

**Taiwan's Cross-Strait
Economic Strategy and the WTO**

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Executive Summary

This paper challenges the notion that China's growing economic weight poses a threat to Taiwan. To the contrary, China has become reliant on Taiwan firms for a range of economic assets that provide every disincentive for Beijing to threaten these vital flows. Cross-Strait economic dynamics are also integrated into the globalization of production networks in both economies to the extent that Taiwan investors have proven to act as a constraint on both Beijing's and Taipei's political objectives.

Perhaps the most challenging aspect of cross-Strait economic interdependence is the zero-sum mentality that governs each side: if China receives increased investment, technology, and people flows from Taiwan, then China is strengthened at Taiwan's expense, the argument goes. Conversely, if Taiwan can slow or alter these flows, then Taiwan is strengthened at China's expense. This research attempts to evaluate the policy reforms that could create the conditions for Taiwan and China to feel equally confident that economic "interdependence" serves both equally well.

The cross-Strait relationship is among the most complex and unique of any two members in the WTO today. In the absence of any inter-governmental relationship or dialogue, the two economies have become key trade and investment partners, and their complementarities are helping to restructure not only their domestic economies but global production networks as well. Taiwan's role in transforming China's economy is critical. Ultimately, China's efforts to achieve an economic dominion with Taiwan do not mean it will win a domestic consensus on unification. Yet the belief persists among many in Taiwan that economic integration will allow China to force, coerce, manipulate, or maneuver Taiwan into unification. This paper finds the basis for these views unfounded, and that China's dependence on Taiwan businesses and individuals for tax revenue, job creation, management know-how, and worker training give Taiwan considerable leverage in negotiating agreements with Beijing that can accrue political benefits to Taipei.

The conclusions of this research can be summarized as follows.

- China should acknowledge member-to-member relations with Taiwan in the WTO as a core element of its globalization strategy, and recognize the need to safeguard the potential future role of Taiwan firms, government, and people in realizing its transformation goals. Insisting that private sector organizations serve as mediators for a range of bilateral trade and investment interests with Taiwan is anathema to the rules and spirit of WTO, where governments are purposefully endowed with the responsibility to negotiate on behalf of the public interest. Private sector bodies would never be accepted by taxpayers and consumers in other WTO members to protect their interests, and Taiwan is no exception.
- China cannot assume that Taiwan firms will endlessly choose its localities as the focus for investment. Taiwan firms report a slew of problems that they want to be covered by inter-governmental agreements, and Taiwan's industry associations conduct surveys to help Taiwan firms be more discriminating among localities.

China's expectation that Taiwan firms will be driven to invest in the hinterland in search of lower cost labor fails to take into account the increasing discrimination by Taiwan firms in their investments in China. China's unilateral laws may not keep up with the needs of Taiwan firms, and they may seek other markets outside of China when wages and prices rise in the coastal region after the Beijing 2008 Olympics and Shanghai 2010 Expo.

- Taiwan's voice in the WTO could be strengthened by a fuller commitment to implementing its WTO commitments at home. As the 14th largest economy in the world, Taiwan can play an important and even visible role in the Doha Development Round's goals of liberalization in agriculture and services. The political leadership of all parties should focus on linking domestic consensus for policy reform to enhancing Taiwan's role in Geneva, instead of focusing solely on the divisive issue of the political and economic relationship with China.
- To effectively compete with China and with other aspiring East Asian economies, Taiwan needs to implement policy reforms that strengthen its service sector and knowledge-intensive economy. Taiwan is better at rhetorical commitment and passing laws than it is in following through with an open attitude toward foreign involvement in its economy.
- The ASEAN Plus Three consultations are an important opportunity for Asian countries to practice transparency on economic issues and build confidence, and it would be beneficial to China and the region for Taiwan and Hong Kong to join in this regional dialogue, even as observers. Given Taiwan's crucial role in the high technology sector and Hong Kong's expertise in the financial sector, with impacts felt throughout the region, the ASEAN Plus Three process would be greatly enhanced by the involvement of these two members of the Asia Pacific Economic Cooperation (APEC) forum. Involving Taiwan and Hong Kong in ASEAN Plus Three would be a confidence building measure for both sides: China could demonstrate that it can be inclusive of Taiwan in economic fora, and Taiwan could demonstrate that it takes its regional economic relationships seriously enough to not politicize its involvement.
- Little progress is likely until after Taiwan's March 2004 presidential elections. However, Beijing should be prepared to deal with whoever wins in a more constructive "win-win" approach, using the "gathering of economies" approach that has made APEC possible to take cross-Strait cooperation to a higher, more constructive level. A China-Taiwan free trade Agreement (perhaps based upon the model of the China-Hong Kong "closer economic partnership arrangement") should be considered as a way of depoliticizing cross-Strait and broader regional economic cooperation.

Introduction

When China and Taiwan joined the WTO in December 2001 and January 2002, respectively, there was a common hope among WTO members that the difficult negotiations that culminated in separate membership for the two sides would pay off in helping to institutionalize the very robust but largely ungoverned cross-Strait economic relationship. Though WTO members sought to exercise the important principal of separate but equal membership of the two, it was also clear that they expected that WTO-induced liberalization in both Taiwan and China would benefit their own economic interests, not only through liberalization of the two economies, but in greater predictability and openness in cross-Strait economic flows, including trade, capital, labor, and the regulatory environment. In addition, through fostering a “habit of economic cooperation,” the dual WTO membership might even help to mitigate political and security conflicts in Taiwan-China relations.

In the nearly two years of membership, however, few of these goals have come to fruition. It should not be surprising that China has consistently sought to undermine Taiwan’s membership status as the “Separate Customs Territory of Taiwan, Penghu, Kinmen, and Matsu,” which gave it full and equal representation in Geneva. Prior to entry, China lobbied hard to block this membership status, insisting Taiwan should be called a “Representative Economic Office” in line with Hong Kong’s WTO title. Although Beijing lost that round, in February 2003 the WTO Secretariat – reportedly under pressure from Beijing -- submitted a request to Taipei to change its designation. Some analysts argue that Taiwan inadvertently handed Beijing the opportunity to renegotiate Taiwan’s status when it departed from international practice by appointing a foreign ministry official to its Geneva office.¹ To date, the matter remains unresolved.

It is far from clear what kind of international support Taiwan can depend on this time. On the one hand, WTO members are in the heat of the Doha round (which is behind schedule for completion by 2005) and have little time or appetite for mediating the cross-Strait dispute. But more importantly, international business and governments have been surprised that Taiwan’s compliance with its WTO commitments has been a disappointment. Both before and after Taiwan’s WTO accession, observers in the foreign business and diplomatic communities were perplexed that Taiwan officials were not adequately prepared for WTO economic compliance.² Whereas China’s WTO compliance was fully expected to be long and problematic, Taiwan’s history of a well-managed and globalized economy was equally expected to be responsive to WTO liberalization requirements. Yet Taipei seemed to proclaim a political victory and paid scant attention to the economic challenges of WTO compliance.

¹ Rupert Hammond-Chambers, “Cross-Strait Economic Integration After WTO and SARS.” Washington, DC: The US-Taiwan Business Council, June 18, 2003, p. 3. Prepared for “Fostering Business Relations Between the United States and Taiwan,” The Atlantic Council (www.us-taiwan.org).

² Author’s interviews with business executives and diplomats from the U.S., Canada, and the EU, July 2002. See Robin J. Winkler, “Taiwan WTO Survey: Getting a Head Start on Reform.” Taipei: Winkler Partners, Jan 2002 (www.winklerpartners.com); Raymond F. Burghardt, “Is Taiwan ready for the global economy?” Taipei: American Chamber of Commerce, October 16, 2000; Douglas H. Paal, “An Update on U.S.-Taiwan Economic Relations.” Taipei: American Chamber of Commerce, September 3, 2002.

Beijing has consistently attempted to thwart Taiwan's status in Geneva, including holding up WTO negotiating sessions to argue that Taiwan's submission of required documents, issued by its economic ministry, illegally contain the "Republic of China" insignia. There is also the learning curve for any new WTO member in the complex international negotiating process. Yet Taiwan could have anticipated these challenges and sought to develop an economic role that made it an indispensable and valuable participant to WTO members. The importance of China's WTO role is as marked by its economic success as it is by a long list of compliance problems, and Taiwan should comparably be a more productive and valuable WTO member. Yet Taiwan has missed this opportunity.

An ideal WTO strategy for Taiwan would be rooted in a domestic philosophy of reform, which would give it weight to speak out on Doha round issues and to foster informal alliances with like-minded interests of other economies. Instead, it appears that Taipei officials have been distracted by domestic politics and a confused economic direction on its own terrain, and its Geneva WTO office is too easily sidetracked by petty challenges from Beijing. Should this continue, Taiwan will likely see erosion in, or at least a nonchalance, in international support for its continued membership on an equal status with China. Presumably, Taiwan's freedom of action in the WTO might not be limited by a denigration of title, but its economic reputation would certainly suffer and make it more difficult to gain the attention of member states, particularly should trade disputes arise.

In this light, Taiwan would benefit by putting economic actions more squarely in the lead of its political desire to expand its "international space." Taiwan could have caught the attention of WTO members as a new and reliable team player by adopting an energetic implementation of its original commitments. As the 14th largest economy in the world, Taiwan is well positioned to play an indispensable role in the Doha round, yet it has missed this opportunity. It is surprising that Taiwan did not seem to have a clear vision of how to successfully engage the WTO as a vehicle to "expand its international space." Taiwan has such strong economic fundamentals that international governments and businesses alike have been disappointed that Taipei has managed its WTO membership so weakly.

This paper argues that the WTO need not be an irrelevant institution for cross-strait economic interactions, but that Taiwan has the largest stake in making WTO membership work to its advantage and still has the opportunity to do so.³ China can be expected to continue to design obstacle courses to Taiwan's independent status within the WTO, and the WTO can be expected to be a weak mediator in these disputes. Yet if Taiwan's priority is to gain a reputation and respect on the international stage, it should adopt an international economic strategy, rooted in vigorous domestic reform, to build international support in the WTO.

³ This updates and supercedes an early draft study prepared for the first anniversary of China's and Taiwan's accession to the WTO.

Cross-Strait Economic Dynamics: Assessing Interdependence

Taiwan investment in China began with the first capital liberalization laws passed by Taipei in 1987, and through the late 1990s was concentrated primarily in the small and medium enterprise (SME) sector of labor-intensive goods. Throughout this period Taiwan firms gained an international reputation in the OEM (original equipment manufacturing) model in the burgeoning global technology sector, where tightly clustered relationships between individual producers and suppliers made Taiwan firms among the most efficient and reliable source for the world's major technology producers. In 1998-2000, Taiwan investment in China began to shift the lower-end manufacturing of technology products to China, partly in response to China's unilateral liberalization policies and partly in response to the global trend of a maturing technology sector which saw sales begin to decline and profit margins shrink. This phase of investment saw a new explosion in 2000-2003 with the burst of the technology bubble in the United States, and global firms began a pronounced shift of an ever wider array of manufacturing to China for component assembly there.

Trade and Investment Patterns. Since 1987 to present day, the Taiwan government has attempted to limit the outflow of capital to China, initially with a cap of \$50 million per project, which was expanded to \$100 million in early 2002, with larger projects approved on a case by case basis. Yet Taiwan firms have historically adapted to this restriction by either registering in third countries (i.e., the Virgin Islands) or routing investment through Hong Kong, so that Taiwan statistics typically undercount a significant portion of capital bound for China. China's statistics of inbound capital from Taiwan are also suspect due to provincial over-reporting of investments of all kinds, and the international financial institutions (IFIs) responsible for international statistics do not have an independent way of measuring these flows.

Taiwan firms' cumulative investment in China to date ranges from a low of \$40 billion to \$150 billion, with most analysts (including Chinese and Taiwan economists) settling on about \$80 billion during the last 15 years. While significant, it should be noted that Taiwan's growing investment fits a global pattern of increased capital flows to China; in 2002, total foreign direct investment (FDI) in China totaled \$52 billion, overtaking the U.S. for the first time as the principal global recipient of FDI. Nevertheless, the estimate of Taiwan investment will become more controversial in years to come as the larger and most profitable Taiwan firms increase their presence in the mainland with larger and more sophisticated projects. Improving cross-Strait capital flow estimates has become a priority for Taiwan as it tries to better gauge the impact of capital outflow on its own economy.

Yet clearly, year-on-year Taiwan investment has been growing. According to Taiwan's statistics, it approved \$6.9 billion of investments in 2002, up from \$1.9 in 2001 (reflecting in part the limitation increase), while actual investment totaled rose 39 percent year on year to \$3.97 billion. Taiwan estimates this comprises about 70% of all outbound investment. However, if one includes investment from the Virgin Islands of \$6.9 billion, Taiwan falls into China's top three sources of investment in recent years, along with

Japan and the United States. Taiwan investment is most pronounced in the technology sector, but also includes consumer goods, processed foods, plastics, energy, and textiles, among other sectors.

Taiwan still retains an import ban on more than 2,600 mainland products ranging from agriculture, textile and steel, to washing machines and cars. This list has been shrinking in recent years, particularly following China and Taiwan's entry into the World Trade Organization (WTO), yet the Taiwan government justifies its "exclusionary list" as long it is unable to redress trade grievances on an inter-governmental basis. On the other hand, Taiwan's exports to China have been growing apace, about 20-30% per year over the past three years, which is on a par with China's overall import growth, reflecting China's liberalization policies and its growing hunger for imported electrical components. In 2002, according to Taiwan's Board of Foreign Trade, two-way trade hit a record high of \$41 billion, a 37% increase over 2001, comprised of \$33.06 billion of Taiwan exports and \$7.95 billion of imports from the mainland, up from 2001 exports of \$27.3 billion from Taiwan and \$5 billion of imports from the mainland. In 2002, Taiwan's exports to China accounted for about a quarter of the total, and was the principal source of a growing trade surplus, which also concerns Taiwan officials should this increasingly important export source be adversely affected.

Role of Taiwan Businesses in China's Economy. The growing quantity of Taiwan investment reflects a deepening role that Taiwan firms play in China's economy. The often-cited factors of linguistic, culture, and geographical proximity are true motivators for a complex nexus relationship that has developed among Taiwan and Chinese firms, as well as with provincial and central government officials. There is a strong preference among Chinese workers, businessmen, and officials to work for and negotiate with Taiwan companies; they are more adept than foreigners at developing *guanxi* (relationships) that are critical to navigating the maze and chaos of China's market. In addition, Taiwan firms' expertise in marketing and established global sales networks have helped to fuel China's export boom, and business leaders and officials from both sides of the Strait acknowledge that Taiwan firms seem to be able to uniquely infuse a spirit of competitiveness and work ethic to staid Chinese companies in a range of industry sectors.

Beijing's efforts to decentralize decision-making to the provinces over the past 15 years, and its more recent efforts to judge job performance of local officials on the basis of FDI, job growth, and export performance, has created fierce competition among provinces, leading one Taiwan executive to observe that "China is one country -- with many systems."⁴ Taiwan firms are thus prized by local officials for providing jobs, tax revenues, management and production skills, and "capitalist role models" in general. Tax incentives, competitive interest rates for yuan-denominated loans, and exemption from administrative fees are all fair game as the coastal provinces try to best each other's deals to lure Taiwan firms.⁵

⁴ Author's interview with representatives of Taiwan Manufacturers Association, July 14, 2002.

⁵ "Beijing, Shanghai, Shenzhen compete to lure Taiwan chip makers," *China Online*, March 7, 2002.

About 90% of Taiwan investment is concentrated in six coastal provinces which, in turn, are the locus of China's export strength. In the past two years, Taiwan firms have been shifting their focus from the Pearl River Delta surrounding Hong Kong to the Yangtze River Delta around Shanghai. In 2002, the distribution of Taiwan investment was in Guangdong (35 percent), Jiangsu and Shanghai (32 percent), Fujian (11 percent), Hebei and Beijing (6 percent), and Zhejiang (5 percent). According to one analyst, Taiwan invested firms (TIEs) employed a total of 8.2 million Chinese workers, or 3.9 percent of China's urban labor force, and produced \$70.2 billion in output, or 4.6 percent of China's total industrial output.

In specific localities, the contribution of TIEs is even more significant. In Guangdong, TIEs employed about 2.9 million laborers, or 29.4 percent of secondary industrial workers, with output of \$24.6 billion, or 19.4 percent of Guangdong's total industrial output. In Jiangsu and Shanghai, TIEs employed 2.6 million laborers, or 18.9 percent of secondary industrial workers, with output of \$22.5 billion, or 13 percent of total industrial output. In Fujian, TIEs employed .9 million laborers, or 23.1 percent of manufacturing workers, with \$7.7 billion of output, or 28.9 percent of its total industrial output.⁶

For some specific cities in China, such as Dongguan and Kunshan, Taiwan's investment is particularly vital. In Kunshan City, by 2001, \$2.8 billion, or 42 percent of total FDI, was from TIEs. In addition, TIE-produced goods totaled \$20 billion, or 60-70 percent of Kunshan exports, and about 200,000 mainlanders worked for TIEs. These provinces and cities have a tremendously high stake in maintaining steady cross-Strait economic relations.

One recent study examines the relationship of Taiwan firms with China's localities, and the impact of the localities pressuring Beijing. During times of crisis, the provincial authorities acted to help mediate Beijing's behavior toward Taiwan. The conclusion is that rather than Taiwan firms over-reliance on the China market, the provincial officials have become so dependent on Taiwan investment that they tend to act as a brake on Beijing's posture toward Taiwan. Taiwan invested enterprises (TIEs) in China have created association (TIEAs) that have become mediators of the cross-Strait relationship. Chen observes, "TIEAs maintain a very close relationship with Chinese officials and play a critical role in negotiating or communicating with Chinese authorities in order to protect and advance TIEs' interests. On the flip side, Chinese authorities also treat TIEs as extremely important entities, and thus, TIEAs have gradually gained strength to influence Chinese central and local governments."⁷

⁶ Total industrial output in these regions refers to the gross output value for all state-owned industrial enterprises plus non-state-owned industrial enterprises with an annual sales income of over 5 million yuan. National Bureau of Statistics (PRC), *China Statistical Yearbook*, no. 19 (2000) (Beijing: China Statistics Press, 2000), p. 117 and pp. 410-411.

⁷ Chen-Yuan Tung, "China's Economic Leverage and Taiwan's Security Concerns with Respect to Cross-Strait Economic Relations." Dissertation for the Johns Hopkins University (Baltimore, Maryland: May 2002), p 273. (<http://gotochung.com>).

Chen's study analyzes several cross-Strait conflicts and concludes, "During the 1995-96 and 1999-2000 incidents, Chinese leaders never articulated any threat to impose economic sanctions against Taiwan. To the contrary, they feared that the PRC military threats might have a serious impact on Taiwanese investment in China. The Chinese government faced tremendous and constant pressure from TIEAs who were anxious about cross-Strait instability and resentful of Chinese military threats against Taiwan. Subsequently, TIEA leaders threatened Beijing that they would withdraw their capital from China if Beijing continued its military threats against Taipei. Moreover, some TIEA leaders even threatened that they would return to Taiwan and fight against China if China dared attack Taiwan."⁸

Another illustration of the depth of Taiwan individuals' economic impact is reflected in the Shanghai real estate market. Economist Andy Xie notes that Shanghai's surplus liquidity has always been a source of investment funds for the rest of the country, and he estimates that property purchases by non-residents have been the principal source for Shanghai's surplus of \$25 billion during 1999-2002. He further estimates that one-third of Shanghai's property sales in 2002 (totaling \$9.8 billion or 15% of GDP) are by non-residents, and within that group Taiwan individuals form the bulk. Thus Taiwan's half a million people living in the Yangtze River Delta are helping to fund a property boom that Shanghai would find difficult to replace.⁹

In the next five to ten years, it is expected that Taiwan firms will continue to find China an attractive investment site, although with some caveats. Taiwan businesses are developing a more sophisticated view of the China market, and in years to come will likely become more discerning about where to invest, creating even more competition among the provinces, which could increase Taiwan businesses' clout. In one survey of manufacturing firms, businessmen rated risk assessment factors such as uniformity of laws and regulations, social conditions, infrastructure spending and development, safety and security, and water quality, for example.¹⁰ Provincial officials avidly seek briefings of the survey to determine what measures they need to take to improve not just the investment climate but the living environment. In future years, Taiwan firms may well require more and should not be taken for granted.

Over the next decade, however, it is not clear that there will be an unending flow of capital from Taiwan businesses. Some business leaders express doubt that China's market economy will develop beyond the coastal provinces of some 300 million people, and they believe this market will become saturated and over-priced as the 2008 Beijing Olympics and the 2010 International Expo in Shanghai come on line. Wage and land prices will rise and could become prohibitive for the types of investment Taiwan firms specialize in today. Clearly it is Beijing's hope that Taiwan firms will expand into

⁸ Op Cit, p. 418.

⁹ Andy Xie, "Shanghai, The Dream Factory: Bubble or Miracle?" Global Economic Forum [Hong Kong: Morgan Stanley], July 15, 2003 (<http://www.morganstanley.com>).

¹⁰ "2001 Mainland China Investment Environment and Risks Survey: Abridged Version." Taiwan Electrical and Electronic Manufacturers' Association, June 28, 2001. (<http://teema.org.tw>). Also author's interview with Luo Huai-Jia, TEEMA, July 12, 2002.

China's hinterland sooner rather than later, aiding China's "Go West" policies critical for balanced economic growth among the regions. For its part, Taipei hopes that its "Go South" policy that encourages investments in Southeast Asia will prove to balance investment in China.

Yet Taiwan business leaders may not be receptive to either of these destinations. Southeast Asia no longer provides attractive labor or production costs, and while some firms have tried investment in Subic Bay, cross-cultural problems such as lack of work ethic have impeded further investments, except for minimal labor-intensive firms such as small-scale bicycle and food processing firms in Vietnam. As for China's undeveloped hinterland, business leaders cite poor infrastructure as well as the mindset of the inland populace, which is "not hungry to learn" and is too traditionally dependent on government patronage.¹¹ There is thus a cautionary note that over the next decade, Taiwan businesses may alter their investment patterns, which could potentially reduce the mediator role that Taiwan's investors have played in cross-Strait tensions.

China and Taiwan in Global Production Networks

Taiwan Firms as a Bridge for China's FDI. Taiwan companies play an important bridging role in bringing global capital to China, thus drawing China into global production networks, particularly for lower-end high technology products. U.S. companies have a high level of confidence and trust in Taiwan firms and their developed relationships in the mainland market. As one U.S. business leader argues, "Taiwan firms are increasingly viewed as the solution to market entry [in China]."¹² No wonder China's provincial officials are eager for Taiwan investment, as it introduces a new range of a talent pool, high technology. Taiwan firms also gain technological advantage partnering with U.S. and other foreign firms in the China market, which can accrue to their higher value-added activities in the Taiwan market.

Taiwan and China companies also link up in third markets, such as Taiwan's China Development Industrial Bank and Beijing-based Capital Biochip which set up a joint venture in San Diego in 2001 that aims to sell to chips to detect disease to the Chinese market.¹³

Shifting Roles in the Global Information Technology Sector. Taiwan's IT firms have responded to the competitive demands of a world-wide shift in IT production networks to utilize China's cheaper resources and upgrade domestic value-added products. Taiwan investment in China has aided industrial upgrading and improving competitiveness of Taiwan firms, contrary to the belief that the shift to mainland production has led to an industrial hollowing out. Several studies that analyze Taiwan

¹¹ Author's interviews with the Taiwan Electrical and Manufacturing Association, July and November 2002.

¹² Rupert J. Hammond-Chambers, "Fighting the Flight: Taiwan's Changing Role in the Global IT Supply Chain," Washington, DC: U.S.-Taiwan Business Council. Prepared for the CSIS conference, "Taiwan: Economic Issues Ahead," February 6, 2002 (<http://www.csis.com>).

¹³ Allen T. Cheng, "Taiwan Puts Its Chips on Biotech." *Fortune*, 146:7, October 28, 2002, p. 31.

investment in the mainland during 1995-2003, it was clear that an intra-firm division of labor has been established, where Taiwan's large enterprises produce more value-added goods in Taiwan while their subsidiaries in China manufacture labor-intensive products.¹⁴

Taiwan firms account for a major portion of China's growing exports in the IT sector. By 2000, China displaced Taiwan as the world's third largest producer of information technology hardware (behind the U.S. and Japan), yet Taiwan firms accounted for 72 percent of the \$25.5 billion in computers and related equipment produced in China that year.¹⁵ LCD monitor and notebook makers have been the most aggressive in transferring operations to overseas bases. In 2000, only three percent of LCD monitors were produced outside of Taiwan, but by the first half of 2002, this reached 71 percent, with 61 percent in China. Production of notebooks outside of Taiwan rose from zero percent in 2000 to 5.2 percent in 2001, and to 24 percent in the first half of 2002. The ratio of Taiwan's IT production value generated from China rose from 36.9 percent in 2001 to 51 percent in the first half of 2002.¹⁶ The production of other low-end products in the IT sector include scanners, motherboards, CD drives, which have all seen a shift to production in the mainland.¹⁷

Particularly key is the semiconductor industry. In March 2002, Taiwan relaxed a longstanding ban to allow its semiconductor companies to invest in less advanced wafer fabrication plants in China. While bowing to business pressure to ease the ban, the Taiwan government hopes to prevent the export of sensitive technology to China that could weaken the island's dominance in the semiconductor industry. Under the new policy, manufacturers are allowed to produce chips etched on 200 millimeter semiconductor wafers in China after they have begun producing more advanced 300 millimeter wafers in Taiwan (thinner lines are etched on the 300m wafers, allowing the chips to run faster and use less electricity.) Taiwan Semiconductor Manufacturing Co (TSMC), the world's largest maker of made-to-order computer chips, has signed a letter of intent to invest \$10 billion in the mainland over the next eight years.¹⁸

In the industry's value chain, China and Taiwan may end up complementing each other in both domestic and global markets. Taiwan's emphasis will be on leading-edge manufacturing, while China will push into the labor-dependent design and assembly-and-test functions, as well as nonleading-edge manufacturing. Taiwanese electronics companies have already established manufacturing centers in China. Now, many semiconductor companies are setting up design centers there while also considering

¹⁴ Chen-yuan Tung, "Taiwan's Investment in China in the Age of Globalization: An Interim Assessment of the Impact of Taiwan's Investment in China on Taiwan's Economic Development." Paper presented to the International Conference on Greater China and the World Economy sponsored by the Chinese Economic Society, Pudong, China: July 5-7, 2000. See also Paul Cavey, *Leaping dragon, trailing tigers? Taiwan, Hong Kong and the challenge of mainland China*. Economist Intelligence Unit Ltd., May 2003.

¹⁵ Nicholas R. Lardy, *Integrating China into the Global Economy*. [Washington DC: Brookings Institution Press, 2002], p. 52.

¹⁶ Market Intelligence Center, Division of Institute for Information Industry, July 29, 2002.

¹⁷ Information Technology: The Roles of Taiwan and China in the Global Restructuring of Production Networks.

¹⁸ "TSMC Signs Agreement to Build Shanghai Plant." *Associated Press*, 8/29/2002.

investments in foundries.¹⁹ Yet analysts believe it will take a decade for China to develop the manufacturing capability to develop sophisticated domestic chip manufacturers and will rely on imports for both low and high-end products.²⁰

¹⁹ Andrew Chun Chen and Jonathan R. Woetzel, "Chinese Chips," *The McKinsey Quarterly*, No. 2, 2002.

²⁰ *Electronics Industry Outlook*. Beijing: Global Sources Ltd and CMP Media LLC, June 2003; Andrew Batson, "China's Reliance on Chip Imports to Continue, Study Says," *Wall Street Journal*, July 24, 2003 (<http://online.wsj.com>).

Strategies for Developing Taiwan's WTO Role

Analysts agree that Taiwan needs to upgrade production and continue to build stronger R&D and service-related capabilities in the domestic market. As a leading U.S. business leader notes, "Taiwan's future does not lie in the manufacturing of low cost goods, whether they be IT related or toys, but in moving upstream in the global IT supply chain and to focus on logistics, design, marketing, engineering, and the legal environment necessary to protect (and attract) intellectual property."²¹

Taiwan's Economic Restructuring Challenges. Some analysts argue that China is to blame for a "hollowing out" of Taiwan industries and that increased investment in the mainland displaces investment at home. Yet significant research demonstrates that Taiwan's sunset industries are wisely relocating to the mainland and new competitive higher value-added products are being profitably developed in Taiwan. Taiwan's economic weakness lies in the lack of domestic infrastructure and governmental policies to support these new industries, including upgrading education, fostering R&D, intellectual property protection, and deregulation, among other policy prescriptions. Taiwan's economic backbone has shifted from manufacturing to the service sector, which has been stifled due to inconsistent policies as well as by ongoing restrictions with the mainland, which inhibit the competitiveness of key service sectors such as finance, transport, tourism, and IT. Ironically, by fearing further economic integration with China, Taiwan weakens its comparative advantage in the fiercely competitive global economy, thereby achieving a vulnerability to China's economic dominance – as well as vulnerability to competitors in East Asia -- that China's economic leverage is unlikely to attain alone.

The election of President Chen Shui-bian of the opposition Democratic Progressive Party (DPP) was a watershed in Taiwan's democratization, yet it led to a volatile contest for political power, particularly bitter regarding Taiwan's economic and political relationship with China.²² While there is a consensus that Taiwan needs to strengthen its service industries, President Chen inherited economic weaknesses from the previous administration, and Taiwan is late in developing the service sector.²³ The antidote to fear of China's dominance is for Taiwan to develop capabilities where China's capabilities are weak, yet Taiwan's decision makers have been polarized over the degree that this economic transition needs to involve opening up linkages to mainland

²¹ Rupert J. Hammond-Chambers, *op cit*, p. 1.

²² Author's interviews with Taiwan analysts, senior party officials, and cabinet members, July and November 2002. See also Willem van Kemenade, "Taiwan: Domestic Gridlock, Cross-Strait Deadlock." *The Washington Quarterly*, 24:4, Autumn 2001 [Washington, DC: Center for Strategic and International Studies], pp. 55-70; Yu-Shan Wu, "Taiwan in 2001: Stalemated on All Fronts," *Asian Survey*, 42:1, pp. 29-38; Shelley Rigger, "Taiwan in 2002: Another Year of Political Doughts and Typhoons," *Asian Survey*, 43:1, pp. 41-48.

²³ Li-min Hsueh, Chen-kuo Hsu, and Dwight H. Perkins, eds., *Industrialization and the State: The Changing Role of the Taiwan Government in the Economy, 1945-1998* (Cambridge: Harvard University Press, 2001).

China. Analysts agree that Taiwan needs to upgrade production and building stronger R&D and service-related capabilities in the domestic market. As a leading U.S. business leader notes, “Taiwan’s future does not lie in the manufacturing of low cost goods, whether they be IT related or toys, but in moving upstream in the global IT supply chain and to focus on logistics, design, marketing, engineering, and the legal environment necessary to protect (and attract) intellectual property.”²⁴

Inaugurated in May 2000, the Chen administration encountered a complex set of economic and political dynamics, driven by internal and external factors. The opposition Democratic Progressive Party was challenged to govern for the first time, and the former ruling Kuomintang Party (KMT) and its offshoot, the People’s First Party (PFP), became opposition parties in the Legislative Yuan (LY) for the first time in their history. In the economic arena, President Chen inherited a host of structural problems that were unaddressed by the previous administration and which his young administration was ill-equipped to address, yet necessary for moving away from a manufacturing base to a service sector economy. On the external front, the burst of the tech bubble in the United States in mid-2000 not only caused a severe drop in demand for Taiwan’s high tech products, but in response to depressed U.S. and global demand and in search of improved profit margins, global firms began a marked shift toward high tech manufacturing production in China, albeit at the lower end of the value-added chain. Taiwan firms were no exception.

This series of events resulted in severe economic and political malaise toward the end of 2000 which are still in play, and have led analysts to conclude that internal political weakness and demoralization has set in.²⁵ In 2001, Taiwan suffered its first negative economic growth (-1.9 percent) in 50 years, unemployment rose to a record high of 5.3 percent, and factory closings were at such a pace that the perception of a massive exodus to the mainland was endemic. One long-time foreign resident of Taipei remarked that the feeling was that “the last one to leave should turn the lights out.” Chen cabinet officials have stated privately that they felt caught between intense pressure from private business to open the flood gates to the mainland and a popular perception that Taiwan businesses were selling out Taiwan’s economic jewel to the “enemy.”²⁶

Whatever the reason for policy paralysis, the KMT and PFP pounced on Chen’s inexperienced team and lack of an economic policy response with a referendum movement to unseat him. By November 2000, as the stock market fell to a four year low and the currency dropped to a 19 month low, a group of business leaders from across the political spectrum intervened to urge restraint by all sides to “stop the political arguing.”²⁷ This unique intervention by the business community may have had a leavening effect in the immediate term: the recall effort stopped and President Chen inched toward a new set of policies that eased some restrictions on mainland investment.

²⁴ Rupert J. Hammond-Chambers, *op cit*, p. 1.

²⁵ See, for example: Denny Roy, *Taiwan’s Threat Perceptions: The Enemy Within*. Occasional Paper Series [Honolulu: Asia-Pacific Center for Security Studies] March 2003.

²⁶ Author’s interviews with Taiwan cabinet officials, July 2002.

²⁷ Erik Guyot, “Taiwan Businesses Intervene.” *Wall Street Journal*, November 24, 2000, p.14.

Yet the tone of confrontation between the minority “mainlanders” (those fleeing with Chiang Kai Shek in 1945-49) and the native Taiwanese majority had been unleashed, with the economic relationship with China in the middle of the ideological storm of party politics.

Review of Economic Policy, 2000-2003. After this divisive start, President Chen tried to forge a bipartisan consensus on economic policy, including a new stance on economic integration with China. The results have not been encouraging, however; during Chen’s term, there have been three premiers, four finance ministers, and three ministers of economic affairs, accompanied by mixed messages and policy reversals.

In mid-2001, President Chen created the Economic Development Advisory Council (EDAC), which made a long list of recommendations including a shift from former President Lee Teng-hui’s “no haste, be patient” approach toward China to “active opening, effective management,” which President Chen officially embraced. Yet similar to the outcome of President Lee’s 1995 plan of establishing Taiwan as an Asia Pacific Regional Operations Center (APROC), which aimed to attract the headquarters of multinationals and is still an active goal, the EDAC proposals have only been partially enacted and have failed to live up to expectations by foreign or Taiwan investors.

The ruling coalition of DPP and the Taiwan Solidarity Union (TSU, founded by former President Lee) retains a cautious if not overtly hostile approach toward economic opening with China. A popular phrase that has emerged in Taiwan is “Globalization, not Sino-lization,” which rightfully argues that Taiwan should balance cross-strait economic ties with global ones. Taiwan needs to diversify its economic relationships not only because of the political/security tensions with China, but as a small economy it needs the flexibility of a broad range of trade and investment to withstand business cycles and fluctuations in the global economy. Taiwan officials often express open-minded rhetoric toward China; for example, Dr. Tsai Ing-Wen, Chairperson of the Mainland Affairs Council (MAC) and principal spokesperson on mainland policy, expressed in a 2001 speech to an American audience that “Globalization has proved to be a major stabilizing factor in cross-strait relations and this trend will be furthered when the WTO moves forward with its trade liberalization agenda.”²⁸ Dr. Tsai’s overall speech demonstrated a balanced view of globalization that is inclusive of China, yet the MAC is still seen as the “gatekeeper” of a “Taiwan first” policy that remains cautious toward opening toward China. Other noted economists urge caution in creating dependencies with China, such as noted economist Pochih Chen, the former head of EDAC, who warns that Taiwan’s ratio of investment in China compared to GDP is exceeding two percent compared to the U.S. and Japan which amounts to just 1/1000 percent.²⁹

A second economic initiative was the “Challenge 2008” plan which tried to address criticisms that the government was not proactively solving entrenched economic

²⁸ “A New Era in Cross-strait Relations? Taiwan and China in the WTO,” Dr. Ing-wen Tsai, Heritage Foundation, December 13, 2001.

²⁹ Pochih Chen, “Toward a Knowledge-based Economy: Taiwan’s Strengths, Strategies, and Prospects.” *Sino-American Relations* (Taipei: The China Academy], Vol. XXVIII, No. 3, Autumn 2002, pp. 3-19.

problems, including fostering Taiwan's capabilities in more high-end technology products.³⁰ It pledged government funding to establish business expertise in nanotechnology, biotechnology, as well as in more advanced semiconductor chips, and set a goal of increasing expenditures on R&D to three percent of GDP in six years through a variety of initiatives and incentives to domestic and multinational firms. As a result, a number of prominent firms have announced significant investment plans, including pledges by at least ten foreign firms to set up R&D centers on the island, and Taiwan's largest computer component manufacturing firm will invest in a nanotechnology and moulding machinery plant.³¹

The magnitude of economic restructuring for Taiwan's future competitiveness and security clearly requires a united political front. The list of economic reforms is long and difficult, including deregulation across the board, privatization, financial services reform, vastly improved public and private education, health care reform, a stronger social safety net, and larger and more competitive service industries. Ultimately, these economic reforms involve political and social costs, and require strong political leadership to withstand vested interests and the ability to change inbred attitudes developed during the long period of one-party rule. Taiwan's challenge is not just to maintain competitiveness vis-à-vis China but among East Asian competitors as well. Taiwan's globalization strategy thus should start at home with the realization that service sector linkages with Singapore, Hong Kong, South Korea, Japan, and the United States are more critical than loss of manufacturing to China.³² Taiwan's location in the spectrum of policy responses to China's growing economic importance is beyond the scope of this paper, but cannot be stressed enough as a potential focus for Taiwan's policy makers.

Political factors. Since President Chen and the DPP came to power in 2000, China has attempted to use economic leverage on Taiwan businesses to harass DPP supporters and strengthen KMT/PFP supporters. These measures have failed to harm, strengthen, or otherwise sway the political orientation of Taiwan businesses. Although there may well be a segment of Taiwan's businesses that claim no loyalty to Taiwan's future, a significant majority of business people involved in cross-Straits economic ties are of both political stripes. Business leaders supportive of the DPP and a "Taiwan first" policy are among the most concerned about cross-Straits political and economic stability.³³

As a result, although Beijing's harassment and inducement measures have irked the Taiwan government, they have failed to entail economic costs for the Taiwan government or its businesses. On the contrary, Beijing's measures tend to backfire, as President Chen and former President Lee, have been able to use such instances as grist to stir up anti-China sentiment among Taiwan's electorate. One of the most significant

³⁰ "Challenge 2008-Plan for National Development," Council for Economic Planning and Development, Executive Yuan, May 31, 2002 (www.cepd.gov.tw/english/special/challenge2008.ppt).

³¹ *Taiwan Country Report*. The Economic Intelligence Unit Ltd, May 2003, p. 21 (www.eiu.com).

³² See Shahid Yusuf and Simon J. Evenett, *Can East Asia Compete? Innovation for Global Markets*. [New York: The World Bank and Oxford University Press], 2002.

³³ Chien-min Chao, "Will Economic Integration between Mainland China and Taiwan Lead to a Congenial Political Culture?" *Asian Survey*, 43:2, March/April 2003, pp. 280-304

instances was the circumstances surrounding Taiwan's withdrawal from the APEC meeting in Shanghai in October 2001, which came ahead of the crucial December elections in the Legislative Yuan when the DPP hoped to gain a majority. In the attempt to elevate Taiwan's participation level in APEC, Chen announced that former Vice-President Li Yuan-zu would be Chen's envoy, accompanied by then-economics minister Lin Hsin-yi. However, the two arrived in Shanghai without Beijing's approval, and when Yuan-zu was rejected – and the economic minister was rebuffed in a news conference hosted by China's foreign minister, which aired widely in Taiwan – Taiwan voters were incensed by Beijing's bullying tactics. Some analysts believe President Chen intentionally provoked the incident, but in any case, it helped Chen reorient the election onto identity issues and away from the economic crisis. China unwittingly helped fulfill Chen's strategy and the DPP and the TSU gained enough seats in the LY to enable it a two member majority.

The APEC incident also illustrates that DPP and TSU strategists have tried to steer domestic economic issues to the back burner and focus elections on identity issues and China's attempt to absorb Taiwan, successfully using economic decline to paint China as an economic threat. The perception persists among loyalists in the DPP and particularly in the TSU that Beijing is trying to achieve unification by economic annexation rather than by military force.

While the division among Taiwan's political parties about the relationship with China can be attributed to Taiwan's evolving democracy, it is useful to put today's dynamics in the historical context of Taiwan's political development. From its early years, Taiwan's political culture developed without a strong administrative center and endowed society with a strong sense of individual interests and family loyalties. As one analyst notes, "This independence of spirit frustrates those who try to bend Taiwan toward their own goals," and whether it is Chinese leaders trying to affect an election outcome, a LY leader trying to pass legislation, or U.S. officials urging restraint against provocative behavior, "bullying Taiwan rarely works, and often backfires."³⁴ Taiwan will improve its governance system over time, some argue, and many in Taiwan believe that "more, not less, democracy is necessary."

The Three Links Debate. One of EDAC's most significant recommendations was that direct shipping, air, and postal links is "not a question of if, but when." In the subsequent two years, the issue remains divisive at every twist and turn and the debate inches along. DPP officials express a strikingly broad range of fears about three links, from China covertly flying a military versus a commercial plane into Taiwan's airspace to the impact on the "mom and pop" retail sector, particularly in southern Taiwan (a DPP stronghold), should Taiwan shoppers flock to Shanghai's cheaper markets for consumer items from toaster ovens to dumplings (witness Hong Kong where weekend shopping sprees to Shanghai are thought to have severely weakened Hong Kong retailers).

³⁴ Shelly Rigger, "The Roots of Democracy." *Topics*, May 2003 [Taipei: American Chamber of Commerce], p. 31. See also Denny Roy, *Taiwan: A Political History*. [Cornell University Press], 2003.

The arduous discussion between Taiwan and China about three links is too long to detail here. However, China seems to have gained the upper hand in the psychological battle in October 2002 when then-Vice Premier Qian Qichen offered a relaxation in wording for three links, stating that they could be called "cross-Strait" routes rather than "domestic" routes. This turn of phrase suggested that Beijing would be willing to consider three links negotiations through unofficial third parties without official Taiwan recognition of "one China" as a precondition. (Interestingly, following the July 2002 conclusion of the Taiwan-Hong Kong open skies agreement -- negotiated by private groups with official representation on both sides, sanctioned by Beijing -- there was broad discussion in Taiwan that this model could be replicated with China.) Yet President Chen's subsequent statement that "there is one country on either side of the Taiwan strait" threw this possible formula into disarray, and no progress has been made to date. Taiwan cabinet officials have expressed privately that there are too many security concerns about three links to be left to unofficial third parties, and the insistence on formal inter-governmental talks remains dominant within the Chen administration for the time being.

Economic Costs of the Lack of Three Links. According to Taiwan's Ministry of Transportation and Communications, direct shipping links with China are critical to the continued competitiveness of Taiwan's harbors, which can serve as transit points for China's Fujian, Zhejiang, and Jiangsu provinces.³⁵ In the last two years, Kaohsiung harbor has dropped from the world's third largest container harbor to the fifth largest, falling behind Pusan, South Korea in 2001 and behind Shanghai in 2002. Given extreme competitive international pricing in the glutted shipping sector, Taiwan needs to compete in as many markets as it is can, with China's harbors a first choice given the demand in China for Taiwan goods. As well, direct cross-Strait chartered cargo flights would lower freight fees for the high volume of goods which now must transit Hong Kong, and all four airlines now offering indirect cargo flights have indicated they would immediately offer direct flights if the Taiwan government lifts restrictions.

Taiwan officials tend to discount the numerous surveys of both Taiwan and foreign businesses that show the establishment of three links is high on the priority list of private sector concerns. Yet the lack of three links is undermining Taipei's continued stated policy goal for eight years now to establish itself as a regional economic hub. The policy has relied on tax holidays and other incentives, but these are insufficient; in reality, Taiwan's domestic market of 23 million is not large enough to justify a company headquarters, and companies need to service the mainland market from their Taiwan base. As the U.S. Chamber of Commerce in Taipei notes, "Most companies want to expand into China, not leave Taiwan." Yet companies are choosing instead to be based in Hong Kong or Shanghai; instead of Taiwan being the hub, Shanghai is becoming the hub with Taiwan as one of many outer spokes.³⁶ Direct commercial flights between Taiwan and China -- which would cut travel time between Taipei and Shanghai from six hours via

³⁵ "Direct cross-strait shipping links vital to Taiwan harbors," *Taiwan Economic Daily*, June 30, 2003 (<http://news.cens.com>)

³⁶ *2003 Taiwan White Paper. Topics*, 33:5, May 2003 (Taipei: American Chamber of Commerce) (<http://www.amcham.com.tw>); Paul Cavey, *Leaping Dragon, Trailing Tigers*, op cit.

Hong Kong to 90 minutes direct -- are cited by Taiwan and foreign investors as key to their ability to rationalize investments in both economies. If given the choice, business travelers with interests in both China and Taiwan will sacrifice the Taiwan leg of their itinerary given the onerous time schedules, further marginalizing Taiwan.

Finally, Taiwan's restrictive policy on providing work permits and visas not only for mainland Chinese but for all foreigners is a separate but parallel argument for establishing the three links. A liberalized policy on people flows will allow the established networks of skilled IT workers, which extends to China, the U.S., and Taiwan, to temporarily train and work in IT firms in Taiwan. In the view of the Taiwanese IT elite, "The sharp contrast between the cautious policies of Taiwan and the aggressive drive of China to attract talent may further weaken Taiwan's international competitiveness."³⁷

Staying Ahead of Regional Competitors. Taiwan's challenge is not just to maintain competitiveness vis-à-vis China but among East Asian competitors as well. Taiwan's globalization strategy thus should start at home with the realization that service sector linkages with Singapore, Hong Kong, South Korea, Japan, and the United States are more critical than loss of manufacturing to China.³⁸ Taiwan's location in the spectrum of policy responses to China's growing economic importance is beyond the scope of this paper, but cannot be stressed enough as a potential focus for Taiwan's policy makers.

³⁷ Tse-Kang Leng, "Economic Globalization and IT Talent Flows across the Taiwan Strait: The Taipei/Shanghai/Silicon Valley Triangle." *Asian Survey*, 32: 2, March/April 2002, p. 249.

³⁸ See Shahid Yusuf and Simon J. Evenett, *Can East Asia Compete? Innovation for Global Markets*. [New York: The World Bank and Oxford University Press], 2002.

Economic Confidence Building Measures

Apart from developing its role in the WTO, Taiwan could consider more informal measures to build confidence in cross-Strait economic relations. Both China and Taiwan would benefit from Taiwan's involvement in regional and bilateral fora to help strengthen domestic consensus in Taiwan for globalizing its economy.

ASEAN Plus Three. Founded in 1999, this group of the 10 ASEAN members plus South Korea, Japan, and China reflects a realization by regional governments (gleaned during the 1997-98 financial crisis) that closer and more open consultations among neighbors can better equip governments to deal with the cross-border effects of globalization. These meetings are often discounted by analysts as talk shops with vague outcomes. Yet these Asia-only dialogues have helped to foster transparency and confidence, and have spurred new economic agreements and economic analyses on the potential impacts of trade and investment liberalization. In many respects, the ASEAN Plus Three dialogues have provided an opportunity for developing a domestic consensus and understanding of regional economic integration. China and ASEAN have agreed to a "free trade agreement" (FTA) by 2010 and Japan and ASEAN have signed an "economic partnership agreement." South Korea, Japan, and China have agreed to exploratory studies of a tripartite FTA, and bilateral studies among these three states have also begun.

It would be ideal for Taiwan to join the ASEAN Plus Three dialogue, either as a member or as an observer, which would benefit all members given Taiwan's central role in the region's trade and investment. Privately, Chinese analysts agree that Taiwan cannot be excluded forever from regional economic dialogues, but they worry that Taiwan – particularly President Chen – will exploit such a role for political gain. Thus, in a different political environment, it might be possible to frame Taiwan's observer status in the ASEAN Plus Three as a confidence building measure for both sides: China could demonstrate that it can be inclusive of Taiwan in economic fora, and Taiwan could demonstrate that it takes its regional economic relationships seriously enough to not politicize its involvement.

Free Trade Agreements. The Chen administration has made FTAs a priority, particularly with the United States. U.S. officials have signaled the U.S. priority is to see Taiwan implement its WTO commitments before any free trade deal would be considered, particularly because an FTA would be considerably more stringent than Taiwan's current WTO agreement. Proponents argue that an FTA -- even with stringent compliance measures -- would give Taiwan's economic liberalization a needed push, not to mention a tremendous vote of confidence which has economic value in and of itself.

The issue might have been put to rest, yet when China entered the fray in July 2002 announcing that other countries "are not allowed" to conduct FTAs with Taiwan, proponents in both Taiwan and the U.S. became even more enthused by the prospect of challenging China's arrogance in dictating Taiwan's economic relationships. The U.S. Congress subsequently mandated an economic analysis of what a U.S.-Taiwan FTA would entail, and the result was that it would make a "very small difference in overall

trade and GDP growth on either side.”³⁹ Nevertheless, Taiwan officials continue to press the idea with the U.S., as well as with Singapore and Japan.⁴⁰

It is unlikely that Taiwan will achieve any new initiatives in this area prior to the March 2004 election. However, Beijing should be prepared to deal with whoever wins in a more constructive “win-win” approach, using the “gathering of economies” approach that has made APEC possible to take cross-Strait cooperation to a higher, more constructive level. One alternative is for China and Taiwan to pursue a free trade agreement as a way of depoliticizing cross-Strait and broader regional economic cooperation. There is the precedent of the China-Hong Kong “closer economic partnership arrangement” (CEPA), and a China-Taiwan agreement might be partially based on that. It could embody some of the key cross-Strait economic interactions not covered by the WTO, including three-links as well as a host of tax and investment-related measures that would ensure protection of Taiwan firms operating in China, as well as Chinese firms operating in Taiwan.

³⁹ International Trade Commission, October 2002 (<http://ftp.usitc.gov/pub/reports/studies/PUB3548.PDF>)
For a more optimistic analysis see Pochih Chen, “The Potential of Free Trade Areas in Asia Pacific Region.” Mimeograph, November 2002.

⁴⁰ In November 2003, Taiwan concluded an FTA with Panama.

Conclusion

This paper argues that cross-Strait economic dynamics are a market-driven phenomenon much broader than Taiwan or China alone. Referring to the integrated nature of cross-Strait economic linkages with globalization, Intel chairman Andrew Grove observed, “It is the computing equivalent of mutually assured destruction. You can’t hurt the other party without hurting yourself.”⁴¹

A comprehensive study of the IT sector also concludes, “There is a significant distance between propaganda sanctioned by the CCP and what the communist leaders would actually be prepared to carry out . . . While inflicting such a setback on its own economy for the sake of ‘the motherland’ might have been acceptable two decades ago, China’s increasing integration into the global economy would make it an unacceptable option today.”⁴²

Over the next five to ten years, economic ties between China and Taiwan will continue to be significant for both sides’ self-interests. While providing a headache for both Taipei and Beijing, cross-Strait economic linkages will mediate political/security tensions given their central role in both sides’ economic growth and globalization needs. China’s economic leverage over Taiwan’s behavior will remain minimal, with the important caveat that Taiwan needs to restructure its domestic economy to sustain domestic living standards, to remain internationally competitive, and to increase its economic relevance to international organizations.

Taiwan has a number of unilateral economic reforms it needs to undertake to build an economy that is not only competitive with China but with East Asia as well. Some of these measures are frustrated by the transition to a service economy; other policy initiatives are frustrated because they challenge vested interest groups developed during Taiwan’s long period of authoritarian rule. These reforms are understandably politically difficult, and Taiwan is not alone in East Asia in trying to grapple with reforms in the context of a new and evolving democracy. Other economic measures necessarily involve opening up restrictions on trade and investment with China, which ideally entails a domestic consensus that the cross-Strait relationship as a “win-win” situation for both sides, yet this does not appear possible in the current political landscape. President Chen’s recent appointment of economic policy advisor Vincent Chen could prove to create new opportunities for compromise, yet the current regime’s reliance on political legitimacy partially rests on staking independent political ground for Taiwan, which translates into economic policies that hinder rather than build on existing cross-Strait ties. The economic benefits that accrue to Taiwan’s domestic economy from the economic relationship with China are controversial and will remain a domestic political football throughout the presidential campaign to March 2004.

⁴¹ Cited in Chen Yuan-Tung, p. 73.

⁴² Craig Addison, *Silicon Shield: Taiwan’s Protection Against Chinese Attack*. (Irving, Texas: Fusion Press, 2001), p. 182.

By focusing on its economic vulnerability to China, many in Taiwan have lost perspective of its vulnerability to competitors in East Asia. Further research on how cross-Strait economic dynamics fit into to globalization trends in East Asia could usefully illustrate policy options for Taiwan to strengthen its international economic relationships across the spectrum of business and government as well as Track II fora, which could serve as a potential effective countermeasure to China's successful diplomatic isolation of Taiwan. Comparative case studies of the strategies adopted by East Asian governments and businesses to maintain competitiveness with China can help to place Taiwan's policies toward China into the context of the broader picture of regional relationships with China that is emerging. Such case studies would highlight policy options that either fail or succeed, and assist Taiwan policy makers in determining a broader range of options that may currently be considered. Even at the Track II level, Taiwan analysts and officials are not as exposed as they need to be to differing responses to the economic realities of China's emergence, and a greater effort to include Taiwan in international fora is more important than ever. Both Taiwan and China economies are critical to the functioning of the world economy, and it should be possible to create a "win-win" economic relationship that does not sacrifice Taiwan's security.