6,914.19	69,194.55	9.99	2,979.94	46,877.59	6.36
2002	4,853	34,171	14.20	6,740.84	82,768.33	8.14	3,970.64	52,742.86	7.53

SOURCE: PRC, Ministry of Commerce

Cross-Strait Trade, 1990–2002

Year	*Total ($ million)*	*Total % Change*	*PRC Imports from Taiwan ($ million)*	*PRC Imports% Change*	*PRC Exports to Taiwan ($ million)*	*PRC Exports % Change*
1990	2,574.0		2,254.3	21.4	319.7	241.9
1991	4,233.0	64.5	3,369.0	61.3	594.8	86.0
1992	6,578.1	55.4	5,880.1	61.6	698.0	17.3
1993	14,934.8	119.4	12,933.1	120.4	1,461.8	110.7
1994	16,327.0	13.4	14,084.8	8.9	2,242.2	53.3
1995	17,882.0	9.5	14,783.9	4.9	3,098.1	38.1
1996	18,984.9	6.1	16,182.2	9.4	2,802.7	-9.5
1997	19,838.2	4.5	16,441.7	1.6	3,396.5	21.2
1998	20,499.2	3.3	16,629.6	1.1	3,869.6	13.9
1999	23,478.6	14.5	19,528.5	17.4	3,950.1	2.1
2000	30,533.3	30.1	25,493.7	30.6	5,039.6	27.6
2001	32,339.7	5.9	27,339.4	7.2	5,000.2	- 0.8
2002	44,649.0	38.1	38,063.1	39.2	6,585.9	31.7
Jan-April 2002	12,627.1		10,823.8		1,803.3	
Jan-April 2003	16,916.7	34.0	14,286.3	32.0	2,630.4	45.9

Source: PRC Customs