The Impact of Cross-Strait Relations on Taiwan's Growth Pattern

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Taiwan's Growth Track

Taiwan is a typical case of a developing country which has utilized its cheap labor and taken advantage of international trade to achieve sustained high growth. Wages, however, are always relative to labor productivity. The gap between wage levels and labor productivity represents the competitiveness of a country's exports. The essence of trade-dependent growth is to raise productivity faster than wage inflation so that a country's exports always remain competitive in the world market. The foreign exchange earned can then be used to import producer goods and further raise productivity.

It can be argued that exchange rate manipulation or wage control can serve the same purpose, i.e. keep exports competitive on the world market. However, manipulating exchange rates always creates distortions in resource allocation and often brings inflation of more expensive imports. Wage levels, on the other hand, hinge on the country's degree of economic development, its labor market structure, and government policies. It is easy to maintain low wages when the economy is still at a low development level, there is an abundant supply of labor, and the government is authoritarian in enforcing its low-wage policy. However, wage control is difficult when the economy is growing rapidly, there is full employment, and the government lacks the ability to suppress union activities and labor movement. This leaves productivity growth as the only long-term method to sustaining growth in a trade-dependent economy.

One therefore needs to examine two crucial elements in Taiwan's economic development: productivity growth and foreign trade. Since the 1950s, there have been two stages of import substitution and two stages of export expansion. Each import substitution stage was a period of raised productivity, and each export expansion stage was a period of penetration into the world market based on mature production technology and relatively cheap labor. Import substitution created native industries that later became the base for launching export expansion. Successful export expansion then raised wage levels, making further productivity growth imperative, but also pro-

vided the means for upgrading industrial structure through accumulation of foreign exchange and importing producer goods and technology. Through an alternate succession of import substitutions and export expansions, Taiwan's economy has sustained a high growth rate in the past four decades.

The 1950s: First Import Substitution

When Taiwan was retroceded to the Republic of China following the end of World War II, economic ties with Japan were abruptly severed. Mainland China was temporarily the major market for Taiwan's main exports (rice and sugar), but that linkage was also terminated with the Communist takeover of the mainland in 1949. During the 1950s, the U.S. supplied more than 40 percent of Taiwan's imports, while Japan again became the major outlet for Taiwan's agricultural exports. Taiwan's trade deficit with the U.S. at that time was met by U.S. aid, which totaled US$1.5 billion from 1951 to 1965. The same aid was also utilized by the ROC government to nurture food processing and textile industries on the island. This was the first stage of import substitution, as high tariffs, import controls, and a multiple exchange rate scheme were instituted to protect nascent domestic industries. As a result, Taiwan's GNP grew 56.1 percent between 1952 and 1958. However, growth momentum soon subsided with a saturated domestic market. Because deepening the market was considered impossible considering Taiwan's small market size, the government then pushed for export expansion based on the very same industries that grew under primary import substitution. The U.S., eager to terminate direct economic aid, also laid pressure on Taiwan to shift to export expansion.

The 1960s: First Export Expansion

Between 1958 and 1961, there was a reform of foreign exchange and trade, a 19-point program of economic and financial reform, and a Statute for Encouragement of Investment. Through these measures, the overall incentive structure was shifted from favoring domestic market production to encouraging export. The timing was optimal, as the 1960s was a golden decade for world trade. The Dillon and Kennedy rounds of GATT negotiations significantly brought down the tariffs of industrialized countries. Taiwan took advantage of this unique opportunity and primarily targeted the U.S. market. Taiwan's exports to the U.S. grew from US$18.9 million in 1960 to US$564.2 million in 1970, a growth factor of 30. In contrast, Taiwan's overall exports increased by 9 times during the same period. In 1967, the U.S. surpassed Japan as Taiwan's largest export market for the first time. One year later, Taiwan registered its first-ever trade surplus with the U.S. (see table 1). The U.S. market also took an increasingly larger share of Taiwan exports, from 11.5 percent in 1960 to 38.1 percent in 1970.

Table 1. Taiwan's Trade with the U.S., 1947-1994

Year	Taiwan's export to U.S. (US$Mn)	U.S. share in Taiwan's export (%)	Taiwan's import from U.S. (US$Mn)	U.S. share in Taiwan's import (%)	Taiwan's trade surplus with U.S. (US$Mn)
1947			9		-9
1948	1		6		-5
1949	2		53		-51
1950	3		23		-20
1951	6		41		-35
1952	4	3.5	86	45.7	-82
1953	n.a.	4.2	n.a.	38.7	n.a.
1954	n.a.	5.4	n.a.	46.4	n.a.
1955	5	4.4	96	47.5	-91
1956	7	5.6	81	42.0	-74
1957	5	3.5	85	49.9	-80
1958	10	6.2	84	37.3	-74
1959	14	8.6	84	36.1	-70
1960	19	11.5	113	38.1	-94
1961	43	21.9	131	40.6	-88
1962	53	24.4	115	38.0	-62
1963	54	16.3	151	41.6	-97
1964	81	18.6	139	32.5	-58
1965	96	21.3	176	31.7	-80
1966	116	21.6	166	26.7	-50
1967	168	26.2	247	30.7	-79
1968	278	35.5	240	26.5	38
1969	399	38.0	292	24.1	107
1970	564	38.1	364	23.9	200
1971	859	41.7	408	22.1	451
1972	1,251	41.9	543	21.6	708
1973	1,677	37.4	953	25.2	724
1974	2,037	36.1	1,680	24.1	357
1975	1,823	34.3	1,652	27.8	171
1976	3,039	37.2	1,798	23.7	1,241
1977	3,636	38.8	1,964	23.1	1,672
1978	5,010	39.5	2,376	21.5	2,634
1979	5,652	35.1	3,381	22.9	2,271
1980	6,706	35.1	3,381	22.9	2,271
1981	8,163	36.1	4,766	22.5	3,397
1982	8,759	39.4	4,563	24.1	4,196
1983	11,334	45.1	4,646	22.9	6,688
1984	14,868	48.8	5,042	23.0	9,826
1985	14,773	48.1	4,746	23.6	10,027
1986	19,014	47.7	5,433	22.4	13,581
1987	23,685	44.1	7,648	21.8	16,037
1988	23,467	38.7	13,007	26.2	10,460
1989	24,036	36.2	12,003	23.0	12,033
1990	21,746	32.4	12,612	23.0	9134
1991	22,321	29.3	14,114	22.5	8,,207
1992	23,572	28.9	15,772	27.9	7,800
1993	23,478	27.6	16,722	21.7	6,756
1994 Jan.-May	9,369	26.0	7,864	23.0	1,505

Sources: Data for 1947-1994, Baldwin, Chen and Nelson 1992, 4.
Data for 1990-1993, *Taiwan chung-yao ching-chi pien-tung chih-piao* (Taipei: Chung-Hua Instiution for Economic Research, April 1994), 11.
Data for 1994, January-May, *Liang-an ching-chi t'ung-chi yueh-pao* (Taipei: Mainland Affaris Council, August 1994), 34-35.

The 1960s was a decade of successful export expansion based on labor-intensive manufactures. If we examine the content of Taiwan's exports to the U.S. during that period of time, we find that textiles and apparel were mainstays, followed by footwear and wood products and then by electrical and electronics products (see table 2). The textile industry was nourished by government subsidies and U.S. aid in the 1950s, as private entrepreneurs in the industry who had benefitted from protectionist policies now moved to the export sector to take advantage of the new incentives. Textiles and apparel remained the dominant export industry until the 1970s and was a successful case of Taiwan's indigenous industrial strength and the

Table 2. Taiwan's Principal Exports to the U.S., 1955-1990

% of total export

Year	Textile and Apparel	Electrical and Electronic Products	Consumer Manufactures
1955	19.3	0	1.2
1956	11.4	0	1.2
1957	23.1	0	3.8
1958	23.5	0	13.4
1959	29.8	0	15.6
1960	31.4	0	11.5
1961	14.5	0	17.5
1962	32.4	0.2	21.8
1963	15.0	1.0	29.1
1964	20.6	1.5	30.5
1965	21.5	5.6	30.6
1966	18.3	12.2	32.2
1967	20.8	16.4	31.6
1968	22.0	21.0	31.3
1969	25.6	20.2	30.7
1970	28.9	20.1	28.5
1971	33.7	19.7	28.6
1972	24.6	26.7	31.7
1973	22.1	30.0	31.9
1974	22.5	28.7	28.9
1975	26.2	20.7	31.9
1980	18.8	20.3	37.4
1985	16.3	18.1	35.0
1990	12.2	18.1	22.4

Source: Ministry of Finance, *Annual Statistics of Exports and Imports, The Republic of China, Taiwan District*, various issues; cited in Balswin, Chen and Nelson 1992: 13.

government's industrial policy (Wu, 1994a, ch. 5). Footwear, wood and other miscellaneous consumer manufactures, such as plywood, toys, sporting goods, travelling equipment, etc., benefitted from American wholesalers and importers who looked abroad for cheaper products to meet domestic competition. Taiwan's small and medium enterprises met their demands for production flexibility. American buyers placed orders, transferred unsophisticated technology, and practically guaranteed markets for local producers. This demand-driven phenomenon rose and fell in a short period of time, as Taiwan was the leading producer for the U.S. market for a short while before the U.S. shifted to other cheaper overseas manufacturing bases. These particular industries were never considered strategic by Taiwan's economic planners and their growth should be attributed mainly to the importers' demand.

In the late 1960s, the most rapid industrial expansion occurred in electronics (see table 2). This was the first industry in postwar Taiwan that was directly linked with foreign investment. Many American giants such as Ford Motor, TWA, RCA, and Admiral set up subsidiaries in Taiwan to produce for the U.S. market. The Export Processing Zones established by the government clearly facilitated the inflow of foreign capital at this critical juncture. In 1970, 49 percent of all the electronics firms registered in Taiwan were foreign-owned, which accounted for 80 percent of all investment funds. Local firms were catching up only in the 1970s. Gradually electronics developed into the most technologically advanced industry on the island, assuring continued growth of the economy as the price of labor became much dearer. The successful development of the textiles and apparel, consumer manufactures, and electronics industries in the 1960s created a booming export sector that fueled Taiwan's economic growth. As a result, before the first oil crisis, Taiwan enjoyed stable prices and high growth without significant business cycles. At the same time, the island's economy was increasingly characterized by medium and small enterprises which proliferated in the export sector.

The 1960s not only saw Taiwan's exports booming and concentrating on the U.S. market, they also saw increasing imports of industrial raw materials and capital goods from Japan. Just as the U.S. surpassed Japan as Taiwan's leading export market in 1967, Japan exceeded the U.S. and became the major import supplier for Taiwan in 1964. In 1971, Taiwan obtained 44.5 percent of its total imports from Japan, compared with 22.1 percent from the U.S. (Baldwin, Chen and Nelson, 1992: 31).

Among Taiwan's three major imports — agricultural products, industrial raw materials, and capital goods — the U.S. remained the primary provider in the first category after the 1960s, thanks to ROC government procurement policies (the Bulk Commodity Import Regulation, the "Buy American Missions," etc.) that favored American exporters. However, Japanese providers managed to dominate the last two categories because the new entrepreneurs

in Taiwan were mainly native Taiwanese who received Japanese education during the colonial period and had a natural tendency to seek market know-how, technical assistance, and producer goods from Japanese firms. The U.S. importers, most of them wholesalers, did not favor products with U.S.-made components or parts. On the other hand, the Japanese trading firms, or sogo shosha, that made procurements in Taiwan and sold on the U.S. market preferred using Japanese capital goods and intermediate materials, and by doing so encouraged local producers to import from Japan. The same phenomenon can be found in the procurement policy of Japanese subsidiaries in Taiwan who overwhelmingly imported components and parts from Japan. The American subsidiaries, on the other hand, showed no such preference for products made in the U.S. Thus Taiwan gradually developed a trade pattern of high export dependence on the U.S. and high import dependence on Japan. In this scheme, Japan was the upstream provider, Taiwan the downstream producer, and the U.S. the end market.

The 1970s: Second Import Substitution

Bottlenecks emerged in the early 1970s, as the ROC faced major economic and political difficulties. The first oil crisis brought about a worldwide recession and touched off protectionism in the West. Taipei was dislodged from the United Nations as Beijing took the China seat in 1971, and Japan shifted its diplomatic recognition from the ROC to the PRC in 1973. Finally, in 1975 paramount leader Chiang Kai-shek died as the island experienced its first export decline since 1956. Chiang Kai-shek's son Ching-kuo took political power and devised a new economic package which included ten major constructions on the island and launched a second import substitution. The emphasis was on petrochemicals, steel, and ship-building, and the production of capital goods was the focus of the new industrialization drive.

Taiwan's domestic industry deepened, though the industrial structure did not overwhelmingly tilt toward heavy industry, as in the case of South Korea. There was a division of labor between the public and private sectors of the economy. The state enterprises and the KMT-party corporations made massive investments in protected heavy industries, while the small and medium private enterprises continued to dominate the export sector, which was governed by the same export-promoting policies installed in the 1960s. The former concentrated on the domestic market, while the latter expanded on the international market. A linkage was established between the two, as the heavy industries became the upstream providers of capital goods for the downstream producers, such as between the petrochemical industries and textiles and apparel industry. This vertical integration contributed to the increasing competitiveness of Taiwan's industry. Though wage levels continued to rise throughout the 1970s and the price of oil surged toward the end of the decade, productivity gains were much greater, and a significant com-

parative advantage was created.

It is worth mentioning that during the 1970s there were significant efforts made by the U.S., the major market for Taiwan's exports, to regulate bilateral trade between the two countries. In 1971, an agreement was reached between Washington and Taipei to control the flow of wool and man-made textile and apparel products. By establishing a large base of exports in the 1960s, Taiwan was actually guaranteed a sizable market share in the U.S. under such regulations. The Multi-Fiber Agreement of 1974 did not change this picture. Also working to Taiwan's advantage was the U.S. Trade Act of 1974, which established a Generalized System of Preferences (GSP) under which Taiwan swiftly became one of the biggest beneficiaries. For example, a full 39 percent of Taiwan's total exports to the U.S. in 1979 were covered by GSP's preferential treatment. In that year, Taiwan reaped US$160 million in tariff saving, which put the country at the top of all GSP beneficiaries (Baldwin, Chen and Nelson, 1992: 19). It is obvious that limited market regulation on the American side did not dampen Taiwan's export drive.

The second import substitution of the 1970s did not lessen Taiwan's import dependence on Japan. Though the public sector had a clear pro-U.S. bias in its investment policy, this simply meant when exports to the U.S. were down, probably due to a recession in the States, the government would come up with a counter-cyclical policy and urge the public sector to increase imports from the U.S. Hence exports to the U.S. and imports from it were conversely related, with the exports "series" leading the imports "series" by one year (Baldwin, Chen and Nelson, 1992: 34). When exports to the U.S. rose and the economy ran smoothly, imports were dominated by private firms that preferred Japanese products. The trade pattern established in the 1960s —export dependence on the U.S. and import dependence on Japan—was sustained throughout the 1970s.

The 1980s: Second Export Expansion

Taiwan's exports continued to surge in the 1980s, as they took full advantage of the previous import substitution's productivity gains and the island's relatively cheap labor. The derecognition of the ROC by the U.S. in 1979 and the second oil crisis of the same year did not dampen Taiwan's economic vitality, as foreign investment continued to pour in after the political shock and Taiwan's exports registered record growth. Foreign trade became highly imbalanced, with Taiwan enjoying unprecedented surpluses against its major trading partners, particularly the United States. In 1986, for example, Taiwan's overall trade surplus was 21.1 percent of its GNP, a phenomenon one usually observed only in oil-producing countries during the oil crises (Liang and Hueh, 1990: 35). In 1987, Taiwan's trade surplus vis-à-vis the U.S. reached an unprecedented US$1.6 billion. Foreign investors from both the U.S. and Japan played a significant role in using Taiwan as a major manu-

facturing base for exporting to the U.S. market (Wu and Chen, 1988: 70). From 1984 to 1986, Taiwan's export dependence on the American market was 47.7 to 48.8 percent, compared with an average of 23.5 percent in the 1960s and 38 percent in the 1970s.[1]

Taiwan became increasingly dependent on the U.S. in the 1980s, even with the severance of official ties between the two countries. Taiwan became the second largest source of the U.S. trade deficit, and as a result was targeted by Washington for currency appreciation, voluntary export restraint agreements, and unfair trade practice investigations. In 1989, Taiwan lost its GSP privileges with the U.S.; it was obvious its export expansion had hit its limit.

The 1980s were primarily a decade of export expansion, with the state doing little to promote import substitution.[2] As in the past, trade-propelled high growth raised wage levels to a new high, making a third import substitution imperative for Taiwan's economic development in the late 1980s and early 1990s. This time, however, Taiwan faced an entirely different political environment. In the past, Taiwan had a strong "capitalist developmental state" (Johnson, 1985). Both Chiang Kai-shek and Chiang Ching-kuo amassed indisputable power in their hands and entrusted economic bureaucrats such as K.Y. Yin and K.T. Li with managing the economy (Wu, 1994a, ch. 5). The state was in a position to shift the country's direction of economic development, and designed and promoted all previous import substitutions and export expansions. The 1980s, however, witnessed the surge of opposition political forces, factionalization of the ruling Kuomintang (KMT), rise of pro-labor and environmentalist movements, political liberalization and democratization, and finally, the death of Chiang Ching-kuo in 1988. Production costs rose sharply, but labor productivity did not grow in correspondence. What was missing was a major effort to upgrade Taiwan's industrial structure, a la the 1950s and 1970s. As a result, Taiwan's exports became increasingly less competitive on the international market.

Since the late 1980s, products made in Taiwan have captured a slimmer and slimmer share of the U.S. market. Taiwan's trade surplus with the U.S. has also declined steadily. Part of this phenomenon has to do with the rising NT dollar, which appreciated against the U.S. dollar by 16.1 percent in 1987, 9.9 percent in 1988, and another 7.5 percent in 1989 under great pressure from Washington. Before this dramatic appreciation, the exchange rate was NT$37.84 to the dollar. In 1990-93, the rate settled between NT$26.38 and NT$25.16 to the dollar. However, when the exchange rate stabilized in the early 1990s, Taiwan's trade surplus with the U.S. began to decline rapidly. It was down 10.1 percent in 1991, 5 percent in 1992, and another 13.4 percent in 1993. Clearly something other than the exchange rate was causing this phenomenon (see table 3). The root of the problem was rising production costs and fleeing capital.

The 1980s not only saw Taiwan's export drive gradually losing momentum, but also witnessed a sharp rise in the island's imports from Japan as

Table 3. Taiwan's Maket Share in U.S., Trade Surplus with U.S., and Exchange Rate to the Dollar, 1986-1993

Year	U.S. market share of Taiwan's exports (%) and its growth rate (%)		Taiwan's trade surplus via-à-via U.S. (US$Mn) and its growth rate (%)		Exchange rate (NT$) to (US$1) and its growth rate (%)	
1986	5.35		13,851		37.84	
1987	6.07	13.5	16,037	18.1	31.74	-16.1
1988	5.62	-7.4	10,460	-34.8	28.59	-9.9
1989	5.14	-8.5	12,033	15.0	26.41	-7.5
1990	4.60	-10.5	9,134	-24.1	26.89	1.8
1991	4.70	2.2	8,207	-10.1	26.82	-0.3
1992	4.67	-0.6	7,800	-5.0	25.16	-6.2
1993	4.35	-6.9	6,756	-13.4	26.38	4.8
1994 Jan. May	4.12	-5.3	1,505	-46.5 (annualized)	26.49	0.4

Sources: *Lian-an ching-chi t'ung-chi yueh-pao* (Taipei: Mainland Affairs Council, June 1994), *Taiwan chung-yao ching-chi pien-tung chih-piao* (Taipei: Chung-Hua Institution for Economic Research, April 1994), 11.

local manufacturers found themselves tied with Japanese providers and trading firms and suffered from the rising yen. At the same time, the U.S. made every effort to open Taiwan's domestic market in order to increase Taiwan's import of American products. Intensive bilateral negotiations began in 1981, and in 1985, Premier Yu Kuo-hwa commissioned an Economic Reform Committee which produced a report calling for liberalization and internationalization. In this context, Taiwan gradually opened up its domestic market, a process which was accelerated with the ROC's bid for membership in the GATT (WTO). However, the biggest beneficiary of Taiwan's opening-up policy was not U.S. firms, but Japanese companies with intricate linkages to Taiwan's businesses.

Cross-Strait Investment Surge

At the turn of the decade, Taiwan was unable to implement a large-scale import substitution. With general production costs and wage levels rising rapidly, Taiwan was hard pressed to find a solution for its trade-dependent economy. At this juncture, Taiwan was offered a unique opportunity to seek cheap labor overseas to maintain its export edge. With the political thaw across the Taiwan Strait, Taiwan's labor-intensive industries hurried to invest in the Chinese mainland to prolong their life-spans. This strategy entailed no gains in productivity, as Taiwan's investors were more interested

in using the mainland's cheap labor than to invest on R&D. However, as long as wage levels on the mainland remained low, Taiwan's trade-dependent economy would be rejuvenated.

Mainland China was in its own stage of export expansion based on production technologies that Taiwan mastered in the 1960s and 1970s. In 1988, after consecutive years of trade deficits, a critical decision was made in Beijing to shift the focus of the mainland's open-door policy from introducing Western technology to earning badly-needed foreign exchange through exporting labor-intensive products, a strategy based on mainland China's comparative advantage. Following Wang Jian's "grand international circulation" theory, Premier Zhao Ziyang decided to plunge China's east coast into the world market (Sah, 1991: 101-2). The mainland economy was oriented toward export expansion, very much like what had happened in the East Asian NICs several decades before.

Taiwan investment fit into this picture, as its labor-intensive export industry was oriented toward the international market and was a perfect source of direct foreign investment for mainland China at this critical juncture. Following sound economic logic, the PRC's State Council promulgated the Regulations Encouraging Taiwan Compatriots to Invest in the Mainland (the 22 Articles), which was later followed by the Law on Protection of Investment by Taiwan Compatriots in 1994. Provinces competed in offering privileges to Taiwan investors, including tax holidays, duty-free imports, land-use rights, permission to purchase bonds, and special areas for exclusive Taiwan investment (*Ta-lu t'ou-tzu chih-nan*, 1991: 112-3). In addition to these favorable policies, other "pull" factors included geographical proximity, cultural similarities, great market potential, access to raw materials, GSP treatment that mainland exports enjoyed in the U.S. market, and much lower production costs. On the "push" side, one found a surging NT dollar, rising labor and land costs, pressure from environmentalists against industrial pollution, and increasing competition from other Asian countries with low wage levels. In some cases, Taiwan firms were asked by Western importers to establish manufacturing bases on the mainland (Li Tsung-che, 1994: 78). In 1990, the ROC government finally legalized investment activities by Taiwan businessmen on the mainland in an effort to gain information on the outflow of capital from the island and to better direct it.

As a result, Taiwan's investment on the mainland grew by leaps and bounds. At its beginning in 1987, it had 80 investment projects and US$100 million. The following year there were 430 projects and US$600 million invested. The investment surge was not deterred in the slightest by the 1989 Tiananmen incident, as witnessed by the fact that at the end of 1989 Taiwan investors had launched 1,000 projects involving US$1 billion. This trend steamed ahead into the 1990s. In 1993, Taiwan's investment hit the US$10 billion mark, making Taiwan the second largest foreign investor on the Chinese mainland, next to only Hong Kong and Macao.[3] According to a

conservative official estimate (*Monthly Statistical Report on Cross-Strait Economic Relations*, August 1994), mainland China was the major outlet for Taiwan's overseas investment in 1993. With US$3.17 billion in 9,329 cases, Taiwan's mainland investment accounted for 66 percent of the total (see table 4). This was six times as large as Taiwan's investment in the U.S., which ranked second in receiving Taiwan's outflowing capital, or 11 times as large as Taiwan's investment in Southeast Asia. On the mainland one could find roughly 20,000 Taiwan firms as well as 200,000 Taiwan businessmen and technicians, many of whom had moved their families over. Having said that, Taiwan's mainland investment is still characterized by its small scale and low technology content. For example, only 5.8 percent of the products manufactured by Taiwan-invested firms on the Chinese mainland are of higher quality than similar products made in Taiwan, compared with 8 percent in Southeast Asia and 72 percent in the United States (Li Tsung-che, 1994: 79).

Cross-Strait investment has had a decisive impact on Taiwan's industrial structure and export capacity. For example, more than 80 percent of Taiwan's shoe-making industry has been transplanted to the Chinese mainland. As a result, in 1991, shoes made in mainland China captured 45 percent of the U.S. market, the same share enjoyed by Taiwan products in 1986. Mainland investment has also affected local capital markets, interest rates, and the effectiveness of the government's monetary policies. Thus when the Central Bank pursued an expansionary policy by lowering interest rates, the economy responded slowly, for a large portion of the released capital flowed to the mainland and contributed little to capital formation in Taiwan.

Investment-driven Trade

The same rapid growth of Taiwan's mainland China also characterizes investment-driven trade across the Taiwan Strait, which grew from a low of

Table 4. Officially-Approved Indirect Investment on the Chinese Mainland, 1991-1994

US$1,000

Year	Cases	Amount
1991	237	174,158
1992	264	246,992
1993	9,329	3,168,411
1994 Jan-June	532	434,712
Sum	10,362	4,024,273

Source: Investment Commission, Ministry of Economic Affairs; cited in *Liang-an ching-chi t'ung-chi yueh-pao* (Taipei: Mainland Affairs Council, August 1994), 42.

US$1.7 billion in 1987 to over US$15.1 billion in 1993 (see table 5).[4] Cross-Strait trade has become the main source of Taiwan's overall trade surplus.[5] As Taiwan's trade surplus with the U.S. declined steadily and its trade deficit with Japan rose at a higher rate, cross-Strait trade was instrumental in enabling it to avoid developing an overall trade deficit. The other side of the coin is that without the trade deficit mainland China accumulated with Taiwan in 1993 (US$12.9 billion), the mainland would have had an overall trade surplus that year (it had an overall deficit of US$12.1 billion). In 1993, Taiwan's trade dependence on mainland China was 9.32 percent and its export dependence was 16.47 percent. It was further estimated that by 1996 mainland China will surpass the U.S. to become Taiwan's largest trading partner.

Cross-Strait trade is currently highly unbalanced. If one takes a look at the trade balances between Taiwan and mainland China in 1987-93, one indisputable fact immediately stands out: Taiwan has enjoyed an increasingly large trade surplus (see figure 1). In 1987, when Beijing's economic incentives were not yet in full play, Taiwan exported goods worth US$1.3 billion to the mainland and imported US$289 million in products across the Strait, giving the island a trade surplus of US$978 million. In 1988, Taiwan's cross-Strait exports jumped to US$2.2 billion, imports rose to US$479 million, and Taiwan's surplus reached US$1.8 billion. This trend continued into the

Table 5. Cross-Strait Trade Through Hong Kong, 1979-1993

Unit: US$ Mn; %

Year	Total trade Volume Growth rate		Taiwan's export to Mainland Volume Growth rate		Taiwan's import From Mainland Volume Growth rate		Taiwan's trade dependence on Mainlland
1979	77.8		21.5		56.3		0.25
1980	311.2	300.18	235.0	994.41	76.2	35.39	0.79
1981	460.0	47.61	348.8	63.49	75.2	-1.35	1.05
1982	278.5	-39.39	194.5	-49.38	84.0	11.76	0.68
1983	291.3	4.60	201.4	3.55	89.9	6.49	0.64
1984	553.3	89.74	425.5	111.27	127.8	42.18	1.06
1985	1,102.7	99.30	986.8	131.92	115.9	-9.28	2.17
1986	955.6	-13.35	811.3	-17.78	144.2	24.43	1.49
1987	1,705.2	78.45	1,266.5	56.11	288.9	100.35	1.92
1988	2,720.9	59.57	2,242.2	77.04	478.7	65.67	2.47
1989	3,918.8	44.03	3,331.9	48.60	586.9	22.61	3.31
1990	5,160.0	31.67	4,394.6	31.89	765.4	30.41	4.32
1991	8,619.5	67.04	7,493.5	70.52	1,126.0	47.11	6.20
1992	11,666.6	35.35	10,547.6	40.76	1,119.0	-0.62	7.06
1993	15,096.7	29.40	13,993.1	32.67	1,103.6	-1.38	9.32
1994 Jan.-May	6,642.2		6,154.1		488.1		9.42

Source: *Liang-an ching-chi t'ung-chi yueh-pao* (Taipei: Mainland Affairs Council, August 1994), 31, 32.

1990s, with Taiwan enjoying a surplus of US$3.6 billion in 1990, US$6.4 billion in 1991, US$9.4 billion in 1992, and US$12.9 billion in 1993. Last year, Taiwan's exports constituted 92.7 percent of the overall trade across the Taiwan Strait.

Not only was there a steadily rising trade surplus in Taiwan's favor, the island's export dependence on the mainland market (as calculated by the mainland's share in Taiwan's overall exports) also increased over the years. In

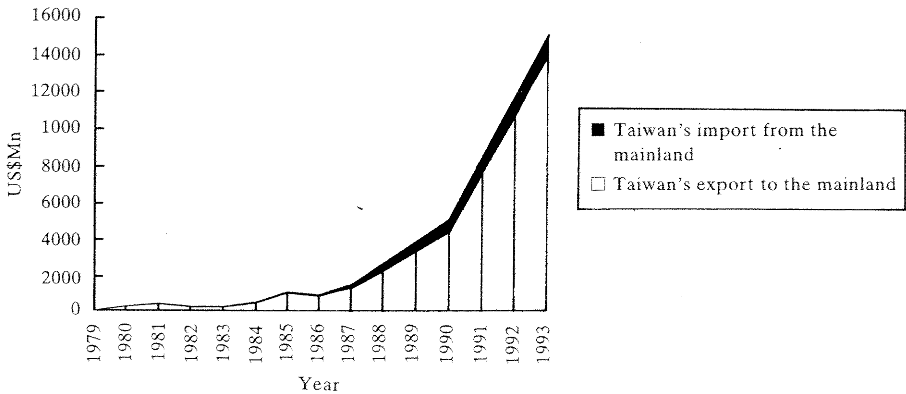

Fig. 1. Taiwan's Export to and Import from the Mainland.

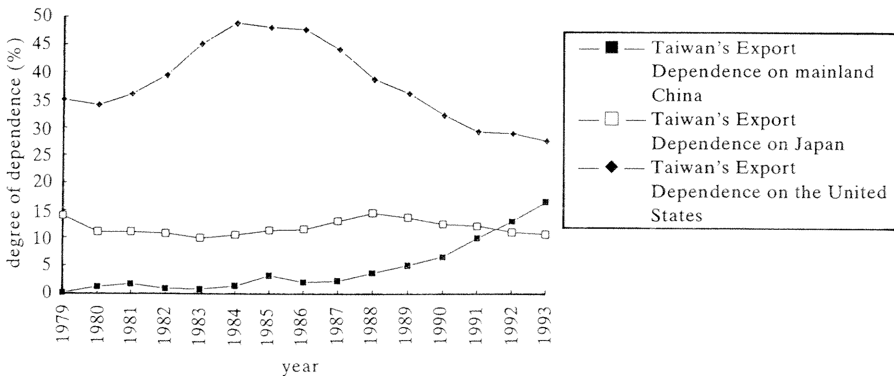

Fig. 2. A Comparison of Taiwan's Export Dependence on Mainland China, Japan, and the United States (1979-1993)

Sources: *Taiwan Statistical Data Book* (Council for Economic Planning and Development, 1992), 196; *Liang-an ching-chi t'ung-chi yueh-pao* (Mainland Affairs Council, May 1994), 30, 34, 35; *Taiwan chung-yao ching-chi pien-tung chih-piao* (Taipei: Chung-Hua Institution for Economic Research, April 1994), 11, 12.

1988, mainland China accounted for 3.70 percent of Taiwan's exports. That figure rose to 12.95 percent in 1992, and 16.47 percent in 1993(see figure 2). The same can be said of the mainland's import dependence on Taiwan. In 1988, Taiwan supplied 4.06 percent of the mainland's overall imports. In 1992, Taiwan's share rose to 13.08 percent, and it reached 13.46 in 1993. The flow of Taiwan's products to the mainland market was not matched by trade in the opposite direction, however. Mainland China's exports to Taiwan grew roughly at the same rate as the overall exports, creating a low and stable export dependence rate on the Taiwan market over the years (1.01 percent in 1988, 1.23 percent in 1990, and 1.20 percent in 1993). Taiwan's import dependence on the mainland correspondingly showed a slightly increasing rate (0.96 percent in 1987, 1.40 percent in 1990, and 1.43 percent in 1993). In short, over the years Taiwan's exports to the mainland have bceome a very significant portion of Taiwan's overall exports and the mainland's overall imports, while mainland China's exports to Taiwan have remained a minor phenomenon on both sides. In 1993, mainland China had grown into Taiwan's third largest trading partner and Taiwan had become the mainland's fourth largest trading partner (Lee, 1993). However, an abnormal 92.7 percent of this booming economic relationship was accounted for by Taiwan's exports to mainland China.[6]

If one compares the track record of cross-Strait trade with the mainland's overall trade patterns, the abnormalcy becomes even clearer. One typical case is developments immediately following the Tiananmen incident. From 1984 to 1989 the mainland registered a trade deficit for six consecutive years. Foreign indebtedness reached US$41.3 billion at the end of 1989. The brutal suppression of the Tiananmen pro-democracy movement invited international sanctions against mainland China, which added to the economic recession that the mainland had been experiencing since the retrenchment policy (*zhili zhengdun*) was adopted in Fall 1988. Foreign exchange reserves dropped to the 1987 level. A contractionary policy was obviously in order, and it was undertaken with a vengeance. In 1990, Beijing slashed its overall imports by 9.8 percent, which greatly contributed to the country's resumption of a surplus position that year. However, at the same time the mainland's imports from Taiwan witnessed a 31.9 percent increase, which was clearly against its general trade pattern and current import phase (in 1990, mainland imports from the U.S. dropped by 16 percent, and those from Japan by 28 percent).

This strange phenomenon is explainable in terms of the nature of the cross-Strait trade. It is investment-driven, i.e., it supports the investment activities of Taiwan's businessmen on the mainland to a great extent (Lee, 1993). This feature can clearly be seen by examining the content of Taiwan's exports to the mainland, which has been the bulk of cross-Strait trade. From 1988 to 1993, SITC section 6 and 7 products (materials, parts and accessories, and machinery equipment) averaged around 70 percent of

Taiwan's exports to mainland China. A large portion of these producer goods were imported by Taiwan-funded enterprises on the mainland. It was estimated that 54 to 78 percent of the materials and spare parts, and 75 to 95 percent of the machinery and equipment needed by Taiwan businessmen (*Taishang*) were imported from Taiwan (Li, 1993; Li Tsung-che, 1994). This is the case because Taiwan businessmen were required to provide for their own materials and semi-finished products so as not to disturb the mainland's domestic market. As Taiwan's exports to the mainland were predominantly production factors needed by the mainland's own export drive, it was only reasonable to expect a rising flow of goods from Taiwan to mainland China as the latter's export industry boomed. As these producer goods have high added value, they have contributed greatly to Taiwan's trade surplus with the mainland.

Based on this theory, the 1990 rise in Taiwan's exports to the mainland against the background of general import reduction was not an abnormalcy. In order to tide over an unprecedented economic crisis for the Communist regime, it was necessary not just to cut imports, but to expand exports. In 1990 the SITC section 6 and 7 commodities constituted 76.7 percent of the mainland's imports from Taiwan. These were producer goods utilized by Taiwan-funded and other mainland-based enterprises to export to the international market. Small wonder that cross-Strait trade ran against the general pattern of the time and that economic difficulties gave an additional boost to Taiwan-mainland trade relations.[7]

Other factors have contributed to the mainland's growing deficit with Taiwan, primarily Taiwan's own political considerations. It has been considered prudent for Taiwan not to allow mainland investment on the island. The argument that capital endowment determines the direction of investment flow and that there are no economic incentives for the mainland capital to come to Taiwan is untenable. The major reason for the absence of mainland investment on Taiwan is a political one. This being the case, it would be impossible to expect any investment-driven exports from mainland China to Taiwan. The other obstacle to increasing imports from the mainland is the limits that Taiwan's government has set on permitted items of import. Mainland-produced consumer goods are prohibited to enter the Taiwan market altogether. Agricultural and industrial materials and semifinished products are regulated by a list of approximately 1,700 permitted items which are allowed in Taiwan in order to cut production costs of local manufacturers. To import any products beyond these specified items is illegal. On the mainland side, limited transportation capacity and growing domestic needs for materials and semifinished products also restrict the available products for the Taiwan market. It is only natural that mainland China exports have been growing modestly compared with the leaps and bounds of the growth of Taiwan's exports to the mainland, hence increasing trade imbalance.

Shifting Dependence

Cross-Strait economic relations signify a great shift in Taiwan's growth pattern; Taiwan is still trade-dependent, but the direction of its foreign trade has changed. To be more specific, Taiwan still relies on Japan for most of its producer goods imports to the extent that although the rising yen has raised Taiwan's trade deficit with Japan to an unprecedented high, Japan's share in Taiwan's imports has been sustained (see figure 3). The great shift has occurred in the direction of Taiwan's exports. In the past, Taiwan exported labor-intensive products to the U.S. and accumulated large sums of trade surplus. Since the late 1980s, as Taiwan's exports have gradually lost competitiveness in the U.S. market and Taiwan's firms have rushed to transplant their manufacturing bases to the Chinese mainland, the trade imbalance between the ROC and the U.S. has been redressed. However, as Taiwanese investment on the mainland accelerates, and Taiwan-invested firms there maintain their symbiotic relations with mid- and upstream producers on the island, mainland China is in a position to gradually replace the U.S. as Taiwan's major outlet for exports. The content of this export is no longer labor-intensive manufactures, but materials, parts, machinery and equipment. In the past, Taiwan accumulated a huge trade deficit with Japan, but then gained overall trade surplus through aggressive exports to the U.S.

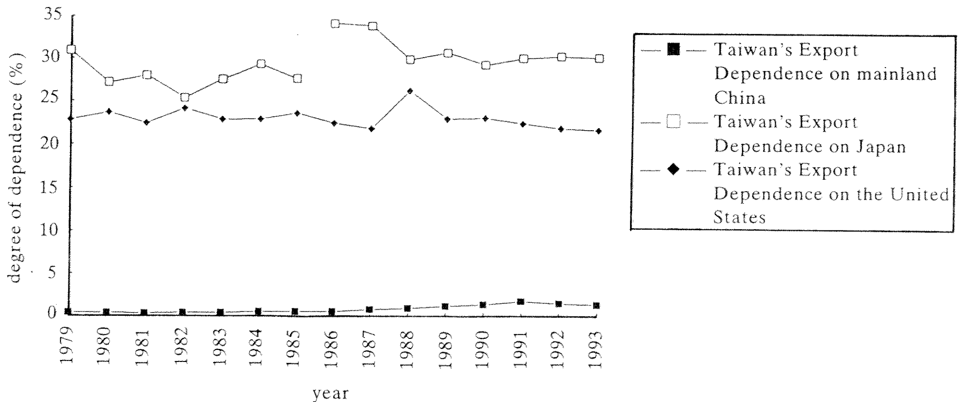

Fig. 3. A Comparison of Taiwan's Import Dependence on Mainland China, Japan, and the United States

Sources: *Taiwan Statistical Data Book* (Council for Economic Planning and Development, Republic of China, 1992), 196; *Liang-an ching-chi t'ung-chi yueh-pao* (Mainland Affairs Council, May 1994), 30, 34; *Taiwan chung-yao ching-chi pien-tung chih-piao* (Taipei: Chung-Hua Institution for Economic Research, April 1994), 11, 12.

market (Hokichi, 1992: 178). As Taiwan's trade deficit with Japan continues to rise and its trade surplus with the U.S. declines, it counts on cross-Strait trade to balance its trade account. As Taiwan's economy is still fueled by the export drive, the mainland market now plays a crucial role in determining Taiwan's economic growth rate. Put in a nutshell, Taiwan still relies on Japan for import, but has been shifting its export dependence from the U.S. to the Chinese mainland.

Two problems, economic and political, arise from this grand shift. Taiwan's foreign exchange reserve, now standing at more than US$90 billion, is the second largest in the world, behind only Japan's. However, Taiwan's economy cannot be properly characterized as advanced and on a par with OECD countries. Yet, when one takes a look at Taiwan's long-term capital outflow from 1986 to 1992, one finds that Taiwan was the world's sixth largest investor, after Japan, Germany, Switzerland, Britain and the Netherlands, all of whom are well ahead of Taiwan in terms of economic development and per capita income. This critical period was exactly when Taiwan needed to channel funds into developing new production technologies for its third import substitution. The direction of Taiwan's outflow capital, however, was toward pursuing cheap labor in less-developed countries, particularly mainland China. The ratio of overseas to domestic investment for Taiwan was 21.4 percent in 1988, 33.9 percent in 1989, and 29.5 percent in 1990, four to six times as high as Japan's corresponding numbers. In 1991-92, when Premier Hao Peitsun was in charge of the government, the ratio dropped to 9.2 percent and 6.6 percent. In 1993, due to efforts by the new Lien Chan cabinet to invigorate the economy, Taiwan's overseas investment grew by 87 percent. The trend has continued, and the government and business community are both worried about a "hollowing up" of Taiwan's economy.

Accompanying accelerated overseas investment has been a significant decrease in Taiwan's economy. From 1980 to 1990, Taiwan's annual growth rate averaged 8.25 percent, lower than rapidly developing mainland China (10.1 percent) and South Korea (9.9 percent), but higher than Hong Kong's 7.1 percent and Singapore's 6.3 percent (Barfield, 1994: 59). But in this decade, Taiwan's economic growth has slowed: 5.02 percent in 1990, 7.24 percent in 1991, 6.02 percent in 1992, 5.87 percent in 1993, and (according to a rosy government estimate) 6.17 in 1994. Premier Hau counted on a gigantic six-year development plan (*liu-nien kuo-chien*) to upgrade Taiwan's outmoded infrastructure and generate growth momentum through infusion of government expenditures on hundreds of construction projects throughout the island. However, this stimulus proved of limited effect, as the projects fell short of expectations due to financial constraints on the government and an eruption of scandals implicating high government officials (Wu, 1994b: 50). Lien Chan, Hau's successor, was forced to slash government investment in mid-1993 and put the hope of growth back on the private sector's shoulders.

As has been demonstrated, this means relying on exports to mainland China as the growth engine. However, according to a survey made by the Ministry of Economic Affairs on 1,000 Taiwan firms in the mainland in 1994, there has been a tendency for Taiwan businessmen to reduce their dependence on suppliers on the island of materials (from 60 percent in 1992 to less than 55 percent in 1993) and parts and semifinished products (70 percent in 1992 to 61 percent in 1993). This shows that investment-driven export may be on the decline. This being the case, Taiwan may very soon develop an overall trade deficit.

The second problem of Taiwan's dependence shift is the political risk involved in relying on the mainland market. Modern integration theories propose that economic exchanges are the optimal starting point to produce integrative momentum that may "spill over" to the political realm and achieve political amalgamation (Keohane and Nye, 1975: 364, 396). Though economic interactions are usually beneficial to all contracting parties and are less threatening to national sovereignty than any direct attempt at unification, political integration through economic interaction does not have to be a voluntary process, as suggested by the integration theorists of the post-WWII era. Adolf Hitler's strategy of creating a group of East European satellites through monopolies and monopsonies in the 1930s serves as a good example of how political dominance can be achieved through economic manipulation. As cross-Strait economic relations have developed into the most important linkage between Taiwan and the mainland, it seems only natural that Beijing will play economic cards with Taipei to promote unification. Though it may be that the most immediate considerations of Beijing's Taiwan policy makers are economic (Wu, 1994c), it does not preclude the possibility that when push comes to shove, Beijing will blackmail Taiwan through the economic linkages that are currently growing. That prospect haunts Taiwan's political leaders and has forced them to take precautions.

Reorienting the Economy

It is based on the understanding of Taiwan's increasing economic dependence on the Chinese mainland that economic planners in Taipei have attempted to reorient the island's economy toward the international market in general and Southeast Asia in particular. In this context, bidding for membership in GATT (WTO) and building Taiwan into the "Asian-Pacific operation center" (*yat'ai ying-yun chung-hsin*) are meant to expand business opportunities for Taiwan as well as dilute dependence on the mainland. The Southward Policy (*nan-chin cheng-ts'e*) championed by President Lee Teng-hui has an even sharper focus on directing Taiwan's overseas investment from mainland China to Southeast Asian countries that are also labor abundant.

GATT/WTO membership and Asian-Pacific operation center are mixed blessings in that, if realized, both will open a much broader arena for Taiwan's business activities, while making closer ties with mainland China inevitable. The world trade organization demands non-discriminatory trade policies by members that would make Taiwan's constraints on cross-Strait trade difficult to defend. The proposed Asian-Pacific operation center (which is basically an attempt to replace Hong Kong's position after 1997) is unthinkable for Taiwan if economic transactions across the Taiwan Strait are restricted as they are now. The idea of diluting Taiwan's economic dependence on the Chinese mainland through a greater degree of internationalization and liberalization is an illusion in that mainland China has attracted such a volume of international business activities that opening up to the world market today means opening up to mainland China. This being said, it is still politically desirable to join international organizations and facilitate international business transactions to reduce the political risks involved in cross-Strait relations and create bargaining chips for dealing with Beijing (Li Wen-chih, 1994: 5). Whatever the merits of the two major internationalization plans, the Asian-Pacific operation center thus far remains a blueprint on the desk of high government officials, while the bid for membership in WTO has progressed to the point of bearing fruit at the time of this writing, if political pressure from Beijing can be effectively resisted by member states.

The other major government effort to reorient the economy has been the Southward Policy championed by President Lee Teng-hui. Launched in the winter of 1993-94, this policy is intended to expand Taipei's political-economic influence into Southeast Asia via President Lee's "vacation diplomacy" and direct Taiwan's overseas investment away from mainland China and toward Southeast Asian countries. The government hopes that its stewardship may tilt profit parameters toward the south and change the investment direction of private enterprises. However, only state enterprises and KMT-party corporations have followed the government's lead so far and the bulk of private investment still flows to mainlandChina.[8]

The bid for GATT-WTO membership, the attempt to build Taiwan into the Asian-Pacific operation center, and the Southward Policy are strategic moves to enhance Taiwan's economic position vis-à-vis mainland China in the context of Taiwan's increasing export dependence on the mainland market. The shifting dependence from the U.S. to the Chinese mainland has its root in an outflow of massive capital from the island at a time when there is a great need for industrial upgrading. Taiwan's fundamental problem thus lies in its failure to conduct the third stage of import substitution. Without productivity gains comparable to wage rises, it is only reasonable to expect continued capital outflow to the mainland, and increasing dependence and vulnerabilities. Any offsetting strategies of internationalization and reorientation will have a limited effect.

Notes

1. The high concentration of Taiwan exports in the U.S. market in the early 1980s had a lot do with the appreciation of the U.S. dollar against other major currencies at that time. Because the NT dollar was pegged to the U.S. dollar, Taiwan's exports suffered from a heavy loss of competitiveness in international markets other than in the U.S.
2. The only exception was the Science Based Industrial Park in Hsinchu, which was founded in 1980 to promote the computer industry.
3. In 1993, the Ministry of Economics approved 9,329 projects involving US$3.2 billion of investment on the mainland. These figures are widely considered below the actual numbers.
4. Cross-Strait trade is always underestimated for two reasons. First, researchers usually rely on the statistics provided by the Hong Kong government, but Hong Kong is by no means the only entry point for cross-Strait trade. Second, only re-export trade is calculated in the Hong Kong government's statistics, leaving out transhipment trade and triangular trade. It is estimated by Chien Tse-yuan that cross-Strait trade reached US$14.8 billion in 1992 (the Hong Kong government's official number is US$7.4 billion) if transhipment and triangular trade of that year are included (Chien, 1993: 76). The ROC government calculates the difference between Taiwan's exports to Hong Kong (F.O.B.) and Hong Kong's imports from Taiwan (C.I.F.) during the same period of time and adds that difference to the official figure released by Hong Kong's customs service. The result is US$11.7 billion for 1992, and US$15.1 billion for 1993. In the following discussion, I will use this last set of figures.
5. In 1993, out of the US$7.9 billion trade surplus that Taiwan accumulated, US$6.5 billion, or 82 percent of the total surplus, was from cross-Strait trade. If we use the ROC's government's estimates, which include transhipment trade, Taiwan's surplus against the mainland in 1993 was US$12.9 billion, or 163 percent of Taiwan's overall trade surplus.
6. No comparable imbalance can be found in the mainland's trade with major countries in the world.
7. Before the investment boom of the late 1980's, cross-Strait trade conformed to the mainland's general trade pattern. Taiwan's decline of exports to the mainland in 1982 (-49.38 percent) and 1986 (-17.8 percent) are perfectly in sync with the mainland's import cycles. These fluctuations in trade did not reappear in 1987-93, a period characterized by uninterrupted growth (Chien, 1994: 72).
8. From January to July of 1994, 31.13 percent of Taiwan's overseas investment went to the mainland, totaling US$467 million in 589 cases. The

next largest receiptor of Taiwan's outflowing capital was Hong Kong, with 27 cases and a sum of US$113 million. Since most of Taiwan's investment in Hong Kong actually went to mainland China, a full 38.67 percent of Taiwan's overseas investment in this seven-month period was made across the Taiwan Strait. The Southward Policy did not produce any significant impact, as none of the targeted countries were among the top nine receptors of Taiwan's capital in January-July 1994 (*United Daily*, October 25, 1994: 19).

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