



UNISCI Discussion Papers

ECONOMIC RELATIONS BETWEEN TAIWAN AND CHINA

AUTOR¹:**CHEN-YUAN TUNG²****Institute of International Relations
National Chengchi University, Taiwan****FECHA:****Enero de 2004**

1. Trade Relations between Taiwan and China

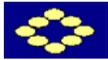
Because of political and military hostilities, economic exchange between Taiwan and China was virtually nonexistent between 1949 and 1979. On 1 January, 1979, after adopting reforms and open policy in late 1978, China proposed establishing the three links (direct trade, postal, and transportation links) between Taiwan and China. In 1980, China organized a mission to Hong Kong and purchased \$80 million worth of Taiwanese products. In the same year, to further encourage trade, China announced a tariff-free policy on Taiwan-made imported goods. However, the zero tariff policy lasted for only one year.

Beijing's initiatives received no response from Taipei until the mid-1980s. In 1985 Taiwan for the first time responded to China's request for cross-Strait trade by announcing the "Non-interference Principle of Indirect Exports to the Mainland." From then on, cross-Strait trade started to grow rapidly along with China's increasing economic reforms and Taiwan's gradual relaxation of limits on cross-Strait economic interaction. Nevertheless, Taiwan's imports from China are still under regulations. Only 53.9 percent (or 5,777 items) of 10,724 Harmonized Tariff Schedule (HS) system coded 10-digit trade commodities were permitted to be imported from China to Taiwan by December 2000 and 77.5 percent (or 8,306 items) by September 2003, respectively.

Statistics on trade between Taiwan and China should include the transit exports (re-exports) to China via Hong Kong, and other places; trans-shipment (goods are consigned directly from Taiwan to a buyer in China, though the goods are transported via Hong Kong); transit-shipment (goods do not change vessels and they just pass through Hong Kong on their way to China); direct trade (small-scale trade often conducted by fishermen, legal for China, but not for Taiwan); and smuggling (illegal for both Taiwan and China). Some portion of

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² Chen-yuan Tung is an assistant research fellow at the Institute of International Relations, National Chengchi University (Taiwan), director of China Economic Analysis project of the Cross-Strait Interflow Prospect Foundation, adjunct assistant professor at the Department of Political Science, Soochow University, and adjunct assistant professor at the Graduate Institute of National Development, National Taiwan University. He received his Ph.D. degree majoring in international affairs from the School of Advanced International Studies (SAIS), Johns Hopkins University. His expertise focuses on economic relations between Taiwan and China, Chinese economic development, and Taiwan-U.S.-China Relations.



Taiwan's exports to northern China transit through Japan and Korea, in particular through Japan's Ishigaki-jima (Shiyuan Islands).

Taiwan's Mainland Affairs Council (MAC) estimates that Taiwan's exports to China are equal to transit trade plus the difference between Taiwan's exports to Hong Kong and Hong Kong's imports from Taiwan. This estimate should be better than the figures from China's customs service because China's figures do not take different types of Taiwan exports to China into account and thus underestimate the total amount. Because the MAC has provided a consistent series of estimates for bilateral trade between Taiwan and China since 1981, scholars usually adopt its estimated figures.

Based on the MAC's estimates, Taiwan's indirect trade with China via Hong Kong was only \$460 million in 1981 and \$279 million in 1982. Thereafter, cross-Strait trade increased tremendously to \$3.9 billion in 1989, \$17.9 billion in 1994, \$31.2 billion in 2000, and \$37.4 billion in 2002. Between 1981 and 2002, Taiwan's trade with China has increased 134 fold.

In addition, Taiwan has enjoyed a continuous and large trade surplus with China for the past two decades. In 1981, Taiwan ran a trade surplus of \$310 million, with \$385 million of exports to, and \$75 million of imports from, China. In 1989, Taiwan ran a trade surplus of \$2.7 billion, with \$3.3 billion of exports to, and \$587 million of imports from, China. In 2002, Taiwan ran a trade surplus of \$21.6 billion, with \$29.5 billion of exports to, and \$7.9 billion of imports from, China.

Since 1993 China has become Taiwan's third largest trading partner, after the United States and Japan. In 2002, Taiwan's trade with the United States, Japan, and China was \$44.9 billion, \$39.3 billion, and \$37.4 billion, respectively. In addition, since 1993 China has also become Taiwan's second largest export market, next to the United States. In 2002 China became Taiwan's largest export market for the first time. According to the MAC's estimate, in 2002, Taiwan's exports to China (excluding Hong Kong), the United States, and Japan were \$29.4 billion, \$26.7 billion, and \$12 billion, respectively.

In comparison, between 1990 and 1999 Taiwan was China's fourth largest trading partner, next to Japan, the United States, and Hong Kong. Between 2000 and 2002 Taiwan was China's fifth largest trading partner, next to Japan, the United States, Hong Kong, and Korea. In 2002, China's trade with Japan, the United States, Hong Kong, Korea, and Taiwan was \$101.9 billion, \$97.2 billion, \$69.2 billion, \$44.1 billion, and \$37.4 billion, respectively. In addition, since 1993 Taiwan has also become China's second largest supplier (Japan has been its largest supplier). In 2002, China's imports from Japan and Taiwan were \$53.5 billion and \$29.5 billion, respectively.

Based on Taiwan's customs statistics, Taiwan's exports to China were concentrated in four of the 22 sections in the HS system: section 7 (plastics and rubber); section 11 (textiles); section 15 (base metals); and section 16 (machinery, mechanical appliances, electrical equipment, parts, and accessories). These four sectors included 61 percent of Taiwan's total exports to China in 1992, 75 percent in 1994, 77 percent in 1996, and 79 percent in 1998. Moreover, between 1992 and 1998, the merchandise structure of Taiwan's exports to China was similar to that of Taiwan's total exports and these four sections were the same four largest sections of Taiwan's overall exports.



In particular, the share of both section 15 and section 16 has been increasing exponentially. In 1992, section 15 represented 5 percent of Taiwan's total exports to China and section 16 represented 25 percent. In 1998, section 15 represented 13 percent of Taiwan's total exports to China and section 16 represented 33 percent. These two sections accounted for about 46 percent of Taiwan's total exports to China in 1998. By contrast, section 12 (footwear, headgear, and artificial flowers) accounted for 16 percent of Taiwan's total exports to China in 1992, but then declined dramatically to 2 percent by 1998.

This trend is closely related to Taiwan's investment in China. In the late 1980s and early 1990s, most of Taiwan's investment in China was in the shoe, textile, apparel, and plastics industries (sections 7 and 12). By the mid-1990s, the bulk of Taiwan's investment in China was concentrated in electronic and electric appliances and basic metals industries (sections 15 and 16). As a matter of fact, Taiwan's exports were mostly driven by Taiwan's investment in China.

According to Taiwan's customs statistics, the merchandise structure of Taiwan's imports from China was also concentrated in four of 22 sections in the HS system: section 5 (mineral products); section 6 (products of chemical or allied industries); section 15 (base metals); and section 16 (machinery, mechanical appliance, electrical equipment, parts, and accessories). These four sectors accounted for 61 percent of Taiwan's total imports from China in 1992, 61 percent in 1994, 69 percent in 1996, and 73 percent in 1998. These four sections were also the same four largest sections of Taiwan's overall imports between 1992 and 1998.

In particular, section 16 (machinery, mechanical appliance, electrical equipment, parts, and accessories) has increased rapidly, from 0.3 percent of Taiwan's total imports from China in 1992 to 37 percent in 1998. In addition, section 15 and section 16 accounted for about 57 percent of Taiwan's total imports from China in 1998. By contrast, in 1992, section 2 (vegetable products) accounted for 15 percent of Taiwan's total imports from China, then declined sharply to 3 percent in 1998. Furthermore, section 5 (mineral products) also declined from 28 percent of Taiwan's total imports from China in 1992 to 9 percent in 1998. Overall, Taiwan's imports from China are no longer China's basic agricultural and industrial raw materials, but products closely related to Taiwan's investment in China (sections 15 and 16).

Finally, trade between Taiwan and China was characterized by intra-industry trade (IIT), which refers to simultaneous exports and imports of commodities in the same industry or production group during a given time. The IIT index measures the degree of intra-industry trade and varies between 0 (complete inter-industry trade) and 100 (complete intra-industry trade). Based on the HS classification, the IIT index for the manufacturing industry of trade between Taiwan and China increased from 16 in 1992 to 30.4 in 1998.

2. Financial Relations between Taiwan and China

In 1987, Taiwan's government deregulated the control of foreign exchange leading to a rapid increase in outward investment by Taiwan entrepreneurs. In the late 1980s, Taiwan's outward investment mainly focused on the United States and the member countries of the Association of South East Asian Nations (mainly the Philippines, Indonesia, Thailand, Malaysia, and Vietnam, hereafter ASEAN-5). By the 1990s, Taiwan's investors rapidly shifted their attention to China. Such investors were primarily attracted by China's cheap labor (the most important reason) and the potential local market (the second important reason).



In addition, the Chinese government promulgated several regulations and laws to attract and protect Taiwan's investment in China. In July 1988, in order to attract Taiwan enterprises, China's State Council promulgated the "Regulations for Encouraging Investment by Taiwan Compatriots." China offered preferential treatment, with numerous cities and provinces setting up special investment zones, which granted Taiwan-invested Enterprises (TIEs) many privileges, including tax exemption or reduction. In March 1994, China's National People's Congress promulgated the "Taiwan Compatriot Investment Protection Law of the People's Republic of China." Furthermore, in December 1999, China's State Council issued the "Implementing Rules for the Taiwan Compatriot Investment Protection Law of the People's Republic of China."

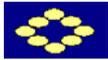
At the same time, Taiwan's government gradually relaxed the regulations on cross-Strait economic exchange at a crucial moment (1987-1988) when Taiwan exports were suffering due to a strong New Taiwan dollar, high cost of labor, and environmental controversies. Along with the relaxation of foreign exchange control, Taiwan's government liberalized its China policy by nullifying martial law and allowing Taiwanese to visit China. In October 1990, Taiwan's Ministry of Economic Affairs (MOEA) formally lifted the ban on indirect investment in China by promulgating the "Regulations on Indirect Investment and Technology Cooperation with the Mainland Area."

Although investment from Taiwan to China began to increase rapidly in the late 1980s, Taiwan's Investment Commission did not compile formal statistics until 1991. According to Taiwan's official figures, in 1991 Taiwan's outward foreign direct investment (FDI) into China was only \$17 million. Since 1992, however, China has become the largest recipient of Taiwan's outward investment. In 1993, the numbers increased dramatically to nearly \$3.2 billion, which was 66 percent of Taiwan's total FDI for that year. By the end of 2002, Taiwan's cumulative FDI in China was \$26.6 billion, or 43.4 percent of total Taiwan outward FDI. In just one decade, China became the destination with the most accumulated Taiwan's outward FDI.

Overall, Taiwan's FDI in the late 1980s and early 1990s involved mainly small-medium, labor-intensive enterprises looking for overseas manufacturing bases, most of them focusing on China as well as ASEAN-5. After the mid-1990s, Taiwan's FDI in China involved more and more large enterprises with high capital and technology intensities, companies looking for both overseas manufacturing bases and access to China's huge potential market. For instance, in 1995, only 14 percent of Taiwan's information technology (IT) products were produced in China; in 2003, 63.3 percent were already produced in China.

Taiwan's official figures considerably underestimate the extent of Taiwan's "real" investment in China because many Taiwan businesses began in the mid-90s to invest in China through their holding companies in third tax-exempt countries, such as Virgin Islands and Cayman Islands. For instance, Perng Fai-nan, governor of Taiwan's Central Bank, estimated that by the end of 2002 the real figure of Taiwan's cumulative investment in China was about \$66.8 Billion.

As a result, scholars usually use China's official data on Taiwan's investment in China because it is mandatory for TIEs to register their investment with the Chinese government. According to China's statistics, the first TIE in China opened in 1983, and by 1991 Taiwan's total realized investment in China was \$844 million divided among 3,446 projects, with a



cumulative contracted amount of \$2.78 billion and an average contracted amount of \$0.81 million per project. Since 1991, Taiwan's investment in China has been increasing dramatically with an average annual contracted amount of \$5.3 billion or an average realized amount of \$2.9 billion.

As of June 2003, Taiwan's accumulated contracted investment in China was \$65 billion (57,856 projects), of which \$35.2 billion was actually utilized, with an average contracted amount of \$1.12 million per project -- average project size has grown by about 39 percent. In addition, the share of Taiwan's cumulative realized investment in China was 7.4 percent of total FDI in China. Taiwan was the fourth largest source of FDI in China, next to Hong Kong (45.2 percent), the United States (8.9 percent), and Japan (8.2 percent).

Nevertheless, Chinese figures might also underestimate Taiwan's "real" investment in China because many Taiwan businesspeople began in the mid-1990s to invest in China through their holding companies in British Central America. Parenthetically, Virgin Islands (part of British Central America) was the fifth largest investor in China by June 2003, with cumulative realized FDI of \$27.7 billion or 5.8 percent of China's total FDI.

Regarding Taiwan's investment in China by industry, there is no available Chinese data and thus this article relies on Taiwan's official data. As of July 2003, according to Taiwan's MOEA Investment Commission, Taiwan's total investment in China included: \$10 billion (31.1 percent) in electronics and electrical appliances; \$2.8 billion (8.7 percent) in basic metals and metal products; \$2.2 billion (6.9 percent) in plastic products; \$2.2 billion (6.9 percent) in chemicals; \$1.8 billion (5.6 percent) in food and beverage processing; \$1.8 billion (5.5 percent) in precision instruments; \$1.6 billion (5 percent) in non-metallic minerals; \$1.3 billion (3.9 percent) in transportation equipment; \$1.2 billion (3.9 percent) in textile; and \$1.1 billion (3.4 percent) in machinery equipment. As of July 2003, Taiwan's investment was focused in the manufacturing industry, which accounted for 96 percent of Taiwan's total investment in China.

As of July 2003, the geographic distribution of Taiwan's cumulative investment in China was as follows: \$13 billion (40.2 percent) in Jiangsu (including Shanghai); \$10 billion (31.1 percent) in Guangdong; \$3 billion (9.2 percent) in Fujian; \$1.9 billion (6 percent) in Zhejiang; \$1.6 billion (4.9 percent) in Hebei (including Beijing); and \$562 million (1.7 percent) in Shandong. Based on Taiwan's statistics, these six coastal provinces comprised 93 percent of Taiwan's total cumulative investment in China.

In addition, TIEs tend to partner with local and foreign enterprises when they invest in China. According to a 1996 report by Taiwan's MOEA, which included a sample size of 1,312 companies, 36 percent of TIEs established joint ventures with other partners. Fifty-six percent (multiple choices) of TIEs who entered joint ventures cooperated with local Chinese enterprises, 35 percent cooperated with Chinese local governments, and 28 percent cooperated with foreign enterprises.

According to a 1999 report by Taiwan's MOEA, which included a sample size of 1,627 companies, 38 percent of TIEs established joint ventures with other partners. Fifty nine percent of these TIEs held less than a 50 percent share in the joint ventures. Thirty one percent (multiple choices) of these TIEs cooperated with local Chinese enterprises, 20 percent cooperated with Chinese local governments, and 26 percent cooperated with foreign enterprises.



Regarding other capital flow between Taiwan and China, the Taiwanese government began to compile statistics on individual remittances to China (including household remittance, donation, and other transfer payments, but excluding travel expenditures) on 21 May 1990, and on both Taiwan business remittances to China and remittances from China to Taiwan on 29 July 1993. In 1993, Taiwan remitted \$254 million to China and China remitted \$26 million to Taiwan. In 2002, Taiwan remitted \$2.5 billion to China and China remitted \$2.3 billion to Taiwan. As of July 2003, Taiwan had remitted a cumulative \$12.7 billion to China and China had remitted a cumulative \$8.3 billion to Taiwan.

Nevertheless, the Taiwanese government's figures hardly tell the truth of capital flow across the Taiwan Strait. For example, Taiwan's Central Bank estimated in late 2000 that Taiwan's total capital flow to China was around \$70 billion, of which \$40-50 billion was Taiwan's FDI in China. That is, in 2000 Taiwan might have remitted as much as \$20-30 billion in total to China, including portfolio flows to China.

3. Prospects of Economic Relations between Taiwan and China

With Taiwan and China entering the World Trade Organization (WTO) in late 2001 and Taiwan's increasing direct investment in China, trade between Taiwan and China has been growing rapidly. Based on the MAC's estimate, Taiwan's exports to China witnessed a 34.3 percent jump in 2002, followed by a jump of 28.3 percent in the first seven months of 2003; Taiwan's imports from China witnessed a 34.7 percent jump in 2002, followed by another jump of 35.3 percent in the first seven months of 2003. Accordingly, Taiwan's exports to China accounted for 24.0 percent of Taiwan's total exports, while Taiwan's imports from China accounted for 8.3 percent of Taiwan's total imports.

In addition, according to China's official statistics, in the first six months of 2003, Taiwan's realized investment in China was \$2.1 billion, increasing by 9.4 percent year over year. By June 2003, Taiwan's cumulative FDI in China was \$35.2 billion, or 51.7 percent of total Taiwan outward FDI. Since the mid-1990s, Taiwanese firms in China have expanded from labor-intensive manufacturing investment to more capital- and technology-intensive ventures, particularly in the IT industry. Taiwanese financial services firms are also positioning for entry.

"Made by Taiwan but Made in China" would be a new expression to describe the global division of labor across the Taiwan Strait driven by Taiwanese businesspeople's direct investment in China. Over the last decade, both sides of the Strait benefited tremendously from this economic division of labor in the IT industry. For instance, from 1996 to 2003, the average annual growth rate of Taiwan's IT products made in Taiwan was negative 0.7 percent while that in China was 39.4 percent. Taiwanese businesspeople's investment in the IT industry in China has improved tremendously the competitiveness of their IT products through reducing input costs and accessing the Chinese market. In comparison, during the period of 1999-2001, the Taiwanese businesspeople contributed to around 60-70 percent of China's IT hardware products. Based on the market force, this economic division of labor across the Strait in the IT and other industries would be broadened and deepened continuously in the future.

Although both sides of the Taiwan Strait benefits enormously from rapidly increasing economic exchange, bilateral economic disputes become emerging issues after Taiwan and China entered the WTO in late 2001. As of December 2003, the Chinese government has conducted five anti-dumping investigations and adopted some transitory safeguard measures against Taiwan's exports to China. Nevertheless, the Chinese government refused to solve



cross-Strait trade disputes through the WTO existing channel. Without a formal mechanism of consultation and negotiation, these trade disputes will continue to become controversial for both sides.

Now the highlighted agenda of economic relations between Taiwan and China would focus on the negotiation of bilateral direct links across the Taiwan Strait over next few years. After July 1999, China disrupted cross-Strait negotiation through bilateral semi-official channels, i.e., Taiwan's Strait Exchange Foundation (SEF) and China's Association for Relations Across the Taiwan Straits (ARATS). China insists that Taiwan must accept the one-China principle before resuming SEF-ARATS negotiation.

Nevertheless, after August 2000, China asserted that establishing the "three direct links" did not mean that the two sides needed to resolve political issues (the one-China principle) first. China proposed this issue to be solved through private-to-private, industry-to-industry, and company-to-company channels. Furthermore, in October 2002, China defined cross-Strait air and sea links as "cross-Strait routes," minimizing the political controversies of the "direct links."

In 2003, both sides across the Taiwan Strait have further shown their commitments on the negotiation. On August 13, Taiwanese President Chen Shui-bian pledged to resume direct links with China by the end of 2004. Two days later, the Taiwanese government issued a policy paper called "The Assessment of the Impact of Direct Cross-Strait Transportation," which meant that the Taiwanese government was preparing the direct links negotiation.

On October 9, Taiwan's parliament, the Legislative Yuan, passed the revisions to the Statute Governing the Relations between the People of the Taiwan Area and the Mainland Area. According to the revisions, the Taiwanese government will have to draft bylaws concerning the opening of direct cross-Strait transportation links within 18 months. More importantly, government agencies will be able to entrust private organizations to engage in cross-Strait negotiation on their behalf. That is, Taiwan has agreed to China's preference of the negotiation channel over the direct links.

In addition, on December 17, China issued a policy paper on promoting direct links between Taiwan and China, reiterating its flexible position on the negotiation of the direct links. These measures taken by the both sides should help break the prolonged impasse in the cross-Strait dialogue and negotiation of the direct links and even other economic issues.