Statement before the U.S.-China Economic and Security Review Commission

Cross-Strait Economic and Political Issues

A Statement by

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Cross-Strait relations have marked a path of reduced tension and increasing cooperation after the election of President Ma Ying-jeou of the ruling Chinese Nationalist Party (KMT) in 2008. Taiwan's efforts to institutionalize its engagement with the People's Republic of China (PRC), particularly in trade and investment activities, presents both opportunities and challenges on both sides of the Strait, and also for the United States.

Taiwan's effort to forge mutually beneficial economic relations with the PRC under the Cross-Strait Economic Cooperation Framework Agreement (ECFA) reflects the importance and complexity of the triangular relationship. There are delicate economic, political and security issues in play in a scenario of a closer cross-Strait integration. These include ECFA's impact on Taiwan's economy and its trade relationships, the possibility of an eventual cross-Strait political integration that could follow intensifying economic cooperation, and the risk of power imbalance in the triangular relationship as a result.

This paper intends to focus on the cross-Strait economic undertakings and would address three areas as follows:

- The current status and assessment of cross-Strait trade and investment flows and their trends since 2008.

- The implications of closer cross-Strait economic integration for Taiwan and the United States.

- Policy recommendations and potential Congressional action.

Cross-Strait Economic Relation

Current Status

Both Taiwan and the PRC have undertaken a systematic effort to stabilize cross-Strait relations since President Ma took office in 2008. This has helped reduce business uncertainty and foster trade and investment flows for both sides. The PRC has consequently become Taiwan's largest trading partner in terms of total trade and export market, as well as its second-largest importer. According to Taiwan's Mainland Affairs Council (MAC), Taiwan had an overall trade volume of US$124 billion with China in 2013, growing nearly three times since 2000. During the same period, the share of Taiwan's exports to mainland China rose to 28.5 percent from 16.9 percent, while the share of its imports from China rose to 15.8 percent from 4.5 percent. The exporting share increases to nearly 40 percent when incorporating exports routed through Hong Kong. As a result, Taiwan has maintained a relatively consistent trade surplus with mainland China, valued at US$39.2 billion in 2013.

As a small island with scarce natural resources, Taiwan has been an avid overseas investor as part of its economic development. It has become a major investor in mainland China, whose share of Taiwan's outward foreign direct investment (FDI) grew to approximately 80 percent in recent years from approximately 50 percent in the early 1990s, as estimated by the Chung-Hua Institute for Economic Research (CIER) which is a policy institute for Taiwan's government.

As Taiwan grows more dependent on investment in China for its economic performance, it would have more at stake in the event of changes in either direction. This would in turn give the PRC more leverage over Taiwan.

According to the MAC, Taiwan's approved outbound investment in mainland China since 1991 reached US$133.7 billion by 2013. The annual amount of Taiwan's approved FDI into China peaked at US$14.3 billion in 2011, the first year when ECFA was enacted, and growing 450 percent since 2000. This annual FDI flow then tapered downward to US$9.1 billion in 2013.

At the sector level, the manufacturing industry in China is the top recipient of Taiwan's approved outbound investment with an accumulated value of nearly US$107 billion from 1991 to 2013. Electronic parts and components manufacturing, in particular, has garnered the majority of Taiwanese manufacturing FDI flow. This partly reflects a cross-Strait production cluster, where Taiwanese industrial components are exported to the PRC, which has comparatively cheaper labor costs, then manufactured into final products and re-exported. In 2013, Taiwan's approved FDI in China's manufacturing was valued at $5.1 billion, more than half of the total.

As the cross-Strait economic interaction deepens and the PRC eases access to its financial system, Taiwanese FDI in the finance and insurance sectors is also on the rise. In 2013, it became the second largest recipient sector, capturing over 20 percent of the funding with a value of close to US$2 billion. Moreover, finance garnered the largest average investment, with a value of US$95 million per case.

Some could argue that these statistics may under-estimate the level of Taiwan's investment. It is not an uncommon practice for some Taiwan investors to invest in China through a Hong Kong entity or via third-party routings to avoid governmental scrutiny. Moreover, there are more than 70,000 Taiwanese companies with operations in China that could reinvest their retained earnings instead of remitting profits back home. Additionally, it is informally estimated that more than one million Taiwanese businessmen and their families currently reside in China and may also contribute to investment flows locally. All these factors further raise the degree of Taiwan's dependence on China for economic gains.

Cross-Strait Economic Cooperation Framework Agreement (ECFA)

The Ma government has regularly urged opening up cross-Strait economic relations. This push derives partly from the broader concern over Taiwan's becoming potentially marginalized, and less globally competitive, as an outsider in the rising trend in bilateral and multilateral Free Trade Agreements (FTA) in East Asia. For its part, ECFA was considered the first official attempt between Taiwan and the PRC to institutionalize under an FTA-natured framework the existing and mostly private cross-Strait economic activities. The blueprint for ECFA was a stated commitment to "gradually reduce or eliminate tariff and non-tariff barriers to trade" in goods and services sectors, in an effort to further cross-Strait economic integration and stability over the long run.

The first milestone of ECFA is the "Early Harvest Program." It aims mainly to reduce trade tariffs on goods, with some market access allowance in banking and other service industries, between the two sides of the Strait. Early Harvest involves 539 Taiwanese goods, covering 16 percent of Taiwan's exports to the mainland China and estimated to be close to US$14 billion. The PRC will, in turn, receive tariff cuts on 267 Chinese products, which make up 11 percent of China's exports to Taiwan worth approximately US$3 billion. As Taiwan already enjoys a large trade surplus with the PRC, the Early Harvest provisions appear to further enhance Taiwan's trading edge with China, at least before additional liberalization agreements in services and merchandise are built into the program as part of a completed ECFA.

The CIER has projected that ECFA, enacted in January 2011, will serve to increase Taiwan's gross domestic product (GDP) growth by 1.65 to 1.72 percentage points, to raise its export growth by 5 percent, and to create approximately 263,000 new jobs. Based on data from the International Monetary Fund, Taiwan's real annual GDP growth reached 10.8 percent in 2010, the year when ECFA was signed and before its implementation, declining in 2011 to 4.2 percent. The sharp increase in 2010 was partly due to the heightened expectation of ECFA's effect during negotiation, as well as the low GDP base figure from the preceding year due to the global financial crisis.

When the Early Harvest program was put in place in 2011, Taiwan's exports to mainland China grew 9.1 percent according to Taiwan's Customs Bureau. This figure then dropped to a negative growth of 3.9 percent in 2012, the year of Taiwan's highly contested Presidential election, before recovering back to 1.3 percent in 2013. The annual growth rate of those Early Harvest exports in particular peaked in its first year of implementation at 18 percent, dipped to 3.3 percent in 2012, then rose close to 11 percent in 2013.

There are three main industry categories highlighted in the Early Harvest product list - petrochemical, steel, and electronic- and optical-related items. Other items such as agricultural and textile products comprise less than 3 percent of the Early Harvest program. Many analysts would consider the sectors covered under the Early Harvest list to be the main beneficiaries from ECFA to date. For instance, Taiwan's core petrochemical export to mainland China is diethylhexyl phthalate (DEHP), a key plasticizer in polyvinyl chloride (PVC) manufacturing. After the Early Harvest program, the market share of Taiwan's DEHP exports to China increased to 73.8 percent and was valued at US$132 million in 2013 from 43.4 percent and US$121 million in 2010, according to Taiwan's Bureau of Foreign Trade (BOFT). Taiwan's main competitor, South Korea, saw its market share in the same product decline to 22.9 percent from 42.6 percent and its export value dropping to US$41 million from US$119 million.

China also became the largest exporting market for Taiwanese agricultural products in 2013, according to Taiwan's BOFT. Taiwan's agricultural products enjoy a trade surplus valued at US$20 million in 2013 with its Chinese counterparts, a change from a trade deficit of US$190 million in 2009. Farmed food fish products such as groupers make up 70 percent of the overall agricultural exports to China. Over 14,234 tons of Taiwanese groupers were exported to China in 2013, from 4,159 tons in 2010.

Early Harvest benefits Taiwan's finance and insurance sectors with market access opportunities in China to establish a foothold before their potential competitors. There are eleven Taiwanese banking firms that currently have operations in the PRC as of the first quarter of 2014, as shown in Taiwan's BOFT data. Moreover, China has approved FDI from thirteen Taiwanese securities firms whose funding total is valued at US$1.8 billion to date. Ten Taiwanese insurance companies are granted Qualified Foreign Institutional Investors (QFII) status with total investment limit up to US$170 million.

Taiwan's CommonWealth (CW) magazine reported in April that Chinese Early Harvest-related exports to Taiwan have increased their market share to 30 percent from 24 percent before the program. This report stands against the conventional wisdom that is held by many analysts. They have suggested that Taiwan would benefit from Early Harvest since tariff cuts provide cost savings for the related Taiwanese exports, and thus increase their competitiveness and market share in China. Nevertheless, while the figures described above indicate increases in *total* exports to China, in many cases they do not represent significant increases in market share.

For example, Taiwan's stainless steel industry is included as a part of the main Early Harvest industry groups, and is a core industry in the southern city of Kaohsiung. But their own Early Harvest tariff reductions and especially overcapacity enable Chinese stainless steel producers to lower their prices by as much as 30 percent below market. This low pricing strategy in turn generates an asymmetric competitive advantage over their comparatively smaller competitors in Taiwan. Some Taiwanese producers have thus been forced into bankruptcy and their workers lost jobs. The larger and more vertically integrated Taiwanese producers are also exposed to declining orders as well as low capacity utilization – below 20 percent at one point during the Early Harvest period. In the case of cold-rolled stainless steel products, 30 percent of the production of Taiwan's top two stainless steel firms is replaced by low-cost imports from both China and South Korea, who together enjoy an annual exports volume growth of more 100,000 tons to Taiwan.

There are also preliminary signs suggesting that trade benefits may not be evenly allocated. Few Taiwanese beneficiaries, who are generally larger in size and with a more established distribution network, are positioned to realize greater economic gain as a result of the Early Harvest. This effect could be intensified in sectors with less brand recognition such as the steel industry, and lower entry barriers, such as agriculture. In case of grouper farming, much of the trade gain is reported by Taiwan's CW magazine to come from the few established producers and distributors, who have more than half of the market share in Taiwan, not the many smaller-sized domestic fish farmers. Moreover, cross-Strait procurement of fruits and other agricultural products is mostly done by trading agents from both sides. There may be potential moral hazard and agency problems which would risk carving out trade gains that could have been distributed to the domestic farmers and producers.

It is a challenge at this point to assess the CIER's projection of 263,000 new jobs under ECFA since Early Harvest involves merely 6 percent of the total goods items to be included in the full-fledged ECFA negotiation and few service-sector market openings.

As estimated by economics professor Lin Shun-Kai of Taiwan's National Taiwan University, Taiwan's unemployment rate would drop 1 to 2 percent points from the 4.18 percent in 2013, if those job gains occurred. According to Taiwan's National Statistics, Taiwan's nominal unemployment rate has not been lower than 3.9 percent since 2000. It should also be noted that the unemployment rate has gradually declined from its height of 5.85 percent after the global financial crisis in 2009 to the current level around 4 percent during the period of Early Harvest.

Major Cross-Strait Agreements to Date

As mandated by ECFA, several items are to be negotiated following the Early Harvest program. These include investment protection, services trade, merchandise trade, and dispute settlement. This is an effort to provide a concrete legal framework to foster trade and investment activities between Taiwan and China. There have been more than 20 cross-Strait agreements signed or already in effect since the Early Harvest period.

In particular, the Cross-Strait Investment Protection Agreement (CSIPA) became effective in February 2013. CSIPA addresses the need to institutionalize an investment security mechanism and to build investors' confidence, rather than try to eliminate all risks for Taiwanese investment. CSIPA provides several types of resolution mechanism, both in official settlement and private arbitration, for investment-related disputes. CSIPA also has a notification mechanism to ensure personal safety, where the PRC officials are committed to notify the investor's family or company within 24 hours in case of non-national security related detention. According to Taiwan's Ministry of Economic Affairs, there have been 131 CSIPA-related cases reported and subsequently resolved to date.

The Cross-Strait Services Trade Agreement (CSSTA) was signed in June 2013 as part of ECFA to liberalize trade in services. CSSTA has raised great public concern because of its scope and implications, culminating in a 24-day, student-led, sit-in protest inside Taiwan's Legislative Yuan (LY) and one of the biggest rallies in Taiwan's history this March. It is currently pending in the LY, and is expected to be subjected to additional legislative scrutiny.

As I have noted in *The Diplomat*, the CSSTA aims to formalize existing business practices and lift trade restrictions between Taiwan and China. China would open a total of 80 market segments while Taiwan would liberalize 64 industries. As the smaller economy, Taiwan is expected to benefit more from China's larger market. Many observers have projected that Taiwan's financial and retail-related industries, which together compose roughly 25 percent of GDP, would emerge as the primary beneficiaries. For instance, Taiwanese securities firms would be eligible for fully-licensed operations within China's designated provinces and a maximum ownership of up to 51 percent. Taiwanese banks could offer an expanded Renminbi (RMB) service platform and open sub-branches in China's Fujian Province.

While trade liberalization encourages structural reforms and a more rational allocation of resources, in addition to broader market-opening, the CSSTA is not without economic flaws. In particular, it fosters asymmetric competition, insufficiently reflects service providers' comparative advantages, and potentially harms less competitive groups.

Taiwan's service sector accounts for almost 70 percent of its GDP. It consists mainly of small- and medium-sized enterprises (SME). This stands in stark contrast to their Chinese counterparts, who are usually larger, better-funded state-owned enterprises (SOE). For example, the Boston Consulting Group valued China's overall travel market in 2010 at US$158.6 billion, which is mainly shared by three Chinese SOEs and their affiliates in an oligopoly industry structure. In contrast, there are over 3,000 companies competing in the US$744 million travel market in Taiwan. This scale disparity threatens to place the Taiwanese SMEs at a competitive disadvantage.

Other domestic barriers will remain after the CSSTA's implementation. In regards to e-commerce, Taiwanese portals, such as Yahoo/Kimo and PChome, will continue to be barred from entering China. Some Chinese firms, such as Taobao.com, already operate in Taiwan without similar market restrictions. Also, local Chinese spas and hairdressers are subject to a flat-tax scheme, while Taiwanese entrants may face higher operating expenses, and thus less competitiveness, due to China's progressive income tax mechanism for external investors.

The CIER has projected that the CSSTA will increase Taiwan's GDP growth by 0.025 to 0.034 percent. The study suggests that a relatively small number of targeted beneficiaries would provide the greatest economic contribution. Many service providers are clustered in lower-entry-barrier industries, such as laundromats and printing shops, and they would inevitably feel the effects of increased competition.

The other stakeholders are the workers. Taiwan's service sector employs nearly 60 percent of its workforce. The CSSTA could potentially affect roughly 2.85 million people's livelihoods. With the average annual real salary in 2013 shrinking back to the level of 16 years ago, at around US$14,400 in 1997 dollars, lower-skilled workers in less competitive industries are already at risk. Younger workers may be greatly affected, as many are experiencing lack of job mobility and stagnation in entry-level wages which run approximately 38 percent below norm. Additionally, unemployment rate for the 15-24 year old workforce in 2013 was 13.2 percent, approximately three times that of the overall unemployment rate. It is not clear if the CSSTA will be accompanied by trade adjustment assistance, offer grace periods to cushion the blow, or institute plans to help meet the new market challenges.

As Taiwan grows closer to China, some are concerned that Taiwan will become increasingly reliant on China as the main source for its growth; that the departure of Taiwanese manufacturing firms to China would accelerate; and that the comparatively better funded Chinese firms may become a dominating market force in certain industries when allowed to invest or trade in the smaller market in Taiwan. These fears are not entirely unfounded, as is illustrated by the stainless steel industry. Moreover, China faces slowing economic growth as it attempts to rebalance to a more consumption-driven economy, raising the system risk to Taiwan as well.

As a result of the March protest, the party leaders from the KMT and the Democratic Progressive Party announced that they intend to deliberate on a cross-Strait monitoring mechanism in an attempt to restore public trust and the government's accountability. The monitoring mechanism is envisioned to provide greater civic and legislative oversight over the negotiation processes to ensure that future pacts with China are based on equal and dignified terms. However, it could risk prolonging the negotiation process of and present additional hurdles to both the rectification of the CSSTA and the ongoing Cross-Strait Merchandise Trade Agreement (CSMTA), if it is not managed appropriately. The end result would also serve as an important signal to other countries, including the U.S., in evaluating Taiwan as a trade partner.

There has not been a full disclosure of what the CSMTA agreement would entail. Based on preliminary information, CSMTA presents a more substantive, and thus more complex, liberalization agreement between Taiwan and the PRC. In particular, it would involve tariff reduction and some special quota arrangements for more than 6,000 merchandise items from both sides. Those items would also include 830 agricultural goods which will raise concerns from domestic producers. Given the public sentiment toward the CSSTA, it remains to be seen how the CSMTA could be concluded and in what way it would affect the cross-Strait economic dynamics going forward.

Implications of Closer Cross-Strait Economic Integration for the United States

In light of recent cross-Strait economic integration, there appears to be an imbalance in the triangular relationship amongst the United States, China and Taiwan. As Taiwan's economy grows increasingly integrated with and dependent on the PRC, the economic influence of the U.S. is decreasing. Should this trend persist, it could further weaken the U.S.-Taiwan economic leg and strengthen the PRC's commercial leverage on other side of the triangle. This power disparity could upset the triangular balance and create a potentially unhealthy cycle, where unfavorable economic outcomes are felt in additional aspects of the U.S.-Taiwan relationship, such as security. Furthermore, this imbalance could challenge the conventional assumption that deepening cross-Strait economic interdependence leads to peace and stability over the long run.

In comparison to the expanding American trade relationship with China, U.S.-Taiwan trade appears to be flat or declining in general under President Ma's administration. According to the Office of the United States Trade Representative (USTR), U.S. total trade with Taiwan in 2013 was US$63.6 billion, making Taiwan the 12th largest U.S. trading partner. This figure went slightly downward from US$64.6 billion in 2007; the year prior to President Ma assuming office. U.S. exports to Taiwan were US$25.6 billion in 2013, off by 36 percent from US$38.3 billion in 2007. While the PRC replaced the U.S. as Taiwan's largest export market back in 2002, Taiwan has also steadily dropped in rank to become the 16th-largest U.S. export market in 2013. U.S. imports from Taiwan were US$37.9 billion in 2013, an increase of 44 percent from US$26.4 billion in 2007. This in turn contributed to reversing the U.S. trade surplus of US$12 billion with Taiwan in 2007 to a trade deficit of US$12.3 billion in 2013. In the case of U.S.-Taiwan FDI activities, the U.S. is one of the top investors in Taiwan with its FDI stock invested valued at US$16.5 billion in 2012.

Trade and investment data is likely to underestimate Taiwan's true significance to the U.S. economy, in light of the cross-Strait production cluster in the global supply chain. According to Taiwan's MOEA, U.S. technology companies are among the major buyers of hardware products made by Taiwan firms, which usually own production and assembly facilities in China to capitalize on cheaper labor costs. For example, while Apple's products such as iPhone and iPad are developed in the United States, they are produced and assembled by Taiwanese-invested factories in China with some components from Taiwan. The final products are then re-exported globally, including to the United States.

Additionally, Taiwan is an integral part of the global technology value chain, which in turn increases competitiveness for the U.S. companies. For instance, Taiwan Semiconductor Manufacturing Company (TSMC) is the largest semiconductor foundry in the world, and has its main operations in Taiwan. TSMC not only supplies cost-effective and reliable semiconductor components to leading U.S. companies including Broadcom and NVIDIA, but also acts as a peer outsourcing supplier to those firms such as Intel and Texas Instruments. Additionally, TSMC produces processors for device companies such as Apple.

While Taiwan may fall behind in pursuing talks with its trading partners, its unique position in the technology value chain and competitive collaboration with American companies are not expected to weaken in the near future. It is therefore in the economic interests of the United States to maintain a stable position of trade and investment influence with Taiwan and China, and to ensure each leg of the triangular relationship is in balance with the others going forward.

Policy Recommendations

In light of the evolving dynamics in the Taiwan Strait, the United States ought to be adaptable in its policy considerations as part of its "rebalancing" strategy in Asia. Particularly, strategies concerning cross-Strait interactions and developments need to be deliberated in the regional context since they would have enduring ramifications on the neighboring countries.

From the economic perspective, as China works to adjust to a slower growth path, potential spill-over effects onto its neighboring and trade partners are an inevitable consequence. Preemptive efforts to strengthen competitiveness are the right response. It is in the U.S. interest to be engaged in the region to influence and ensure favorable balance of economic power for all parties involved. Moreover, promotion of internal structural reforms and external market liberalization would need to go in tandem with diversification of trade relationships and partnerships in bilateral or multilateral FTAs such as the Trans-Pacific Partnership (TPP).

Congress could play an important role in furthering this process as follows:

First, Congress could encourage the USTR to intensify negotiations for a Bilateral Investment Agreement (BIA) under U.S.-Taiwan Trade and Investment Framework Agreement (TIFA). The BIA, if enacted, could also serve to accelerate a virtuous cycle by the Taiwanese government to take action on additional structural reforms and further cooperation in preparation for future trade negotiations.

Second, Congress should conduct regular assessments of the effectiveness of the communication mechanism between the U.S. and Taiwan. This in part would serve to ensure that means to conduct periodic bilateral economic discussions, for both public and private actors, exist and function properly. It would also facilitate in reducing misunderstanding and increasing consensus before the two sides engage in official negotiations. This appraisal process could be pursued through hearings, briefings or reports.

Third, Congress ought to enact trade promotion authority legislation to demonstrate its support for the TPP's high free-trade standards. This is also an important commitment to enhance American economic leadership and other vital interests in the Asia-Pacific region.

Fourth, Congress could urge the Administration to support Taiwan's accession to the TPP talks, as Taiwan is an integral part of the American technology value chain and regional production supply chain. This support would also be a strong signal to strengthen Taiwan's domestic support and enabling the aforementioned virtuous cycle of structural reforms.

Finally, Congress should advise the Administration to conduct a comprehensive policy review on Taiwan on a periodic basis. This year marks the 20th anniversary of the Taiwan Policy Review done under the Clinton Administration in 1994. The dynamics in the Taiwan Strait as well as within Taiwan and its people have evolved greatly over the past two decades. It is important to update and incorporate current trends into policy planning to ensure effectiveness going forward.