



Taiwan's New Economic Reality

by Brad Glosserman

In recent weeks, Taiwan has taken two steps to prepare for the transformation of its economy. Taipei's decision to lift many of the restrictions on investment in the mainland and the island's entry into the World Trade Organization will produce fundamental shifts in the way Taiwan conducts its business. The results will modernize the Taiwanese economy; they could trigger political shifts as well.

The process was set in motion last summer when a high-profile 120-member economic council called for the aggressive expansion of commercial ties with the mainland. Traditionally, the Taiwanese government has imposed limits on direct investment in China; currently, any project over \$50 million requires government approval. Those restrictions were adopted to prevent Taiwan from succumbing to the allure of cheap labor in China and becoming overly dependent on the Chinese market; that would have given the Beijing government leverage over decision making in Taipei. The policy enjoyed limited success: It prevented some investments, but many Taiwanese companies merely set up offices in third countries and routed funds through them. As a result, Taiwanese companies have officially invested about \$60 billion in the mainland; unofficial estimates put the total at two to three times that amount.

Most people in Taiwan were content to live with that fiction. But the worst economic crisis in the island's postwar history - Taiwan is poised to experience its first decline in GNP since the Nationalists fled the mainland in 1949 - and general elections to be held in December forced President Chen Shui-bian to take radical steps, such as convening the advisory council. He quickly endorsed the group's conclusions and his government turned them into law a few weeks ago. (Some restrictions on Taiwanese investment remain; details of their implementation have yet to be worked out.)

The second step occurred earlier this month when Taiwan joined the WTO. That too fundamentally changes the economic calculus in Taiwan. Membership in the organization requires both governments to extend "most favored nation" (MFN) status to the other. (WTO rules allow members to withhold MFN status in certain circumstances, but neither government has hinted it will do that.) The decision to lift investment restrictions is seen by some as anticipating the new relationship created by WTO membership. But it could go farther: It also puts increasing pressure on Taiwan to lift the ban on "the three links" that limits direct contacts between Taiwan and China.

While Taiwan's business community has applauded the two moves (and has been instrumental in pushing for the removal of the investment restrictions), others warn that the island could be smothered in the mainland's embrace. The Taipei Times

editorialized that the government was "walking into China's trap." At a recent conference in Washington, D.C.*, Taiwanese officials conceded that overdependence on China rendered the island vulnerable and decreased its options. But Chen Po-chih of the Council for Economic Planning and Development of the Executive Yuan argued that Taiwanese businesses would be forced to become more competitive and adopt new strategies, both of which should insulate Taiwan from Chinese pressure.

"Taiwanese businesses focus too much on China," said Chen. "Our strategy is to alert them to other possibilities in the world and to get them to take advantage of globalization. We need to increase regional cooperation with other countries."

The changes being wrought in China will facilitate that process. The rising competitiveness of mainland companies - aided, ironically, by Taiwanese investment - will force Taiwan's industries to retool, retrench, and refocus on their comparative advantage. WTO rules will limit the support that Taipei can offer declining, or "sunset," industries, and the government is under increasing pressure to end the price-keeping operations that allowed it to intervene in the stock market.

"Taiwan needs more flexible policy, in particular in regard to land use and labor laws," explained Sherman Katz, the William M. Scholl chair in international business at CSIS. Katz warned that Taipei needs to expand its social safety net and suggested that the government focus on worker adjustment assistance.

China's entry into the WTO will also have an impact on Taiwan. Taiwanese businesses have relied on culture and connections to facilitate their work on the mainland. There has been a presumption that shared backgrounds and a common language would give Taiwanese investment an advantage over the competition. (The validity of that assumption is open to question, but Taiwan has become the fourth largest source of foreign direct investment in China despite the official restrictions.) Joining the WTO will erase that advantage. WTO rules will force mainland officials to increase transparency in their decision making and should help level the playing field for investments.

"Taiwanese businesses don't appreciate the extent of these changes," warned Chen. "Their advantage has been the ability to exploit guanxi (connections) and that is decreasing." Taiwan's businesses need to open their eyes to other opportunities in the region. Casting a wider net will decrease the island's reliance on the mainland and buy good will. The government could encourage this with tax or other investment incentives, and the prospect of investment or technical assistance. As China attracts more investments, funds destined for other regional economies are diminishing. Those governments are eager for other sources of capital and Taiwan has both the money and the know-how that is needed. Taiwan is already a source of significant investment capital in some Southeast Asian nations, but it can do more.

Membership in the WTO also has a political dimension. With both Beijing and Taipei taking seats in the trade body, the two governments have a new forum for regular consultation and dialogue. Unfortunately, there is also the danger that their disputes will merely shift to Geneva, where the WTO meets. The nasty spat over Taiwan's representation at last month's meeting of the Asia Pacific Economic Cooperation forum, should leave no room for illusions about China's efforts to ensure that it maintains the upper hand when dealing with Taiwan. During a press conference at the meeting, Chinese Foreign Minister Tang Jiaxuan angrily interrupted a Taiwanese speaker and denied him the floor. It wasn't pretty, but it made the point.

The WTO settlement mechanism is a powerful tool for managing trade disputes. It is already considered one of the organization's great successes. But it is not the right venue for China-Taiwan disputes. China's entry into the WTO will give the organization more than enough work in the years ahead - even after 15 years of negotiations and despite the 21 different committees that will oversee China's multiyear phased-in entry. Katz suggested that the G-7 nations and members of the Organization for Economic Cooperation and Development might want to coordinate cases that go to the WTO to ensure that the dispute resolution mechanism is not overburdened, and to make sure that Beijing does not see the body as merely a device for beating up on China. "We don't want to turn off the Chinese people and the Chinese leadership to WTO mechanisms," he warned.

Getting Taiwan and China to embrace WTO law, precedents, and procedures is another important dimension of the events of recent weeks. Although everyone benefits when China, potentially the world's largest market, and Taiwan, a key trading nation, are playing by internationally accepted rules, China and Taiwan will benefit most.

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