

The Prospects for Economic Cooperation
between the
Two Sides of the Taiwan Strait
兩岸經濟合作的前景

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An Opportunity and a Challenge

- ◆ President MA Ying-Jeou's election presented the first genuine opportunity for improving cross-strait relations between the two sides of the Taiwan Strait at the governmental level in a generation.
- ◆ After sixty years of separation, and two decades of accumulated mutual misunderstanding and mis-trust, it will take both time and effort for cross-strait relations to get better.
- ◆ The process must begin by building trust on both sides. This implies taking small steps that are not so politically sensitive and benefit both sides so that they are sure to succeed.

An Opportunity and a Challenge

- ◆ Improving economic relations and enhancing economic cooperation are therefore likely to be less controversial and more fruitful at this initial stage, especially if the focus is on not so much new initiatives but making more efficient activities that are already on-going and making these activities bi-directional and reciprocal.
- ◆ For example, there is already a huge quantity of cross-strait trade every year. There is no sound economic reason to require a costly detour of both airplanes and ships carrying such cargo. It should be transported via the least expense route possible.
- ◆ For another example, there are already tens of millions of visitors traveling from Taiwan to the Mainland every year. There is no good reason to make them spend so much more time and money getting there and back than is necessary.
- ◆ Allowing direct flights and direct shipping do not enable any new activities but only make on-going activities more efficient, resulting in significant cost savings and benefitting both sides.

An Opportunity and a Challenge

- ◆ A natural way to improve economic relations and enhance economic cooperation is to allow on-going activities that have been predominantly one direction to become bi-directional, making them reciprocal and benefitting both sides equally.
- ◆ For example, there are also many Taiwan tourists visiting the Mainland every year and very few Mainland tourists visiting Taiwan. Thus only the Mainland is earning Taiwan tourists' dollars and Taiwan is not earning Mainland tourists' Yuan.
- ◆ Thus, regular week-end charter flights were launched and Taiwan was opened to Mainland tour groups on July 4 of this year.
- ◆ More recent agreements resulting from Mr. CHEN Yunlin's visit provide for expansion of weekend to daily charter flights, passenger charters to cargo charters, covering more cities, and straightening the flight paths. They also provide for direct shipping links and direct postal service. Note that these are not new activities per se, they mainly make existing activities more efficient, bi-directional and reciprocal.

An Opportunity and a Challenge

- ◆ As expected, there is very little progress on the political front. But there is certainly sufficient goodwill on both sides to make the economic cooperation work. For example, calling the cross-strait flights 兩岸 flights, rather than international or domestic flights demonstrates a spirit of goodwill, compromise, and pragmatism.
- ◆ Other indicators of the spirit of goodwill include the “diplomatic standstill” and the invitation to former Vice-President Mr. LIEN Chan to represent Taiwan at the APEC meeting.
- ◆ Political accommodation on both sides will take a much longer time. It is likely that the status quo will be maintained in the foreseeable future—certainly in the next decade or two. But with mutual respect and the principle of reciprocity, and the spirit of pragmatism, relations can be cordial even in the absence of substantive agreements.

An Opportunity and a Challenge

- ◆ It is extremely important to look beyond the present to form a vision of Taiwan's relations with the Mainland in say twenty years from now. What is the best possible scenario? What is the worst possible scenario?
- ◆ President MA Ying-Jeou's challenge is to come up with a credible long-term strategy to achieve the best possible scenario in terms of cross-strait relations, and to avoid the worst possible scenario, and to convince the people of Taiwan to support and follow this strategy.
- ◆ However, any strategy that is not win-win for both sides cannot possibly succeed. A win-win strategy brings benefits to both sides and should be welcomed by both sides. But to be successful it requests cooperation by both sides. Only a win-win outcome is sustainable in the long run.

Economic

Complementarity and Competition

- ◆ 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.
- ◆ Taiwan has an R&D capability that is much more oriented towards commercial applications.
- ◆ The Mainland has more savings than can be productively invested on the Mainland.
- ◆ The Mainland has abundant low-cost scientific and technical manpower.
- ◆ Taiwan and Mainland's exports are not competitive with each other.

The Comparative Advantages of Mainland and Taiwan

- ◆ 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.
- ◆ Taiwan's small and medium enterprises (SMEs) are extremely competitive, resourceful and internationally oriented.

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 allows economies of scale in production and in innovation to be realized.

Additional Advantages of the Mainland Economy

- ◆ 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.
- ◆ A large domestic market also allows the economy a significant influence on the development and setting of technological standards for products and services in the domestic as well as the world markets. Such influence will also allow the Mainland to share in the benefits of standard-setting.
- ◆ Taiwan's high-technology industry can make good use of the Mainland market as its hinterland and participate in the development and setting of technological standards and benefit from such participation.

Hollowing-Out and Over-Dependence

- ◆ Are there economic disadvantages of increased economic cooperation and interaction between the two sides of the Taiwan Strait?
- ◆ The two most frequently cited disadvantages are:
- ◆ (1) The economy of Taiwan risks being hollowed out as entrepreneurs and enterprises invest in the Mainland and move their manufacturing operations there; and
- ◆ (2) The economy of Taiwan may also become overly dependent on the Mainland if exports to the Mainland is further increased. The Mainland is already Taiwan's most important export destination. Further increases in the share of Taiwan's exports going to the Mainland can give the Mainland too much leverage.

Hollowing-Out and Over-Dependence

- ◆ While hollowing-out has indeed occurred, one has to understand that given the much higher real wage rate prevailing in Taiwan relative to not only the Mainland but also Southeast Asia as a whole, the hollowing-out is inevitable, if not to the Mainland, then to somewhere else, such as Vietnam, or Cambodia, or Laos. For Taiwan enterprises, relocating to the Mainland does have the advantage of not only lower real wage rate but also the convenience of cultural and language affinity.

Hollowing-Out and Over-Dependence

- ◆ Moreover, if Taiwan were to try to hold on to some manufacturing industries, for example, shoe-making, in Taiwan itself, Taiwan's real wage rate, or real income per capita, must decline to a level equal to or below that of the Mainland and stay there. This is not a situation that Taiwan would like to see happen. It would imply a drastic reduction in the living standard of Taiwan. Shoe-making cannot accommodate a high real wage rate and cannot support a high enough living standard for Taiwan.
- ◆ Furthermore, if we look overseas, the Silicon Valley and the Boston area no longer have much manufacturing, but both places thrive economically doing higher value-added R&D and design. They have been happily hollowed out. These are examples for Taiwan to emulate.

Hollowing-Out and Over-Dependence

- ◆ Over-dependence on one customer or one supplier exposes an enterprise to risks of being held up. The customer can demand unreasonable price cuts or the supplier can unilaterally impose large price increases. Economies are no exception—over-dependence can give the customer or supplier excessive leverage.
- ◆ However, with interdependence the situation is different. Most Taiwan-invested enterprises on the Mainland use components and semi-finished products and technology supplied by their parent companies in Taiwan. Thus, they are dependent on Taiwan rather than the other way around. If ever there is an embargo against Taiwan exports to China, most of these enterprises will have to shut down, resulting in unemployment and loss of output.

Hollowing-Out and Over-Dependence

- ◆ It is therefore important for Taiwan enterprises to remain upstream, to remain in the high-value-added part of the supply chain, so that the Mainland enterprises importing from them are technologically dependent on R&D, technology, or critical components from Taiwan.
- ◆ This is in fact how Japan has managed to maintain its economic advantage even as its firms now do most of their manufacturing in their overseas plants (e.g., Canon, Nikon, Toyota), making only the most critical components in Japan.

Sustainable Long-Term Economic Cooperation

- ◆ Taiwan should take advantage of the Mainland economy not only as a manufacturing base for exports but also as a final consumption market on its own, leveraging its intellectual property, know-how, brand names and reputation. Reputation and reliability are particularly valued in the Mainland markets.
- ◆ Mainland can also benefit from the increase in GDP, employment and productivity resulting from the wider application of Taiwan's intellectual property.

Sustainable Long-Term Economic Cooperation

- ◆ The Mainland, with its high domestic savings rate, no longer needs external capital, so Taiwan investment into the Mainland must have an edge other than money. Foreign direct investment accounts for less than 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.
- ◆ Taiwan can provide the intangible capital (R&D capital, human capital, goodwill, brand names, patents, etc.) to be combined with Mainland's tangible capital and labor to create both GDP and employment in both Mainland and Taiwan.

China as a Continental Economy

- ◆ As a continental economy, the share of exports in the Chinese GDP, will, in long-run steady state, be similar to that of the United States, that is, less than 15 percent. (This would be true of the Euro Zone if we consider only exports from Euro Zone economies to non-Euro-Zone economies as international trade.) The same is true of international trade as a percentage of GDP.
- ◆ 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.

China as a Continental Economy

- ◆ 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. However, migration inland only makes sense for Taiwan enterprises that are interested in producing for the domestic Chinese market. The cost will be too high to do “processing and assembly” imports in inland provinces.
- ◆ As labor and operating costs rise in Guangdong, Jiangsu, Shanghai and Zhejiang, the coastal province of Fujian is certainly a potential next wild goose especially for Taiwan entrepreneurs.

The Effects of Aviation and Navigation Agreements

- ◆ The reduction in air and sea transportation costs of both passengers and freight as well as the liberalization of current restrictions should increase two-way trade and the profits of the high-technology companies with assembly operations in the Mainland as well transportation companies such as airlines and shipping lines almost immediately. The only losers are Cathay Pacific Airways and Dragonair of Hong Kong, which stand to lose a great deal of the cross-strait traffic to the direct flights.
- ◆ 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 “Cross-Strait Common Market”.
- ◆ Eventual access to “ASEAN + 3” Free Trade Area for Taiwan in some form.

Bi-Directional Direct Investment

- ◆ Mainland enterprises look for investment opportunities offshore.
- ◆ Taiwan Enterprises can leverage its advantages in intangible capital in the huge domestic market of the Mainland.
- ◆ It is beneficial for both sides to have fixed investment and assets on the other side. It will make it easier, for example, to negotiate agreements on the elimination of double taxation and the protection of investment.
- ◆ There should be some relaxation of restrictions on Mainland-bound direct investment from Taiwan as well as Taiwan-bound direct investment from the Mainland. The latter should be very positive for the Taiwan economy.

Bi-Directional Direct Investment

- ◆ However, investment access should be controlled, with full disclosure and transparency as to ultimate beneficial ownership and allowing only limited leverage, i.e., with a limited debt-to-equity ratio, to discourage moral hazard.
- ◆ The two sides should also agree on a reciprocal list of industries in which the other side will not be allowed to own 100% of any firm, with some “safe harbor” exemptions based on the value of the total assets or net worth. For example, commercial banks of say more than US\$1 billion in net worth cannot be 100% owned by commercial banks on the other side without special permission. But commercial banks with net worth below this threshold are not subject to the ownership restrictions.
- ◆ For ease of regulation and supervision, both sides should agree to use only independently capitalized subsidiaries when investing in each other’s financial institutions.

Bi-Directional Direct Investment

- ◆ The Mainland is interested in investing in tourism-related industries in Taiwan. Potentially Mainland tourists can become the largest group of visitors to Taiwan.
- ◆ Tax agreements on the treatment of each other's enterprises and citizens and permanent residents are urgently needed—in particular, double taxation should be avoided. Tax agreements are also easier to reach if the differentials in tax rates and tax treatments are not large.
- ◆ There are also competitive reasons for maintaining more or less similar tax rules and regulations on the two sides. They will probably never be completely the same, but the more similar they are, the easier it is to cooperate, and the less unhealthy tax competition.
- ◆ Once a cross-strait tax agreement is in place, Taiwan enterprises listed on the Taiwan Stock Exchange can consolidate their global operations on to a single set of financial statements (as well as file consolidated tax returns) so that profits and losses on the Mainland can be properly reflected.

Trade in Services

- ◆ Tourism create service sector jobs for unskilled and low-skilled jobs that, unlike manufacturing jobs or back-office jobs, cannot move away. The “Individual Visit Scheme” is the major generator of employment opportunities among the unskilled and low-skilled workers in Hong Kong. It can bring similar benefits to Taiwan, greatly reducing the unemployment rates among the unskilled and low-skilled workers, especially in Southern Taiwan. It is therefore in Taiwan’s interests to try to increase the flow of tourists from the Mainland, and in particular to push for an “Individual Visit Scheme” similar to that for Hong Kong.

Trade in Services

- ◆ Higher education services is another area that has a great deal of room for expansion--there is a huge demand for tertiary education from the Mainland and an excess supply of university places in Taiwan. So it is natural for Taiwan to consider attracting Mainland students to enroll at universities in Taiwan and for the Mainland to consider allowing its students to do so. The cost is not an issue as many self-financed Mainland students currently study overseas in the U.K., the U.S. and elsewhere at costs that can run as high as US\$50,000 a year. This way Taiwan can also attract additional talents for its R&D activities. However, for such a plan to move forward it would require selective reciprocal recognition of degrees and diplomas and eventually of professional qualifications by both sides.

Trade in Services

- ◆ Taiwan can also provide healthcare services for Mainland residents, especially residents in Fujian.
- ◆ Demand for both educational and healthcare services are high. Taiwan has an advantage over other economies providing such services to Mainland residents because of their affinity in terms of the language (dialect), customs and culture.

Current Global Economic Environment

- ◆ The current 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, for the next year or two.
- ◆ 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 the (partial) de-coupling of the global economy.

Current Global Economic Environment

- ◆ Mainland economic growth is largely unaffected by external developments, including the economic recession in the United States and possibly in Western Europe. This is because of two reasons:
- ◆ (1) Even though the share of exports in GDP is relatively high—approximately 35%, the domestic value-added content of Chinese exports is only approximately 20%. Multiplying the two percentages together, we obtain the result that exports generate only approximately 7% of Chinese GDP. Now, 7% of GDP is very significant—no one wants to lose 7% of GDP. However, if 7% does not grow, and even declines by 10%, and the other 93% of the economy continues to grow, the economy will do reasonably well.

Current Global Economic Environment

- ◆ (2) As a large continental economy, domestic demand, led by the real estate development rather than exports, has been the driving force of Chinese growth during the past five years. With the large economic stimulus package of almost US\$600 billion that was just announced by the Chinese Government, mostly focused in public infrastructural investment, it is quite certain that the Chinese economy will be able to maintain a real rate of growth of at least 8% per annum in the next couple of years.

Current Global Economic Environment

- ◆ Another way of looking at the Chinese economic situation is to compare it with ten years ago. Today, the external environment facing the Chinese and East Asian economies is just as negative as in 1997-1998, though in a totally different way. China and the East Asian economies are once again faced with problems of a decline in the demand for its exports. East Asian economies are also faced with the withdrawal of foreign capital, as in 1997-1998, but for different reasons.
- ◆ However, today, the Chinese Government has far more resources and instruments at its disposal—in terms of the level of official foreign exchange reserves (US\$1.9 trillion compared to approximately US\$100 billion), the rate of increase of fiscal revenue (over 30% per annum), and a much better (although far from perfect) social safety net. Lawrence J. Lau, The Chinese University of Hong Kong

Current Global Economic Environment

- ◆ But the Chinese economy managed to do all right back then (and earned the gratitude and respect of the East Asian economies by not devaluing the Renminbi).
- ◆ I am confident that despite the financial turmoil and economic slowdown and recession in the U.S. and in some of the Western European countries, the Chinese economy will also be able to manage to continue to grow based on its internal demand alone, as it did during the 1997-98 East Asian currency crisis.

Current Global Economic Environment

- ◆ 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 (although it will be affected by the decline in the world price of oil). 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.
- ◆ On this basis, the East Asian economies, which have all run trade surpluses vis-à-vis China, will also be able to manage, especially if they all launch economic stimulus packages of their own.

Concluding Remarks

- ◆ China is at the present time much better prepared to cope with a negative external environment—it has more resources (much higher foreign exchange reserves (at last count over US\$1.9 trillion), large and rising fiscal surpluses, and a much more effective social safety net).
- ◆ The primary focus of China now should be the increase of domestic demand.
- ◆ The promotion and support of affordable owner-occupied residential housing should usher in a long period of rapid economic growth based solely on internal demand. Securitization has a crucial role to play.

Opportunities for Taiwan

- ◆ Taiwan should take advantage of this opportunity to expand its trade and investment with the BRIC economies.
- ◆ Taiwan should be ready to take advantage of the growth of domestic demand in the domestic market on the Mainland, as well as its economic complementarity with the Mainland to create win-win solutions for both.
- ◆ As long as there is goodwill on both sides, politics can be put on a back-burner. Mutual respect and consideration, reciprocity, and flexibility and pragmatism are needed for progress to be made on the economic front.

The Special Advantages of Fujian for Taiwan Enterprises

- ◆ Fujian has not been the major preferred destination of Taiwan direct investment, in part for reasons of national security and the potentially adversary positions of the two sides of the Taiwan Straits, but Fujian's time may now have come.
- ◆ Taiwan enterprises that are still focused on manufacturing for exports to the U.S. and Western Europe will find Fujian attractive as a base.
 - ◆ The transportation costs for the importing of raw material, components and parts and the exporting of the finished goods will be minimized (as compared to location in Hunan and Jiangxi).
 - ◆ The labor costs are lower than those in Guangdong, Jiangsu and Shanghai.
 - ◆ The distances between Taipei and Kaohsiung on the one side and Xiamen and Fuzhou on the other side are so short that it is possible to commute between the two sides of the Taiwan Strait every week.
 - ◆ It takes only 6 hours by sea to go from Taiwan to Fujian, greatly lowering the cost of shipping components and semi-finished goods from Taiwan to the Mainland.
 - ◆ There is the additional advantage of a common dialect and customs.

The Special Advantages of Fujian for Taiwan Enterprises

- ◆ However, in order to realize this potential, Fujian must actively seek the location or the relocation of a cluster of Taiwan-invested enterprises 企業群 to Fujian.
- ◆ It is important to have a cluster of enterprises so that the entire “supply chain” is available at the new location in Fujian; otherwise it is almost impossible to persuade individual enterprises to move. This is especially true for the small and medium enterprises which account for the bulk of the Taiwan-invested enterprises in the mainland.
- ◆ Fujian must commit to the provision of up-to-date, high-quality infrastructure including transportation, communication, power and water.
- ◆ Fujian must be prepared to provide trained personnel.
- ◆ The results can be win-win.

Concluding Remarks

- ◆ Ultimately the Mainland and Taiwan can become a free trade area with free movement of goods and capital—free movement of labor will take a much longer time.
- ◆ Taiwan can specialize in R&D, design and other upstream activities; Mainland can specialize in quantity manufacturing (both light and heavy industry) and provide the domestic market.
- ◆ Mainland can 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. In order to achieve this status, Taiwan must encourage more of its students to pursue advanced studies in engineering, science and technology as well as recruit talents worldwide.
- ◆ Mainland-Taiwan economic cooperation can be win-win and Fujian can have an important role to play.