

**THE BROOKINGS INSTITUTION**  
**CENTER FOR NORTHEAST ASIAN POLICY STUDIES**

**TAIWAN'S ECONOMIC OPPORTUNITIES AND CHALLENGES**  
*and*  
**THE IMPORTANCE OF THE TRANS-PACIFIC PARTNERSHIP**

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# 1. Taiwan's Economy and Trading Relationships

## *Introduction*

The following Working Paper provides an overview of Taiwan's economic structure and the trading relations which have underpinned the globalization of its economy. The Working Paper outlines Taiwan's economic challenges and analyzes the economic costs for Taiwan of not participating in the growth of regional Free Trade Agreements (FTAs). The Paper discusses why it is important for Taiwan to participate in these FTAs - and in particular the Trans-Pacific Partnership (TPP) - both as a means of retaining competitiveness in its key export markets and perhaps more importantly, as an external driver of domestic economic reform.

## *Taiwan's Economy*

Taiwan is an economic success. Since 1992, Taiwan's GDP growth has averaged 4.5 percent. This raised real per capita income from \$9,116 in 1992 to \$19,762 in 2012, with the result that today Taiwan is the 28th wealthiest country globally, and 6th richest country in Asia. And along the way Taiwan has transformed itself from a dictatorship into a vibrant democracy.<sup>1</sup>

Fuelling this growth in Taiwan has been a rapid expansion in international trade. In 1992, Taiwan's total trade was over \$180 billion and represented 82 percent of GDP. In 2012, Taiwan's trade represented 140 percent of GDP and was valued at over \$650 billion, making it the world's 19<sup>th</sup> largest trader even though it is only the 28th largest economy in the world.

Of Taiwan's goods exports in 2012, approximately 99 percent were from the industrial sector, while agriculture goods comprised around 1 percent of exports. In terms of imports, over 77 percent of Taiwan imports are of agricultural goods and raw material, reflecting Taiwan's limited arable land and lack of indigenous natural resources. Capital goods are the next largest imports (14 percent), followed by consumer goods (approximately 10 percent).

As these figures demonstrate, Taiwan's economy is highly dependent on international trade. In fact, from 2005-2012 net exports was the most important driver of growth in Taiwan. Taiwan's economy focuses on producing parts and components that are incorporated into final products, often sold by companies from Japan, the United States, or European Union.<sup>2</sup> In fact, over 70 percent of Taiwan's exports comprise intermediate goods. This so-called contract manufacturing has been especially focused in the information and communications technology (ICT) sector. Taiwan produces 94 percent of the world's motherboards and notebook PCs. And the Taiwan Semiconductor Manufacturing Company produces most of the computer chips used by U.S. companies such as Qualcomm and Nvidia. That said, Taiwan also has some global brand names such as Acer and Asus for PCs, and companies such as Quanta and Wistron are original design

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<sup>1</sup> Shelley Rigger, *Why Taiwan Matters - Small Island, Global Powerhouse*, (Rowman & Littlefield Publishers 2011), pp. 59-94.

<sup>2</sup> Mona Haddad, "Trade Integration in East Asia: The Role of China and Production Networks" World Bank Policy Research Working Paper 4160, March 2007, p. 2.

manufacturers for most global PC brands.<sup>3</sup> Additionally, Taiwan businesses rely heavily on overseas production networks to make goods for export. This varies by sector, but in areas such as ICT, up to 85 percent of Taiwan's exports are made outside Taiwan.<sup>4</sup>

### *Taiwan's Trade and Investment Relations*

Over the last twenty years, Taiwan's changing international trade and investment patterns have been characterized by growing economic interdependence with China in particular, but also East Asia more broadly. For instance, in 1992 China was Taiwan's 26<sup>th</sup> most important trading partner with \$748 million in total trade (158<sup>th</sup> export destination and 20<sup>th</sup> largest import source).<sup>5</sup>

By 2002 total trade with China was worth \$18.5 billion, making it Taiwan's 4<sup>th</sup> largest trading partner. In 2012, total trade with China was valued at over \$121.5 billion (exports to China of \$80.7bn and imports of \$40.9bn). China is now Taiwan's most important trading partner – Taiwan's largest export destination and second largest source of imports - representing over 21 percent of total trade (40 percent of trade including Hong Kong), up from 7 percent in 2002.<sup>6</sup>

Investment in China has also grown substantially over this period and accumulated Taiwan investment in China was valued at over US\$58 billion as of July 2013.<sup>7</sup> Most of the investment is in the manufacturing sector such as electronic parts and components (20 percent) and computer electronics and optical manufacturing (14 percent). Investment in China now represents approximately 80 percent of total Taiwanese FDI.

This investment in China has integrated China into the supply chains of Taiwanese businesses. It has also underpinned the movement of goods between and within Taiwan businesses located in China and Taiwan. As a result, the main categories of Taiwan-China trade are in the same sectors where Taiwanese investment in China is located. For instance, Taiwan's main exports and imports from China are of electrical machinery and equipment (41 percent/42.5 percent) and optical and photographic instruments (15.2 percent/15.5 percent).<sup>8</sup>

A similar story is true for Taiwan's trade with ASEAN countries which saw an increase in total trade from \$33bn in 2002 to \$88bn in 2012. Approved foreign investments in and out of Taiwan with ASEAN's major economies (Indonesia, Malaysia, Philippines, Thailand and Vietnam) also saw a significant increase from \$503 million in 2002 to \$6bn in 2012. This reflects the integration by Taiwan business of ASEAN into regional supply chains. Some countries such as Vietnam have been a source of low cost manufacturing, while in other ASEAN countries such as the Philippines and Malaysia Taiwan companies produce more advanced intermediate goods in

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<sup>3</sup> Economics Intelligence Unit.

<sup>4</sup> Taiwan Ministry of Economic Affairs.

<sup>5</sup> At the time it was illegal for Taiwan companies to invest in China.

<sup>6</sup> Mainland Affairs Council, "Table 1 Trade between Taiwan and Mainland China," *Cross-Strait Economic Statistics Monthly*, No. 238 (February 21, 2013); <http://www.mac.gov.tw/public/Attachment/322015413549.pdf>.

<sup>7</sup> Mainland Affairs Council, "Table 7 Taiwan Investment in Mainland China," *Cross-Strait Economic Statistics Monthly*, No. 245 (September 26, 2013); <http://www.mac.gov.tw/public/Attachment/392610552343.pdf>.

<sup>8</sup> Mainland Affairs Council, *Cross-Strait Economic Statistics Monthly*, No. 245.

the telecoms and IT sectors. Moreover, these goods are then often exported to China for further processing into final goods.<sup>9</sup>

During this period of growing trade with East Asia, Taiwan's trade relations with the United States have become less significant. For instance, in 1992 the U.S.-Taiwan trade relationship was worth almost \$40bn, making the United States Taiwan's number one trading partner representing over 25 percent of Taiwan's total trade. By 2002, total trade had increased a little over 12 percent to \$45.5bn (compared with an increase in Taiwan-China trade during this period of almost 2500 percent) and by 2012 the United States was Taiwan's third largest trading partner with total trade worth \$56.5bn, representing less than 10 percent of Taiwan trade.<sup>10</sup>

### *Taiwan and Asian Supply Chains*

The inclusion of China in Asian supply chains in the 1990s produced important economic gains for participating countries. It allowed for the further fragmentation of production processes across countries, giving businesses the opportunity to concentrate on the tasks in which they have a comparative advantage.<sup>11</sup> This has intensified East Asia dynamism and economic integration.<sup>12</sup>

For Taiwan, the attractiveness of China as a destination for investment and trade has been its cheap inputs such as land and labor that had been used to produce components – increasingly in the electronics industry – that are then either exported back to Taiwan for further manufacturing or exported from China to countries such as the United States as final products. In the 1990s prior to China's WTO membership, China also encouraged Taiwan investment in China by lowering tariffs on trade with China and with other investment incentives.<sup>13</sup>

The growing bilateral trade between Taiwan and China and reduced trade with the United States reflects this shift of Taiwanese manufacturing to China to assemble final goods for export. This suggests that the decline in Taiwan-U.S. trade over the last 20 years does not mean that the U.S. economy is also of declining importance for Taiwan.

A few figures illustrate this point. From 2001 through 2008 Taiwan's IT hardware production increased from \$42.8bn to \$100bn. During this period, the share of that production in Taiwan declined from 47.1 percent to 1.3 percent while China's share increased from 36.9 percent to

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<sup>9</sup> Nobuaki Yamashita and Archanan Kopathoon (2011), "Trade in Supply Chains between ASEAN and China: Development and Implications," in Findlay, C. (ed.), *ASEAN+1 FTAs and Global Value Chains in East Asia*. ERIA Research Project Report 2010-29, Jakarta: ERIA. pp.25-51.

<sup>10</sup> Bureau of Foreign Trade, Ministry of Economic Affairs, "Table 2 ROC's Major Trading Partners," *Monthly Report 2012/12*, <http://www.trade.gov.tw/english/Pages/List.aspx?nodeID=92>.

<sup>11</sup> Richard Baldwin, "Trade and Industrialisation After Globalizations 2<sup>nd</sup> Unbundling: How Building and Joining a Supply Chain are Different and Why it Matters," NBER Working Paper 17716, December 2011; "Trade patterns and global value chains in East Asia: From trade in goods to trade in tasks," The WTO and IDE-JETRO, p. 74.

<sup>12</sup> Mona Haddad, "Trade Integration in East Asia: The Role of China and Production Networks," World Bank Policy Research Working Paper 4160, March 2007, p. 3.

<sup>13</sup> Shin-Yi Peng, "Economic Relations between Taiwan and Southeast Asia: A Review of Taiwan's "Go South" Policy," *Wis. Int'l L.J.* 16 (1998), p. 641.

90.6 percent. As most of Taiwan's IT products are assembled in China and computer products and parts are the largest category of U.S. imports from China, this suggests that much of Chinese IT exports are from Taiwan businesses.<sup>14</sup>

Another example of the trade and investment synergies between Taiwan, China and the United States is that of Hon Hai Precision Industry Company Ltd – the parent company of Foxconn. Foxconn manufactures Apple iPhones, iPods and iPads in China for export to the United States and globally. Foxconn also makes nearly half of the world's top branded computers, mobile phones for Nokia and Motorola, and LCD televisions for Sony. U.S. imports of Apple products are recorded as an import from China even though the product is made by a Taiwanese firm, the final product is owned by a U.S. company, and the Chinese workers contribute only approximately 3.6 percent of the products' value.<sup>15</sup> This reveals limits to bilateral trade data in a world of supply chains. Work by the OECD and WTO to determine the value that each country in a supply chain adds to a final good is beginning to address this. For instance, value-added data reduces the overall U.S. trade deficit with China by 25 percent, reflecting the incorporation of inputs from other countries (including the United States) into Chinese exports to the United States.

## 2. Taiwan's Economic Challenges

### *Revitalizing Comparative Advantages*

As discussed, Taiwan occupies a central position in Asian supply chains. However, the economic model whereby Taiwan manufactures electronic parts and components and semiconductors to be incorporated into products that are branded and sold by foreign companies is under strain. One reason is that the division of labor upon which this economic model relies is changing as real wages in China have grown 283 percent since 2000 and other inputs such as land values have also risen. Additionally, whereas Taiwan business once possessed technical, financial and managerial advantages such as time-to-market and utilized low cost labor to fulfill contracts to products components for established brands, today the co-location in China of suppliers for these sectors combined with good infrastructure is helping Chinese businesses compete with Taiwanese suppliers.<sup>16</sup>

Taiwan itself is also becoming less competitive as a place to do business. A range of factors are contributing to this such as excessive regulation of business, restrictions on FDI, insufficient investment in R&D and stagnant wages which are leading to a brain drain to competing centers of excellence such as Hong Kong and Singapore.<sup>17</sup> Taiwan ranked 16<sup>th</sup> in the World Bank's Ease of Doing Business Report 2013, below regional competitors such as Malaysia (12<sup>th</sup>), Korea (8<sup>th</sup>) Hong Kong (2<sup>nd</sup>) and Singapore (1<sup>st</sup>). And while the World Economic Forum Global

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<sup>14</sup> Shirley A. Kan and Wayne M. Morrison, "U.S.-Taiwan Relationship: Overview of Policy Issues," Congressional Research Service Report for Congress, July 2, 2013, p 37.

<sup>15</sup> Yuqing Xing and Neal Detert, "How the iPhone Widens and United States Trade Deficit with the People's Republic of China," ADBI Working Paper No. 257, December 2010, p. 3.

<sup>16</sup> An-Chi Tung and Henry Wan, Jr, "Chinese Electronics Export; Taiwanese Contract Manufacturing – The Win-Win Outcome along the Evolving Global Value Chain," *The World Economy* (2013), p. 839.

<sup>17</sup> American Chamber of Commerce Taipei, "2013 Taiwan White Paper," p. 5, June 2013, Vol. 43, Issue 6.

Competitiveness Index 2012-13 ranks Taiwan a respectable 13<sup>th</sup> out of 144 countries – the same ranking it has held for the last three years – policy instability, restrictive labor regulation and inefficient government bureaucracy are identified as key problems for doing business in Taiwan.

At the same time, Taiwan is also facing increased competition from countries such as Korea in both the contract manufacturing sector and in branding and selling final goods to China and key developed country markets such as the United States and the EU.

These challenges point to a broader concern about the reliance of Taiwan's economy on international trade as a driver of economic growth and the dominance of trade in ICT parts and components. Indeed, the reliance of Taiwan's economy on international trade was reinforced by the 2008 financial crisis where rapid falls in global demand quickly translated into lower trade causing a decline in exports of over 20 percent, reduced demand for imports by 25 percent lead to a 1.8 percent contraction in Taiwan's 2009 GDP. While growth rebounded strongly in 2010, it slowed in 2011 and in 2012 was only 1.3 percent.<sup>18</sup>

### *Encouraging Foreign Investment*

Foreign investment in Taiwan remains low, particularly by Asian standards.<sup>19</sup> In 2011 Taiwan's stock of inward FDI was valued at \$56.2bn – not much up from \$50.2bn in 2006. And this compares with over \$222bn in Japan, \$134bn in Korea and over \$115bn in Malaysia. In 2012 FDI flows into Taiwan were just over \$5.5bn compared with over \$16bn into Korea.<sup>20</sup> Additionally, FDI inflows pale against FDI outflows which in 2011 were \$213bn, up from \$120bn in 2006.<sup>21</sup> President Ma Ying-jeou has identified removing barriers to foreign investment as a priority.

There are good reasons for encouraging increased FDI into Taiwan. FDI is an important channel for introducing new technology and can also drive economic growth and employment.<sup>22</sup> As important are the new skills foreign businesses bring, such as managerial, financial and legal skills; these are also inputs into the production of goods and therefore can benefit Taiwan's economy broadly. Moreover, Taiwan hopes that the recent Economic Cooperation Framework Agreement with China (ECFA, see below) will encourage investors to view Taiwan as a gateway for exporting to China, and utilizing Taiwan's skilled work force and knowledge of doing business in China.

Taiwan's desire for increased levels of inbound investment is also being driven by concerns that the large Taiwanese investment in China and elsewhere is leading to a hollowing out or deindustrialization of the economy.<sup>23</sup> Concerns about the economic impact on Taiwan of large

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<sup>18</sup> Economics Intelligence Unit.

<sup>19</sup> Victor Zitian Chen, Ming-Sung Kapo and Anthony Kuo, "Inward FDI in Taiwan and its policy context," in Vale Columbia Center on Sustainable International Investment, March 22 2012, p. 2.

<sup>20</sup> American Chamber of Commerce Taipei, 2013 "Taiwan White Paper," p. 5.

<sup>21</sup> The Economist Intelligence Unit.

<sup>22</sup> OECD. 2002. "Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs."

<sup>23</sup> Haddad, Mona. 2007. "Trade Integration In East Asia : The Role Of China And Production Networks," World Bank, ISSN: 1813-9450 .

outward flows of FDI are also paralleled by political concerns about the costs to Taiwan of closer economic integration with China and with the political leverage this may give China over Taiwan.<sup>24</sup>

Starting in 1992 the Taiwan government adopted a “Go South” policy that promotes greater investment in ASEAN to offset the increasing investment in China. More recently FDI figures for Taiwan suggest that businesses are once again looking south, this time in response to the rising costs of doing business in China. Economic integration within ASEAN is also making these countries an increasingly attractive investment destination. Taiwan’s investment in China is declining and at the same time investment in lower cost destinations such as Vietnam and Cambodia is rising. According to Taiwan’s Ministry of Economic Affairs, in 2012 approved investment in China was down while investment in ASEAN countries mainly had more than doubled to \$8.1bn.<sup>25</sup>

### *Developing Taiwan’s Services Sector*

Taiwan’s economy has also increasingly evolved from one dependent on manufacturing to a more services-orientated economy. For instance, whereas approximately 40 percent of Taiwan’s GDP came from industrial production in the 1980s, in 2012 that share had decreased to around 29 percent while the service component was 69 percent and agriculture around 2 percent.<sup>26</sup> The increasing reliance of Taiwan’s economy on services is a trend that other advanced economies have followed. For instance, services account for roughly 80 percent of U.S. GDP.

However, part of this growth in Taiwan of services as a percentage of GDP reflects a declining role for manufacturing due to the significant investment in manufacturing capacity overseas.<sup>27</sup> While Taiwanese businesses tend to retain their sophisticated design and R&D capacities in Taiwan, these companies are setting up R&D and other service centers in China to be closer to what is becoming an end-market in its own right. Moreover, the value added of Taiwan in regional supply chains has been in decline.<sup>28</sup> This supports the above concern that businesses in other Asian countries are becoming increasingly competitive in those tasks in which Taiwan has traditionally had a comparative advantage.

Taiwan’s services sector remains domestically focused, comprising mainly small businesses and with low levels of productivity growth.<sup>29</sup> Growth rates in the services sector have also been weak, thereby acting as a drag on economic growth. This compares with other Asian economies such as Singapore and Hong Kong which have large internationally orientated services market that generate significant levels of economic growth. For example, in 2006 the Taiwan services

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<sup>24</sup> Pasha L. Hsieh, “China-Taiwan Trade Relations: Implications of the WTO and Asia Regionalism,” in *Trading Arrangements in the Pacific Rim* (Oxford University Press 2008), p. 13; Shin-Yi Peng, “Economic Relations between Taiwan and Southeast Asia: A Review of Taiwan’s “Go South” Policy,” *Wis. Int’l L.J.* 16 (1998)

<sup>25</sup> Ministry of Economic Affairs Investment Commission.

<sup>26</sup> Directorate-General of Budget, Accounting and Statistics, Executive Yuan.

<sup>27</sup> Pasha L. Hsieh, “China-Taiwan Trade Relations: Implications of the WTO and Asia Regionalism,” p. 3

<sup>28</sup> “Trade patterns and global value chains in East Asia: From trade in goods to trade in tasks,” p. 77

<sup>29</sup> Donghyun Park and Kwanho Shin, “The Services Sector in Asia: Is It an Engine of Growth?” Institute for International Economics, October 2012.

sector contributed just over 50 percent to economic growth.<sup>30</sup> GDP contracted in 2009 following the financial crisis and in 2010 Taiwan experienced a rebound in growth due to a surge in exports to China and in response to a domestic stimulus program. However, in 2011 services contributed only 47 percent to economic growth and in 2012 that figure had fallen to under 40 percent – and this from a sector representing almost 70 percent of the economy.

### **3. Taiwan’s WTO membership and other International Trade Agreements, and Their Importance for Taiwan’s Economy**

Taiwan’s position in Asian supply chains and its economy’s reliance on international trade has made market access for its exports and stable trading relations a priority. The following outlines Taiwan’s participation in the World Trade Organization and other trade arrangements and outlines the importance of these agreements for Taiwan’s economy. The following section analyzes the impact on Taiwan of being excluded from the proliferation of Asian free trade agreements.

#### *Taiwan and the World Trade Organization*

The WTO is the key multilateral trade organization with 159 members. Established in 1995 following the successful completion of the Uruguay Round of trade negotiations, it includes commitments to reduce tariffs on goods and liberalize market access for trade in services. The WTO also includes commitments by members to offer most-favored nation (MFN) and national treatment (NT) treatment on goods and services (NT only applies to those services sectors to which market access commitments are scheduled). Under MFN, a WTO member applies the same tariff to imports from all other WTO members. The NT commitment requires a WTO member to not accord to domestic goods more favorable treatment than the like imported goods.

The WTO includes commitments on non-tariff barriers and common standards for intellectual property rights. Rules on anti-dumping, countervailing duties and subsidies are also in the WTO. These commitments are enforced using the WTO dispute settlement process which involves an initial panel hearing with opportunity to appeal questions of law to the Appellate Body. Decisions of a panel and the Appellate Body are binding on WTO members and the losing member is required to bring any non-conforming measure into compliance with its WTO commitment and failure to do so can lead to the suspension of trade concessions by the complaining member.

Taiwan became the 144<sup>th</sup> member of the WTO on 1 January 2002. This followed closely on China’s WTO accession to the WTO on 11 December 2001. In fact, Taiwan had been ready for WTO membership for some time prior, having indicated its interest in joining the predecessor General Agreement on Tariffs and Trade (GATT) in 1990. However, to accommodate China’s claims of sovereignty over Taiwan, Taiwan’s accession to the WTO was timed to happen after

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<sup>30</sup> Taiwan Ministry of Economic Affairs.



China joined the WTO.<sup>31</sup> And to avoid any implication that Taiwan had joined the WTO as a state, it joined the WTO as the separate customs territory of Taiwan, Penghu, Kinmen and Matsu – referred to in the WTO as Chinese Taipei.

Taiwan's WTO membership has produced important economic and diplomatic gains. Most importantly WTO membership granted Taiwan MFN treatment in terms of access to all other WTO members' markets. It thereby alleviated the pressure on Taiwan to negotiate free trade agreements with its key markets, something which China would have most likely have opposed as being a process that treated Taiwan as an independent country. However, the growing global trade that is now subject to preferential treatment under FTAs is undermining the value of WTO's MFN commitment. To date, Taiwan has only managed to negotiate FTAs with El Salvador, Guatemala, Honduras and Nicaragua; it has most recently signed an arrangement with New Zealand and is soon to complete negotiations with Singapore.

Under the WTO, Taiwan agreed to tariff reductions resulting in an applied simple average tariff rate of 6.4 percent—though there remain considerable tariff peaks and variations in Taiwan's tariff schedule. In fact, Taiwan's tariffs on non-agriculture products are 4.7 percent, while tariffs on agricultural goods average 17.5 percent and some are much higher, such as a tariff of over 1000 percent on rice.<sup>32</sup>

The economic reforms required by WTO membership improved the efficiency and productivity of Taiwan's economy and drove economic growth rates. For instance, WTO membership required lower tariffs which created competition for businesses, forcing them to improve their own efficiency and productivity. Taiwan also agreed to liberalize its services sector, giving its business access to leading services in areas such as finance and management, which also helped improve these companies overall competitiveness. And adopting the rules on intellectual property in the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) helped reinforce Taiwan as a place for cutting edge innovation and R&D. However, the gains from the reforms brought about by WTO membership have dissipated and new reforms are required.

There remain significant trade barriers that Taiwan has yet to address. The WTO reports a declining trend to base domestic standards on international standards where they exist, creating growing divergence between global standards and Taiwan's domestic standards and also raising the costs for Taiwan of reform.<sup>33</sup> For instance, in 2009 only 18 percent of Taiwan's standards were aligned to international standards, down from 25 percent in 2005.<sup>34</sup>

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<sup>31</sup> Nancy Bernkopf Tucker, "The Taiwan Factor in the Vote on PNTR for China and Its WTO Accession," in *China's PNTR Status and Accession to the WTO* (editors Joseph Fewsmith and Nancy Bernkopf Tucker), *NBR Analysis*, July 2000, p. 7.

<sup>32</sup> WTO Chinese Taipei trade profile 2011.

<sup>33</sup> WTO Trade Policy Review of Chinese Taipei 2009.

<sup>34</sup> WTO Trade Policy Review, Report by the Secretariat, Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu, WT/TPR/S/232, 31 May 2010, p. xii.

As discussed, Taiwan's services sector is also in need of reform. Along with 20 other countries Taiwan is participating in the plurilateral negotiations at the WTO for an international services agreements that includes the United States, the EU, Australia, New Zealand, Canada and Japan. Successful conclusion of an ambitious agreement on services could be an important vehicle for reform of Taiwan's services sectors while also opening up new market opportunities for Taiwan's services exports.

The incorporation of Taiwan into the WTO provided it with space to conduct its international trade relations. Importantly, WTO membership also affected cross-strait trade relations as it required China and Taiwan to offer imports from each other MFN and NT and to resolve disputes using the WTO dispute settlement mechanism. In this way the WTO helped normalize trade relations between China and Taiwan. Taiwan does retain restrictions on trade with China which are justified for national security reasons, an exception the WTO allows. Taiwan has also maintained restrictions on Chinese investment in Taiwan in certain sectors such as services, energy and finance – though investment regulations are not the subject of WTO rules.

#### *China-Taiwan Economic Cooperation Framework Agreement (ECFA)*

Under President Ma Ying-jeou, Taiwan has pursued ever closer economic integration with China. The most significant vehicle for this is the Economic Cooperation and Framework Agreement (ECFA) which entered into force on 12 September 2010. The ECFA, as its name suggests, provided a framework for further negotiations aimed at liberalizing trade in goods, services and investment.<sup>35</sup>

The most recent ECFA services agreement was signed on 21 June 2013. According to reports, China has agreed to a WTO-plus outcome and has liberalized 80 services sectors and Taiwan will open 64 sectors. China also provided Taiwan with an early harvest under ECFA and in January 2011 reduced tariffs on 539 products. This follows a trend under ECFA where Beijing has been willing to provide Taiwan with benefits that are disproportionate to what Taiwan is providing China.<sup>36</sup> For instance, China has already provided an early-harvest by reducing tariffs unilaterally on a range of imports. The services agreement will also make it easier for citizens from each side to visit and work in the other.

On the investment front, Taiwan has opened to Chinese investors in the manufacturing, services and financial sectors. Investment in high technology areas such as integrated circuits and semiconductors are also being liberalized.<sup>37</sup> Since ECFA came into effect, approved Chinese investment in Taiwan has increased from \$94mn in 2010 to \$328mn in 2012.<sup>38</sup> The next stage under ECFA is to negotiate an agreement on goods and dispute settlement.

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<sup>35</sup> See Mainland Affairs Council, "Economic Cooperation Framework Agreement Background"

<sup>36</sup> Xinhua, "Mainland, Taiwan negotiators sign service trade agreement," June 21, 2013,

[http://news.xinhuanet.com/english/china/2013-06/21/c\\_132475046.htm](http://news.xinhuanet.com/english/china/2013-06/21/c_132475046.htm).

<sup>37</sup> 2012 Industrial Development in Taiwan, R.O.C., Ministry of Economic Affairs.

<http://www.moeaidb.gov.tw/external/view/en/about/>.

<sup>38</sup> Investment Commission, Ministry of Economic Affairs, "Statistics Summary Analysis," January 2010, December 2010, and December 2012.

For Taiwan, ECFA serves a range of goals. These include: economic growth; becoming a gateway for foreign investment into China; stimulating increased purchases by Chinese companies of inputs from Taiwan, thereby strengthening Taiwan's position in the Asian supply chain; and helping transform Taiwan into a regional industrial center.<sup>39</sup>

According to some estimates ECFA will increase Taiwan's GDP by 1.7 percent and create 260,000 jobs.<sup>40</sup> As China is Taiwan's number one trading partner and investment destination, ECFA should lead to further strengthening of the bilateral trade and economic relationship and underpin the existing supply chain relations outlined above.

Additionally, concluding ECFA with China seems to have relaxed the Chinese government attitude towards Taiwan negotiating trade agreements with other countries.<sup>41</sup> The recent conclusions of the Economic Cooperation Agreement with New Zealand and negotiations for an economic partnership with Singapore which are expected to be finalized this year might prove to be examples of the economic and diplomatic benefits to Taiwan of ECFA and the easing of China's opposition to Taiwan's participation in other FTAs.

ECFA has not been without domestic political challenges for President Ma and the Kuomintang. Concerns remain that the closer economic integration that ECFA will usher in will make Taiwan increasingly dependent on China and thereby give China greater leverage that could be used to achieve its goal of political unification. Chinese Foreign Minister Wang Yi (former director of the mainland's Taiwan Affairs Office) claimed in a speech at Brookings on September 20, "Gradual integration of the two sides [of the Taiwan Strait] through two-way interactions and cooperation will lead to ultimate reunification."<sup>42</sup>

### *U.S.-Taiwan Trade and Investment Framework Agreement*

The U.S.-Taiwan Trade and Investment Framework Agreement signed in 1994 is the most important framework for the two governments to discuss their economic relationship. The TIFA talks were suspended from 2007 until March 2013 due to disputes over access for U.S. beef and pork. And the political capital that President Ma Ying-jeou had to expend domestically to follow-through on his government's commitment to allow increased U.S. beef imports, combined with the ongoing ban on pork treated with ractopamine, have sowed significant doubt in the U.S. administration and in Congress over the capacity of the Taiwan political system to

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<sup>39</sup> Mainland Affairs Council, "Economic Cooperation Framework Agreement Background," p. 4. See also Ta-tung Jacob Chang, "The Importance of US-Taiwan Economic Relations," *The Hill*, 23 July 2013 at <http://thehill.com/opinion/op-ed/312985-the-importance-of-us-taiwan-economic-relations>.

<sup>40</sup> John F. Copper, "The Chain-Taiwan Economic Cooperation Framework Agreement: Politics, Not Just Economics," EAI Background Brief Npo. 548, 2010; see also "Economic Cooperation Framework Agreement (ECFA) Background," Mainland Affairs Council, <http://www.mac.gov.tw/public/data/051116322071.pdf>.

<sup>41</sup> Jane Rickards, "Liberalizing Trade," American Chamber of Commerce Taipei, February 2013, Vol. 42 Issue 2, p. 18.

<sup>42</sup> Wang Yi, "Toward a New Model of Major Country Relations Between China and the United States," speech at The Brookings Institution, September 20, 2013, <http://www.brookings.edu/events/2013/09/20-us-china-foreign-minister-wang-yi>; see also John F. Copper, "The Chain-Taiwan Economic Cooperation Framework Agreement: Politics, Not Just Economics," and Daniel H. Rosen and Zhi Wang, "Deepening China-Taiwan Relations through the Economic Cooperation Framework Agreement," Policy Brief 10-16, June 2010, p. 2.

undertake the type of economic reform that membership in trade agreements such as the Trans-Pacific Partnership would require.

Following the last TIFA meeting in 2013, the United States and Taiwan agreed to establish working groups on investment and technical barriers to trade (TBT) issues; the first of these working groups met recently. It is too early to determine whether Taiwan can now use the TIFA process to move past these previous setbacks on trade and to address issues of economic significance between the countries. But if Taiwan is going to achieve President Ma's goal of joining the TPP, it will have to rebuild confidence in the United States that it can be a reliable partner with which to negotiate a trade agreement.

#### *Other FTAs and Economic Cooperation Agreements*

Taiwan is a party to only five FTAs that have been signed and ratified. These are agreements with Panama (2004), Guatemala (2005), Nicaragua (2008), El Salvador (2008) and Honduras (2008). As noted, on July 10, 2013 Taiwan signed its latest agreement with New Zealand and it is currently negotiating an Economic Cooperation Agreement with Singapore that is expected to be finalized by the end of 2013.<sup>43</sup>

Taiwan also has an investment arrangement with Japan. Under this agreement Taiwan and Japan have agreed to freedom of capital and people associated with an investment in each other's country, investment protections such as against expropriation, and agreed to accord national treatment and MFN in terms of market access for new investments.<sup>44</sup> Taiwan also has investment guarantee agreements with most ASEAN countries.

#### **4. Taiwan's Absence from Bilateral and Regional Free Trade Agreements**

The North American Free Trade Agreement – an FTA between the United States, Canada and Mexico – was finalized in 1994, prior to the World Trade Organization (WTO). So the moment of greatest multilateral success on the trade front also coincided with agreement to form a regional trade bloc second only to the EU.

Asia's tilt towards FTAs took place relatively late, though gathered pace in the 2000s as concluding the WTO Doha Round of trade negotiations became increasingly difficult and as the United States negotiated additional FTAs. As a result, according to the Asian Development Bank, as of January 2013, ratified FTAs involving an Asian country were 109, up from 36 in 2002, with a further 148 FTAs proposed and under negotiation.<sup>45</sup> Taiwan has been absent from this proliferation of Asian FTAs.

The growth in Asian FTAs has underpinned increased Asian economic regionalism. ASEAN countries have made important progress in liberalizing trade under an ASEAN FTA. Under this

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<sup>43</sup> Taiwan negotiates Economic Cooperation Agreements instead of FTAs with countries with which it does not have diplomatic relations.

<sup>44</sup> Ministry of Economic Affairs, "Taiwan-Japan Investment Arrangements under the Global Business Strategies."

<sup>45</sup> Asian Development Bank, "Asian Economic Integration Monitor March 2013," p.50.

FTA, since 2010 Indonesia, Malaysia, the Philippines, Singapore and Thailand have offered zero tariffs on 99 percent of trade products and Vietnam plans to have zero tariffs by 2015.<sup>46</sup>

ASEAN has also negotiated a number of FTAs, including with China, Korea, Japan, India, Australia and New Zealand. Additionally, ASEAN, China, Japan, Korea, India, Australia and New Zealand have commenced negotiations towards a Regional Comprehensive Economic Partnership (RCEP). ASEAN countries Malaysia, Singapore and Vietnam are also part of the Trans-Pacific Partnership (TPP) negotiations that, once concluded, will give these countries preferential market access to the developed markets of the United States, Canada, Japan, Australia and New Zealand. Additionally, Korea has completed an FTA with the EU and the United States and is negotiating an FTA with China. Japan is negotiating an FTA with the EU and is a party to the TPP. Japan, China and Korea are also negotiating a trilateral FTA.

These FTAs will have economic impacts on Taiwan. For one, there are the economic gains to Taiwan of being a party to an FTA. For example, by some estimates participation in the ASEAN+6 FTA – RCEP – would increase Taiwan’s GDP by up to 4 percent and boost exports by over 6.5 percent.<sup>47</sup>

Left out, Taiwan will be harmed by these FTAs’ trade diversion effect – whereby Taiwan’s exports lose out in FTA markets due to increased competition from imports from other FTA partners. The recent successful completion by Korea – a competitor with Taiwan across a range of products – of FTAs with the EU and the United States provides a useful example of some of the costs to Taiwan of not participating in these Asian FTAs. As a result of these FTAs Korean goods now have preferential access to the two largest developed country markets where all tariffs will go to zero. This means that Korean exports of apparel, LCD televisions and bicycles to the EU – all goods in which Taiwan competes – will face zero tariffs while Taiwan exports of these goods face tariffs of twelve, fourteen and fifteen percent, respectively. In total, Korea has managed to sign eight FTAs covering 46 countries.<sup>48</sup>

Additionally, successful completion of a Korea-China FTA will strengthen Korea as a gateway for other countries to trade and invest with China, competing with Taiwan’s ability to use ECFA to play a similar gateway role. A Korea-China FTA will also strengthen existing supply chains whereby Korean businesses have been using China as a low cost manufacturing destination. Reducing trade and investment costs under such as FTA will also improve the competitiveness of Korean products in China and globally.

Moreover, when it comes to trade in intermediate parts, goods may cross borders multiple times before being assembled into a final good. As a result, small reductions in tariffs under an FTA can have outsized impacts on trade costs. For instance, one study has found that a 1 percent

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<sup>46</sup> “Trade patterns and global value chains in East Asia: From trade in goods to trade in tasks,” p. 41.

<sup>47</sup> Peter C. Y. Chow and Dan Ciuriak, “The FTA Music Is Playing in Asia:

After ECFA, Will Taiwan Join the Dance?” *The International Trade Journal*, 26:1 (2012), p. 8.

<sup>48</sup> In addition, Korea has completed FTAs with Colombia and Turkey and is negotiating an additional 11 FTAs.

reduction in trade costs can lead to a 2-4 percent increase in imports of intermediate goods.<sup>49</sup> As Taiwan's economy is focused on contract manufacturing where 70 percent of exports are intermediate goods, the impact of exclusion from these Asian FTAs will be magnified.

Additionally, these FTAs and in particular the rules of origin (ROO) will have important impacts on regional supply chains of which Taiwan is a part and which, depending on their outcome, could further disadvantage Taiwan's current position in the Asian production networks. For instance, restrictive ROOs that make it difficult for final goods using imported parts and components to qualify for preferential market access under the TPP could lead businesses in TPP parties to changing their source of inputs. For Taiwan, which predominantly produces components incorporated into final products, this has the potential to shut Taiwanese businesses out of some Asian supply chains.

In addition to providing preferential market access, the most comprehensive of these FTAs, such as the South Korea-U.S. Free Trade Agreement (KORUS; and this will also be true of the TPP), go further than the WTO in a range of areas such as intellectual property rules, services, and non-tariff barriers such as standards. Additionally, these FTAs address so-called "WTO-plus" issues that are not addressed in the WTO by including commitments in areas such as investment access and protection, trade facilitation, competition, environment and labor policy. For instance, the investment chapter in KORUS includes new market access, investment protection commitments and agreement to improve the transparency of investment regulations. Additionally, KORUS gives investors from each country access to international adjudication to enforce the investment chapter commitments against the other government. Through such WTO-plus commitments, these FTAs more closely integrate the economies of the parties and underpin economic reforms that improve their efficiency and competitiveness.

The inability of Taiwan to participate in FTAs, and the failure of the WTO Doha Round, also means that since WTO accession in 2002, Taiwan has not been compelled to undertake significant domestic economic reform in order to join a trade agreement. This has had a negative impact on Taiwan's economy broadly, reducing its efficiency and productivity, and has been an underlying factor that has worsened Taiwan's other economic challenges.

Participating in these FTAs would require economic reform that could help address the main economic challenges identified above. For instance, for Taiwan to reap the full benefit from its growing services sectors requires reform. Liberalizing its services market under an FTA would open the services sector to competition and lead to improved productivity. Moreover, as services are often important inputs into the manufacturing and industrial sectors, increased productivity in the services sector will flow through to the overall economy.

Participation in FTAs would also further Taiwan's goal of increasing inward FDI. As discussed, comprehensive FTAs include commitments to liberalize investment restrictions and include rules on investment protection. Such action should lead to increased FDI into Taiwan. This would be

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<sup>49</sup> Gordon H. Hanson, Raymond J. Matalone and Matthew J. Slaughter, "Vertical Production Networks in Multinational Firms," *Review of Economics and Statistics*, 87(4) 2005, p. 664-78.

of particular benefit for Taiwan's services sector where many services such as banking and insurance are delivered via a commercial presence.

The inability of Taiwan to participate in FTAs is also acting as an incentive for Taiwan businesses to invest in other Asian countries to take advantage of the tariff preference for exports from these countries to other FTA parties. The successful negotiation by ASEAN of FTAs is giving goods manufactured in ASEAN preferential market access to large and growing economies, making ASEAN an increasingly attractive investment destination from countries seeking to use ASEAN as a base to access markets in China, Japan and Korea. This partly explains the new surge in Taiwan investment in ASEAN countries – to access countries that ASEAN already has an FTA with and as a means to position themselves for outcomes from the TPP and RCEP negotiations.

## 5. The Taiwan Government's Response

President Ma Ying-jeou has identified economic liberalization as a key driver of economic growth and has pledged to reform Taiwan's economy to be ready to join the TPP by 2020.<sup>50</sup> Achieving this goal will be important to not only open new markets for Taiwan exports and preserve its role in Asian supply chains, but also will be an important driver of the types of domestic economic reforms the government has identified as crucial for Taiwan's future economic prosperity.

To this end the Taiwan government has started to identify its core economic challenges and is proposing policy solutions to them. For example, a government policy report titled "2012 Golden Decade National Vision" identifies the need to address economic imbalances in the economy such as too large a reliance on industry and manufacturing, the challenges and limits to an economic model that produces intermediate goods combined with a reliance on too few export markets, and the need to expand innovation.<sup>51</sup>

The government is also seeking to reduce Taiwan's reliance on trade as a driver of growth by increasing domestic demand and encouraging greater private sector investment in Taiwan. This includes policies to encourage Taiwanese firms to invest in Taiwan instead of overseas (mostly China) and greater FDI inflows into Taiwan. Policies the government has adopted that support these goals include reducing the business income tax, liberalizing restrictions on the ability of business people to visit and work in Taiwan, supporting increased investment from China and signing the ECFA in 2010.

Taiwan also has a Service Industry Development Plan that aims to increase the competitiveness of Taiwan services sector and achieve greater market access overseas. However, it does not do enough to emphasize liberalization of Taiwan's services sector and the impact that greater competition can have on the domestic service industry.

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<sup>50</sup> Taiwan Today, "President Ma prioritizes trade negotiations," July 23, 2013, <http://www.taiwantoday.tw/ct.asp?xItem=193827&ctNode=421>.

<sup>51</sup> Executive Yuan, "2012 Golden Decade National Vision," June 7, 2012, <http://www.cepd.gov.tw/dn.aspx?uid=11629>.

The government is establishing free economic pilot zones where a range of economic reform can be tested and, if successful, expanded to the broader economy. According to President Ma “the initiative will fast-track Taiwan’s efforts to joining regional trade blocs such as the Trans-Pacific Partnership and the Regional Comprehensive Economic Partnership.”<sup>52</sup> These zones will initially focus on transnational industrial cooperation, logistics, medical care and value-added agriculture products. And the types of economic reforms that will be tested include tax reform, reduced tariffs, liberalized foreign investment restrictions and greater scope for foreign national professional to work and live in Taiwan.<sup>53</sup>

## 6. Conclusion

Over the last 50 years Taiwan has transformed itself from an autocratic developing society into a wealthy, industrial democracy. Throughout this period, Taiwan has demonstrated a capacity for reform, innovation and developing political outcomes that are pragmatic and can address key challenges. Taiwan is now facing a range of new challenges that will test anew the capacity of Taiwan’s vibrant but still nascent democracy to pull together to address important issues.

For one, its exclusion from trade agreements in the Asia Pacific region has undermined the competitiveness of its manufacturing sector and these impacts will grow as regional supply chains increasingly bypass Taiwan as businesses invest elsewhere to take advantage of these agreements’ trade preferences. Taiwan’s leaders must also overcome domestic challenges to introduce needed economic reform including liberalizing the economy to greater international competition and developing a competitive and innovative services sector – something increasingly important for an advanced economy.

Fortunately, President Ma Ying-jeou is seized of the challenges and his government is already seeking to implement the types of reforms that will help Taiwan compete going forward. Unfortunately, this alone may not be enough if he is unable to convince the public of the need for and benefits of trade liberalization, economic reform and increased openness. And an often fractious legislature continues to oppose reform efforts.

In this environment, participating in trade agreements—and in particular the TPP—is key, not only for the market access opportunities but as an impetus for the type of economic policies that Taiwan needs to adopt. But joining the TPP will present its own challenges, including U.S. wariness about Taiwan’s capacity for the type of reforms that TPP membership will require, and likely opposition from China. However, the importance to Taiwan of participating in the growing sweep of trade liberalization in the Asia Pacific region is not a question for Taiwan of “if,” but of “when.” Navigating these domestic political restraints and implementing domestic economic reform while convincing China to support Taiwan’s participation in the TPP are the great challenges going forward.

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<sup>52</sup> Taiwan Today, “Ma reaffirms importance of FEZ initiative,” July 15, 2013, <http://taiwantoday.tw/ct.asp?xitem=207316&CtNode=415>.

<sup>53</sup> Taiwan Council for Economic Planning and Development, “Taiwan’s Free Economic Pilot Zones.” March 27, 2013.