

The Potential for Cross-Straits Economic Cooperation

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The Potential for Cross-Straits Economic Cooperation

- ◆ The potential areas for economic cooperation
- ◆ The potential benefits from economic cooperation
- ◆ Economic cooperation should and can be win-win

Economic Complementarity

- ◆ The economies of the Mainland and Taiwan are at different stages of economic development.
- ◆ Taiwan has a per capita GDP of approximately US\$18,000 compared to US\$2,500 for the Mainland.
- ◆ Taiwan has high real wage rates whereas the Mainland has relatively low real wage rates.
- ◆ Taiwan has a better educated labor force than the Mainland.
- ◆ The Mainland has more savings than can be productively invested on the Mainland.
- ◆ Taiwan and Mainland's exports are not competitive with each other.
- ◆ Taiwan's comparative advantage is increasingly in knowledge-intensive and intellectual property-intensive industries and sectors (e.g., Taiwan Semiconductor Manufacturing Corporation is a major intellectual property producer and accounts for almost half of Taiwan's patents granted by the U.S.) whereas Mainland's comparative advantage remains in labor-intensive light manufacturing and only recently begins to shift to capital-intensive, heavy manufacturing.

The Comparative Advantages of the Mainland

- ◆ A high national savings rate of currently in the mid-40s. The Mainland is therefore self-sufficient in capital and not dependent on foreign direct investment or foreign loans to maintain its high rate of investment.
- ◆ An almost unlimited supply of surplus labor—almost 40% of the labor force in the primary sector (agriculture and mining) produces approximately 12% of GDP. There will not be any upward pressure on the real wage rate of unskilled entry-level labor for decades to come.
- ◆ A large domestic market permits the realization of economies of scale.

Additional Advantages of the Mainland Economy

- ◆ A large domestic market also allows the Mainland a significant influence on the development and setting of technological standards for products in the domestic as well as the world markets.
- ◆ A large domestic market also enhances the returns to R&D and other forms of intangible capital, including intellectual property and brand names. Economies of scale in the creation and utilization of intangible capital imply that the rate of return increases more than proportionally with the size of the market. The fixed development costs of innovative technologies and products or the promotion of a brand name can be more easily recovered from a large base of domestic demand. Taiwan firms can therefore profit by leveraging their intellectual property and brand names in the Mainland market.
- ◆ Reputation and reliability are particularly valued in the Mainland markets.

China as a Source of Savings and Investment

- ◆ With national savings and investment rates in excess of 40%, Mainland China no longer needs foreign capital per se. In fact, additional foreign capital inflows create pressure on the Renminbi to appreciate as well as excess liquidity in China, driving up prices of assets, both financial and real.
- ◆ Mainland China is poised to become a major capital-exporter because its domestic savings far exceed domestic investment that can be made profitably. Mainland enterprises and individuals may well be interested in investing in Taiwan, including its real estate.

China as a Source of Savings and Investment

- ◆ Mainland China still welcome foreign direct investment (FDI), but not because it needs the money, but because FDI brings with it technology, know-how, designs, markets, business models and methods that the Mainland does not have.
- ◆ However, Mainland China can minimize the inflow of foreign exchange caused by the inflow of FDI by allowing qualified foreign direct investors (QFDI) to borrow Renminbi funds from Mainland Chinese commercial banks on the Mainland and using it to invest in China, provided that these loans are guaranteed by their ultimate parent companies or collateralized with foreign currency deposits in a Mainland Chinese commercial bank offshore.

China as a Source of Savings and Investment

- ◆ It is also advantageous for the foreign direct investor because by borrowing Renminbi funds to invest in China, its Renminbi assets in China will be substantially offset by its Renminbi liabilities. It is thus naturally hedged against fluctuations in the Renminbi exchange rate at a minimal cost and for a term much longer than is normally available. For such a foreign direct investor, marking to market of its Mainland Chinese assets and liabilities will have relatively small effects on its income and loss statements and its financial balance sheet.
- ◆ For a foreign direct investor interested in the Mainland Chinese market, since it will have substantial Renminbi revenue, which can be used to service its Renminbi debt, this also helps to avoid currency mismatch
- ◆ There may or may not be an interest rate advantage borrowing Renminbi funds but even if there is an interest rate disadvantage it includes the cost of an implicit long-term currency hedge.

China as a Source of Savings and Investment

- ◆ Even though most people expect the Renminbi to appreciate in the near term, it is not necessarily a sure thing in a five- to ten-year time frame (which would be the time horizon for most foreign direct investments). For example, the exchange rate of the New Taiwan Dollar went from 40 per US\$ in the early 1960s to a peak of 24 per US\$ in the 1980s and is now trading around 32 per US\$. The exchange rate of the Japanese Yen started at 360 per US\$ in the 1960s and at one time went above 80 per US\$, fell back to 150 per US\$ and is currently below 100 per US\$. Thus a natural long-term currency hedge can be worthwhile for direct investors.

Taiwan Direct Investment in the Mainland Can be Win-Win

- ◆ Taiwan can make use of the Mainland economy not only as a manufacturing base but also as a final consumption market, leveraging its intellectual property, know-how, brand names and reputation.
- ◆ Mainland can also benefit from the increase in GDP, employment and productivity resulting from the wider exploitation of Taiwan's intellectual property.
- ◆ The Mainland no longer needs money, so Taiwan investment into the Mainland must have an edge other than money: Foreign direct investment accounts for approximately 10 percent of gross domestic investment in Mainland China. The Mainland still welcomes foreign direct investment (FDI), but not because it needs the money, but because FDI brings with it technology, know-how, designs, markets, business models and methods that it does not have.

China as a Continental Economy

- ◆ The "wild-geese-flying pattern" metaphor of East Asian industrial migration over time, first introduced by the Japanese economist Akamatsu, can apply to Chinese provinces and regions. East Asian industrialization started in Japan in the 1950s and successively migrated to Hong Kong, Taiwan, South Korea and Southeast Asia as the real wage rates in these economies rose and sometimes also as export quotas were imposed by developed economies, and then to Mainland China. But industrialization can continue to migrate and spread within Mainland China just as it did before, from the coastal region gradually to the inland region, province by province, region by region, until most of China becomes industrialized eventually.
- ◆ Taiwan entrepreneurs can play the role of the agent of change (as they did in Southeast Asia and in the coastal region of Mainland China) by leading the migration of industries within the Mainland.
- ◆ Possible intensified economic cooperation with Fujian where Taiwan entrepreneurs have natural advantages.

Direct Links in Transportation and Communication

- ◆ The savings from direct cross-straits passenger flights—approximately US\$500 million a year, not to mention the time saved.
- ◆ The savings from current and future cargo flights are important because of the upstream-downstream relationships between Taiwan and the Mainland.
- ◆ Savings from ocean freight.
- ◆ Taipei as a potential air transportation hub—Taipei should try to have non-stop flights to as many principal Mainland cities as possible.
- ◆ Many Taiwan firms can re-establish their headquarters in Taipei, reducing costs and expenses—e.g. one household rather than two households.

Trade

- ◆ Reduction in shipping costs and liberalization of current restrictions should increase two-way trade.
- ◆ Taiwan exports of agricultural products to the Mainland should increase.
- ◆ Imports of light manufactured products from the Mainland should increase.
- ◆ Possible “Economic Cooperation Agreement” along the lines of the “Closer Economic Partnership Agreement”.
- ◆ Towards a “Free Trade Area” and a “Common Market”
- ◆ Access to “ASEAN + 3” Free Trade Area.

Bi-Directional Investment

- ◆ Mainland looks for investment opportunities offshore
- ◆ It is beneficial for both sides to have fixed investment and assets on the other side
- ◆ It should be controlled access, with transparency and only limited leverage, i.e., with a limited debt-to-equity ratio
- ◆ Investment in tourism-related industries
- ◆ Relaxation of restrictions on Mainland-bound direct investment from Taiwan
- ◆ Tax agreements on the treatment of each other's enterprises and citizens and permanent residents—no double taxation
- ◆ Global consolidated returns for enterprises listed on the Taiwan Stock Exchange so that profits and losses on the Mainland can be properly reflected.

Trade in Services

- ◆ Tourism services-Jobs that cannot go away. The “Individual Visit Scheme” is the major generator of employment opportunities among the unskilled and low-skilled workers in Hong Kong.
- ◆ Educational services-there is a huge demand for university education from the Mainland and an excess supply of university places in Taiwan. So it is natural to consider the recruitment and admission of students from the Mainland. The cost is not an issue as many self-financed Mainland students currently study overseas in the U.K., the U.S. and elsewhere. This way Taiwan can also attract additional talents for its R&D activities. However, it requires selective reciprocal recognition of degrees and diplomas and eventually of professional qualifications.
- ◆ Healthcare services for Mainland residents.
- ◆ Demand for such services are high. Taiwan has an advantage over Hong Kong in terms of the spoken language.

Currency Exchange and Settlement

- ◆ The first step is to facilitate the exchange between the currencies—New Taiwan Dollars and the Renminbi—by the public. Commercial banks on both sides should be authorized to buy and sell both currencies, with an agreed centralized settlement mechanism. (For example, one commercial bank on each side can be designated to do the clearing and settlement and to supply the actual currency if and when needed, at least initially.)
- ◆ A second step is to authorize direct exchange/remittance/conversion between the two currencies without going through a third currency (although possibly based on the underlying cross-rates) through authorized banks. (Again, initially this can be done through a designated commercial bank on each side.) This should help reduce transactions costs.

Currency Exchange and Settlement

- ◆ Further down the road would be the denomination of Taiwan exports in New Taiwan Dollars and Mainland exports in Renminbi, reducing the risks to exporters and importers on both sides. Currently one will have to worry about both the U.S.\$-N.T.\$ as well as the U.S.\$-Yuan exchange rates.
- ◆ When this happens, there will be a stock demand on both sides in terms of the composition of foreign exchange reserves. The central banks on both sides as well as enterprises will begin holding the currency of the other side as exchange reserves. (This does not change the current account balance, however.)
- ◆ In the long run, a stable real parity is beneficial for both sides, given the significant trade and investment relations.

Global Economic Environment

- ◆ The global environment does not favor the traditional final market of Taiwan products—U.S.A. The United States will be entering a period of very slow growth, if not an outright recession.
- ◆ Fortunately, the fastest-growing economies of the world—the BRIC countries (Brazil, Russia, India and China)—are relatively immune to the slowdown in the United States. This is known as de-coupling of the global economy.
- ◆ Taiwan should take advantage of this opportunity to expand its trade and investment with these economies.

The Impact of the Sub-Prime Mortgage Loan Crisis

- ◆ The U.S. demand for imports will likely decline with the reduced household consumption, or at a minimum the rate of growth will decline.
- ◆ Such decline will have a negative effect on the rate of growth of Mainland Chinese exports to the U.S. and hence on Mainland Chinese GDP, but the effect is expected to be marginal.
- ◆ The overall economic slowdown in the U.S. will last a while, until more positive and certain expectations are restored for both firms and households, probably after the Presidential election in November.
- ◆ The U.S. dollar will continue to weaken relative to other reserve currencies as the net inflow of capital, especially that of direct and portfolio investment, is reduced.

The Impact of the Sub-Prime Mortgage Loan Crisis

- ◆ Mainland exports to the U.S. constitute between 8% (Mainland estimate) and 12% (U.S. estimate) of Mainland GDP; however, the direct domestic value added content of Mainland exports to the U.S. is quite low, averaging 17.7%. Thus, the Mainland GDP originating from Mainland exports to the U.S. is only approximately 2.2% (12% times 18% = 2.16%).
- ◆ 2.2% of GDP is reasonably significant and will result in hardships in some localities if completely lost. However, even if Mainland exports to the U.S. falls by 10% (which is considered unlikely), it will cause Mainland GDP to fall by only 0.22%, which is clearly tolerable, especially if the remaining 97.8% of the Mainland economy continues to grow.

The Impact of the Sub-Prime Mortgage Loan Crisis

- ◆ If the indirect domestic value added of Mainland exports to the U.S. is also taken into account, a 10% decline in Mainland exports to the U.S. may result in a decline of Mainland GDP of no more than 0.5%.
- ◆ However, the impact may be quite severe on certain localities where most of the economy is dependent on exports, e.g., the cities of Dongguan and Shenzhen in the Province of Guangdong, and Suzhou in the Province of Jiangsu, where the value of exports is greater than the local GDP. Measures must be put in place in these localities to take care of expected lay-offs of workers as a result of the slowdown in export demand.

The Impact of the Sub-Prime

Mortgage Loan Crisis—De-Coupling

- ◆ In general, the phenomenon of “decoupling” is expected to be operative. Mainland economic growth is largely unaffected by external developments, including a possible economic recession in the United States. The other so-called BRIC countries—Brazil, Russia and India—are even less dependent on exports. Brazil has recently discovered huge oil reserves and should be entering a new era of rapid economic development, financed by its new found oil wealth instead of foreign loans. Russia has already been benefiting from the high world price of oil and is not a major exporter of manufactured goods and hence will be relatively unaffected by external developments. India is also not a major exporter, except in computer software, and its economic growth is mostly internally driven.
- ◆ The BRIC countries can be expected to maintain their rates of growth, more or less, the rest of the world, including developing East Asia, should be able to manage.

The Growth of the Chinese Economy and the Pattern of World Trade

- ◆ Because of the rapid economic growth of Mainland China, and the demand and supply that such economic growth has generated, the economies of East Asia now trade more with one another than with economies outside of East Asia, including the United States. This is a sea change compared to twenty-five years ago. Interdependence of the East Asian economies has been rising over the years and dependence on the United States and Western Europe has declined.
- ◆ Mainland China has become the most important export market for most East Asian economies and runs trade deficits vis-à-vis almost every one.
- ◆ Mainland China has been a staunch supporter of the ASEAN Free Trade Area and has offered “early harvest” to ASEAN countries to foster the ASEAN-China Free Trade Area and the ASEAN + 3 (China, Japan and South Korea) Trade Area.

Concluding Remarks

- ◆ Ultimately a free trade area with free movement of goods and capital—free movement of labor will take a much longer time.
- ◆ Taiwan will specialize in R&D and upstream activities; Mainland will specialize in quantity manufacturing and provide the domestic market.
- ◆ Mainland will supply the light manufactured consumer goods.
- ◆ In the long run Taiwan can be to the Mainland as the Silicon Valley is to the United States.