

# ECONOMIC RELATIONS BETWEEN TAIWAN AND THE EU

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Despite the severe consequences of the global financial crisis (2008-2009), the EU and Taiwan have been able to strengthen their economic ties in recent years. Although both trade and investment activities are intense and growing, this cooperation is far from being fully-fledged. This paper argues that further deepening of economic cooperation between Taiwan and the EU and a comprehensive economic agreement (CEA) is necessary and inevitable in the process. The arguments in support of the agreement are of both economic and political in nature:

1. The manner in which the Taiwanese economy is interpreted is crucial in understanding the relevance of Taiwan within the world economy. Based on the size of the economy and the share of trade, Taiwan may be considered economically insignificant against European countries. The main reason behind this misconception lies in macroeconomic and trade data, which fail to reflect the fact that most added value generated by Taiwanese firms is exported to Europe via Mainland China. Similarly, a significant share of Chinese investments in Europe and the United States is generated by Taiwanese firms. Thelle and Mekonnen (Copenhagen Economics) also stress the importance of the economic arguments for the agreement. Their update of the 2008 Report points out that after the global crisis, the arguments in support of the comprehensive agreement have only become stronger and more convincing based on current trade trends. One explanation is the strong rebound of trade in the Asian region and as a result of this “Intra-European trade is still suffering, but European exports to Asia are increasing at a faster pace than before the crisis.” (Thelle, Mekonnen 2012, p. 2)

2. Another economic argument claims that up to this point no free trade or comprehensive economic agreement between the two parties has been signed; consequently trade between the EU and Taiwan has been determined by WTO rules, which mainly cover issues of international trade, but are less

effective when it comes to international investments, property rights, patents, etc. (On the other hand, the Korea and EU agreement entered into force on 1 July 2010 and includes comprehensive tariff reductions and addresses other non-tariff barriers as well. The EU-agreement with the close competitor of Taiwan puts the country under pressure, and it is likely to distort the EU-Taiwan trade.)

3. The political argument highlights that the 'One China Policy' seems to suggest a clear barrier to the comprehensive economic agreement. This question is one of the most debated issues in literature analysing economic relations between Taiwan and the European Union. Dreyer et al. argue that the European Union's caution not to hurt the Mainland's sensitiveness about this issue might be overemphasized. (Dreyer et al. 2010, p. 56) According to them, the Economic Cooperation Framework Agreement (ECFA) between the People's Republic China (Mainland China) and the Republic of China (Taiwan) has provided a window of opportunity to negotiate and sign a comprehensive economic agreement. (Dreyer et al. 2010, p. 56. p. 59)<sup>1</sup>

In most of the cases, the goals of foreign policy and foreign trade policy are determined by the same players, but it does not apply to the EU. This is the reason why European interests, formulated by the two policies, can vary or seem to contradict each other. International cooperation and hence foreign policy are often based on commonly shared values of the parties (e. g. democracy, free market economy), but they very often focus on short-term economic benefits. In the case of Taiwan, European countries could rely on both long-term and short-term economic benefits, whilst common shared values are the guarantee of a stable partnership. In recent years, the importance of this has been clearly proven by the case of Russia.

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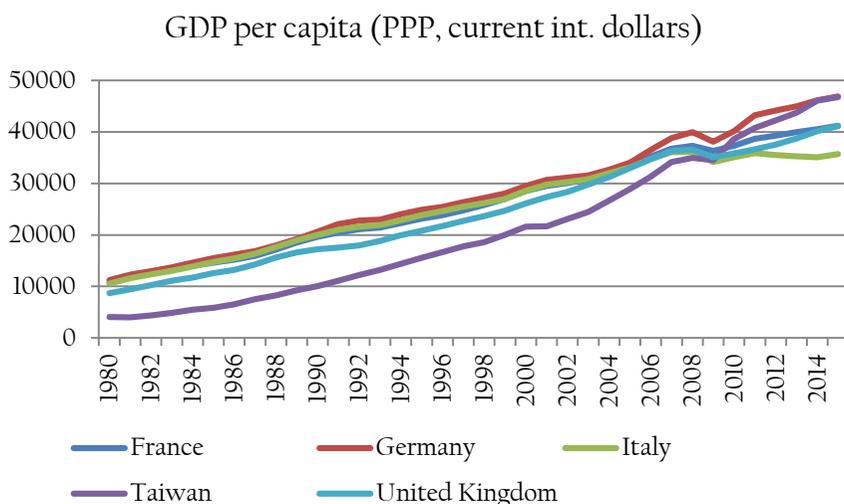
<sup>1</sup> The agreement was signed in 2011 and it ushered in a new era of political and economic relations between Taiwan and Mainland China.

# Arguments for Deeper Cooperation with Taiwanese Economy

## GROWING MARKET, INCREASING PURCHASING POWER<sup>2</sup>

In terms of GDP per capita (PPP), Taiwan overtook France, Italy and the United Kingdom and caught up with Germany after 2007. However, distinctive patterns of GDP per capita growth in current prices demonstrate that different price levels play a key role in this impressive picture. As a result of greater resilience to the devastating effects of the Global Financial Crisis, the Taiwanese economy could avoid the long economic crisis which had emerged in the EU and which had been compounded by political, institutional problems of the eurozone.

Figure 1



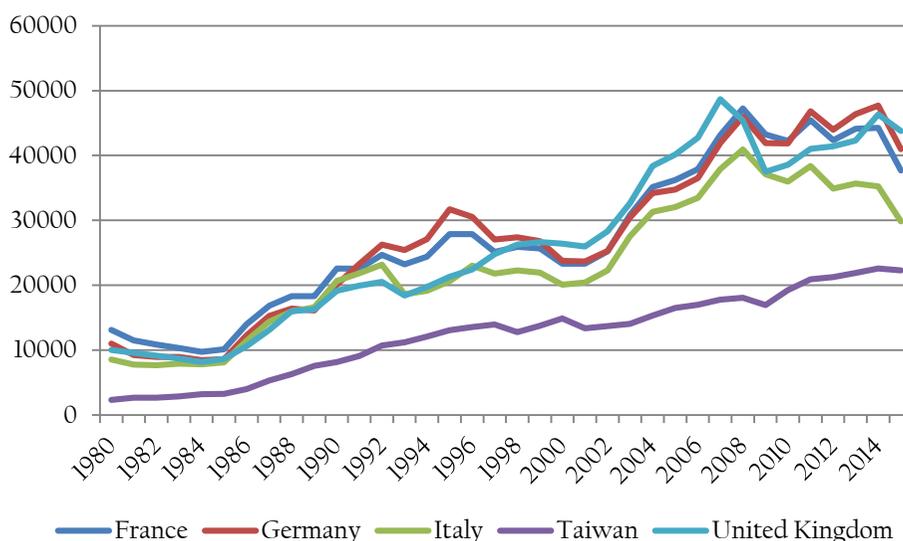
Source: own compilation based on IMF data

<sup>2</sup> Besides this argument, it is important to underline, that EU member countries and Taiwan share similar economic structures and both face the challenge of an aging population. Both Taiwan and the more developed part of the EU run knowledge-based economies. Recent technological innovations leading pose new challenges to these countries. The robotization is likely to reverse the trend of outsourcing. Technological innovations along with rising Chinese labour costs give fewer incentives to outsource. In contrast to earlier periods, the importance of manufacturing and the reliance on cheap labour is declining due the automation and robotization, while technology and knowledge continues to gain in importance. Technological changes, aging population and comparatively high wages have required the adaptation of European and Taiwanese firm strategies, and consequently these enterprises have increasingly invested in Mainland China.

Between 2000 and 2014 Taiwan's annual average growth was much lower than in the 80s and 90s;<sup>3</sup> however, it exceeded the economic performance of the large European economies. The United Kingdom, where GDP growth was the fastest among the EU economies during this period, could only reach an annual average of 1.73%, which is less than the half of that of Taiwan (3.77%). This resilience to economic shocks has been attributable to growing and deepening trade relations with Mainland China.

Figure 2

GDP per capita (current prices, US dollars)



Source: own compilation based on IMF data

As a result of the catching-up process of the past several decades, today Taiwan has reached the average development level of the core European

<sup>3</sup> The core economies of the EU (Germany, France, the United Kingdom and Italy) and Taiwan experienced a Golden Age of economic development in the second part of the 20<sup>th</sup> century. As a result of this, the economies of these regions were able to grow at a breakneck pace over several decades. Taiwan is one of the few countries which avoided the middle income trap and it could increase its GDP by an annual average growth rate of 8.3% over nearly a half century. West Germany, the 'engine of the European economy' grew by 5.3% between 1948 and 1973. But during the 70s, and the 80s, Western European and Taiwanese growth became much more moderate; however, this slowdown was sharper in Europe than in Taiwan. (Brown, Hempson-Jones, Pennisi, 2010 p. 3)

economies, and it has clearly overtaken the Central European countries. By and large Taiwan's economy is in a better shape now than most European economies. Growing purchasing power and openness of the economy make Taiwan an important partner of the European countries.

## ROBUST GROWTH OF TRADE

Most of the Taiwanese economic growth stems from surpluses on the trade balance; of the core European economies only Germany has a similarly positive trade balance.<sup>4</sup> Between 2002 and 2013, a very rapid expansion of international trade took place in Taiwan. During this period, Taiwanese merchandise export expanded by 226%, while overall European performance lagged behind. The export in services was able to expand by 239%. In the same period, the average EU merchandise export was up by only 175% in France, by 193% in the United Kingdom and by 203% in Italy. However, Germany's merchandise trade grew by 236% during the same period.

Although Taiwan has only been the 25<sup>th</sup> export destination of goods, in recent years, export to Taiwan has grown faster than in any other trade relations. With respect to European exports to Taiwan, we find a 42% increase in goods exports between 2008 and 2013 while European export to the world could only grow by 32% in the period considered.

Taiwan's dependence on external trade is remarkable. As table I indicates, the economy is based much more on export of goods and services than any other large economy in Europe.<sup>5</sup> It is apparent too that openness was increasing during the period 2002-2013 and not only in terms of trade in goods, but also in services. Both in terms of services and goods, Taiwan was able to increase its surpluses on the trade balance over the period 2002-2013.

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<sup>4</sup> As a result of the European crisis, balance of trade in Italy turned positive. Whether this surplus is a sign of long term adjustment or is it only short term in nature, it is difficult to answer.

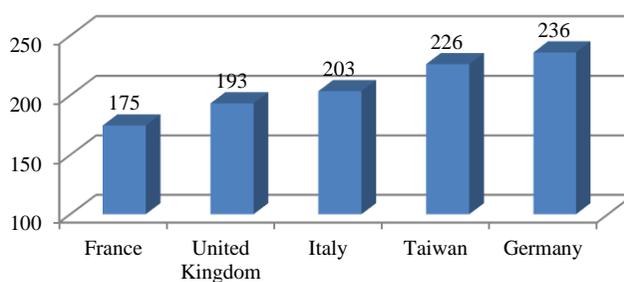
<sup>5</sup> Only Central European countries – Hungary, Estonia, Czech Republic, and Slovakia – and smaller Western European countries – the Netherlands and Belgium – have more open economies in the EU.

Table 1. Openness of the economy				
	Merchandise exports in share of GDP		Exports in services in share of GDP	
	2002	2013	2002	2013
Taiwan	45	62	7	11
France	23	21	6	9
Germany	31	40	5	8
Italy	21	25	5	5
United Kingdom	17	21	8	12

Source: own compilation based on WTO, IMF databases

Figure 3

Merchandise export (2013, 2000=100%)



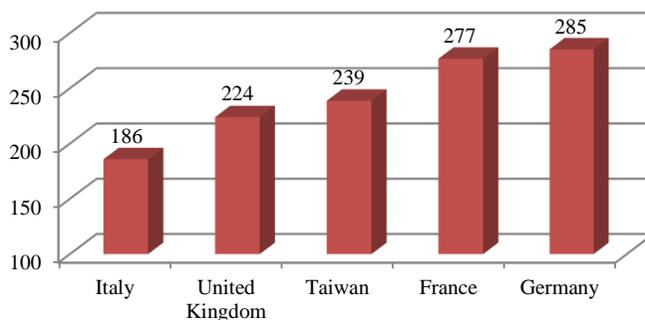
Source: own compilation based on WTO data

In the context of the trade relations between the two regions, European advantages in services trade are apparent, but European disadvantages in goods trade are also clear. The latter balance shows European surpluses, but it cannot offset Taiwanese surpluses in the trade in goods.

Despite the clear Taiwanese surpluses in the aggregate trade balance, Europe as a destination of Taiwanese export has lost its significance in the last decade; according to data of the Taiwanese Statistical Bureau, Europe's share was 13.06% in 2004, and it fell below 10% by 2012. The same trend is evidenced in the US and Taiwanese trade relations. The extent of the change is almost the same, however, the US share was higher in 2004 (15.77%), hence it could remain higher in 2012 (10.95%).

Figure 4

Export in commercial services (2013, 2000=100%)



Source: based on WTO data

Source: own compilation based on WTO data

This can be explained by the growing importance of Mainland China, which “compensates” Taiwanese firms, consequently China as an export destination grows more and more important. During 2004-2012, Mainland China’s share increased from 19.93% to 26.80%! (Adding exports to ASEAN countries, this share is about 55%.) (Da-Nien, Hui-Tzu 2013) It will not come as a surprise to know that a similar pattern is observed in investor relations. Investment in Mainland China increased significantly between 2002 and 2013. The share of

Mainland China is approximately 80%; the accumulated value of this amounts to 58 billion US dollars.

Taiwan’s role in European FDI inflow hasn’t changed so much although the size of investments capital almost tripled (301 million euros in 2011, 818 million euros in 2012). Both Japanese and Korean investments (3.9 billion euros – 4.3 billion euros) have clearly overtaken those of Taiwan. On the other hand, the EU has continued to be the most important investor in Taiwan.

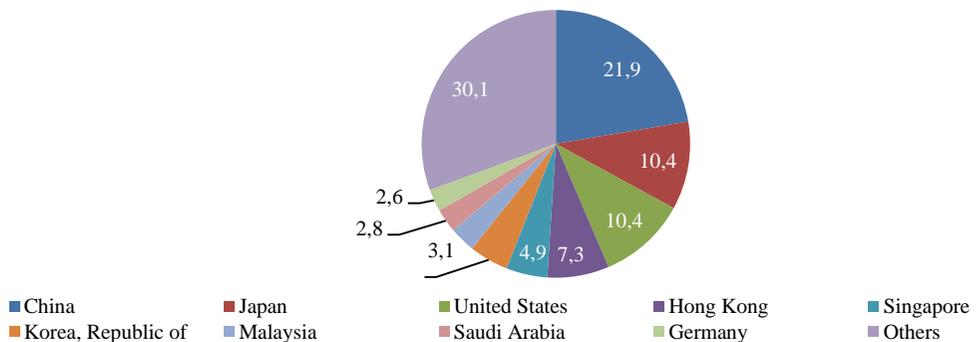
Based on these data, the lessons and processes are clear, the rise of Mainland China seems to be inevitable, and advanced countries are expected to experience a decline. And only relying on these data could one jump to the conclusion that Taiwan should only focus on Mainland China in economic issues; moreover Taiwan should go via Mainland China to the world. This paper, however, argues in support of the direct opposite; it is the global supply chains that provide the basis for our understanding of why and how Taiwan and the EU could be much more important to each other than data would suggest.

#### TAIWAN AS LINCHPIN IN THE GLOBAL SUPPLY CHAINS

In a connected world economy, macroeconomic data presented above can be misleading. In the framework of global supply chains, altering patterns of trade are more indicative of the emergence of new strategies of Taiwanese firms rather than of a real change of the export destination.

Figure 5

Value of exports and imports by country (2013, total trade, share)



Source: own compilation based on the data of the Taiwanese Statistical Bureau

Intermediate products exported from Taiwan to Mainland China are goods that will be exported as final products from China to Europe or to the US. This process is described by Da-Nien and Hui-Tzu: “The United States and the E.U. have maintained their status as the most important markets for Taiwanese final consumption goods, but Taiwan’s exports of intermediates and capital goods to these countries have become less significant, and there has been a weakening in direct trade links between Taiwan and the E.U. and between Taiwan and the United States.” The decline in the export of intermediate goods to Europe and the US, but the prevalence of a constant level of final goods to these countries underline that indirect trade links between Taiwan and the EU and Taiwan and the United States have remained strong.

Morrison refers to a growing consensus among analysts on this question stating that this strategy not only characterizes Taiwanese firms: “Many analysts contend that the sharp increase in U.S. imports from China (and hence the growing bilateral trade imbalance) is largely the result of movement in production facilities from other (primarily Asian) countries to China. That is, various products that used to be made in such places as Japan, Taiwan, Hong Kong, etc., and then exported to the United States, are now being made in China (in many cases, by foreign firms in China).” (2014, p. 9) Another important source of relevant information is the report commissioned by the U. S. International Trade Commission, which states that Taiwan produces over 90% of its ICT hardware in China! (Koopman, Wang, Wei, 2008, p. 21)

Analyzing Taiwan’s economic relations, it is important to underline that Taiwanese investments in other countries are the implications of global supply chain (GSC) strategies, which have integrated these countries into world economy. In recent years, the emergence of global supply chains has altered successful economic policies. Earlier, a successful policy had to rely on building a broad industrial base – US, Germany, Japan, etc. –, but nowadays, it suffices to join a global supply chain. Latecomers such as China, Vietnam, and Cambodia did not have a choice but to join the global chain. The crucial point in the process of specialization is at which point of the added value chain the country is able to join in, and whether it is capable of moving up the value chain. The importance of global supply chains to Taiwan can be demonstrated by the share of intermediate goods in the export. More than 70% of Taiwanese exports comprise intermediate goods, which is mainly concentrated in the

information and communications technology sector (ICT). (Koopman, Wang, Wei, 2008, p. 2.)

As stated above, most Taiwanese ICT products are assembled in Mainland China. This model has been built on cheap wages in Mainland China; however, this general picture has significantly changed because of increasing wages in recent years. This is one of the important reasons why China needs a new economic policy or model, which will be able to maintain the rapid growth experienced after 1990, but at the same time, it ought also to encourage an increase in domestic demand. Export-oriented growth is expected to slow down, wage costs are rising, investment rates, saving rates have already peaked in Mainland China. The country had already joined the WTO, thus the consequent trade boom cannot be repeated. (Magnus 2013, p. 5)

Whether this change in policy will succeed is questionable, but the implications are clear regarding the strategy of Taiwanese firms. These firms are forced to move their firms to other low-wage countries (Vietnam, Cambodia and Laos) which have considerable cost advantages over Mainland China. The threshold wage which induces firms to move abroad may already have been reached and surpassed in many sectors of the Chinese economy.<sup>6</sup>

The economic model relying on cheap Chinese labour is, however, under pressure; the concept of 'island hopping' (developed by Puga and Venables) offers a plausible explanation regarding the consequences of this change. The starting point of the idea is a situation in which all industries are concentrated in one island. In the next stage, one sector is forced to move to another island because of rising wages. The concept not only highlights the significance of wage increases, but also the fact that the distribution of the sectors in question is uneven. After relocating the industry, the first island is not entirely deserted; some of the sectors (with higher added values) continue to remain and operate there. As a result of this relocation, the new sector will be concentrated on one of the earlier empty islands; however, there are other low wage islands in the model too which will not be industrialised at this stage, only later. (Baldwin 2012, p. 18) The model clearly predicts the inevitable change of economic structure which is already taking place in Taiwan.

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<sup>6</sup> Rising wages have already pushed some of the clothing companies to seek lower labour costs in Vietnam, Cambodia.

While looking at global supply chains, the case of the European Union is a more complicated one. Not only because it is a much more diverse region, but also because traditional analyses based on the theory of comparative advantages and economies of scale suggest advanced European countries' competitiveness has been worsening in the last decade. This assumption could only be confirmed by an analysis of the export trends. However, exports do not translate to domestic incomes, which means that exports with high import inputs generate much lower levels of income; in other words, size may matter, but so does quality. (In the regional supply chains, Central European countries have a similar position to that of Mainland China, and the Western European countries are the main sources of capital, knowledge to these countries.)

The EU's advantage is apparent in the global production networks of non-electrical machinery, transport equipment, and in the decline of the advantages is seemingly strong in non-durables and food.<sup>7</sup> As already mentioned, the problems of analysing European supply chains also stem from the fact that some regions do not count with equal weights, which can be important in the regional supply chains. The differing importance of Western and Eastern Europe can be explained by the structure of the hub and spokes, which are dependent on each other albeit asymmetrically. (Baldwin 2013, p. 20) The same can be observed in Europe, where Western European countries are the hubs and the Eastern European countries are the spokes. Not only does this structure characterize the European economy, but also Taiwan, which is a linchpin in the 'Asia factory'. (Rojas-Romagosa, Veenendaal 2012, p. 21)

## SERVICIFICATION

The economic relevance of global or regional supply chains must be interpreted in the light of ongoing technological changes and the above-mentioned pressure on the Taiwanese model stems from the need to relocate industries from Mainland China to other low wage countries, but future technological changes also influence this change.

This technological transformation can be summarized by the term 'servicification'.<sup>8</sup> In other words, along with this process, knowledge and

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<sup>7</sup> More detailed data can be found at Timmer et al. (2013)

<sup>8</sup> The term was first used first used by Vandermerwe and Rada in 1988 (Low 2013, p.66)

skilled labour (due to the spread of new technologies such as app-economy, 3D printing, etc.) become more important if not the most important elements in the manufacturing sectors.

The increasing robotisation of manufacturing processes leads to a new situation, in which labour costs (albeit under pressure) are attributed less significance in total costs. This is the reason why the process of de-industrialisation has posed challenges to labour markets in advanced countries during the past decade.

The experiences of these countries demonstrate that most of the new jobs are created in the service sector.<sup>9</sup> According to a study conducted by the McKinsey Global Institute, instead of manufacturing and service jobs, it is more accurate to classify these jobs as interaction and production/transaction jobs.<sup>10</sup> The study states that “For more than a decade, such interaction jobs – including both high-skill and low-skill ones – have been the fastest-growing category of employment in advanced economies. In the United States, for example, nearly all net new job creation over the past decade has been in interaction jobs; nearly five million interaction jobs were created between 2000 and 2009, while more than three million production and transaction jobs disappeared.” (McKinsey 2012, Global Institute p. 2.)

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<sup>9</sup> The former main structural changes in the economy could easily be described by the transformation taking place between sectors, but these terms are of no use today, because since the 90s, all of the advanced economies have made the transition to service economies, but equally it should not be interpreted as if nothing had happened in the labour market since the 90s.

<sup>10</sup> Production/ transaction jobs can be standardised and scripted, that is why they are shifted to workers in low-wage locations while interaction jobs require knowledge, independent judgment, and experience. (McKinsey Global Institute, 2012 p. 2)

Table 2. Knowledge Economy Index (KEI) 2012 Rankings		
Countries	2012 Rank	2000 Rank
Sweden	1	1
Finland	2	8
Denmark	3	3
Netherland	4	2
Norway	5	7
New Zealand	6	9
Canada	7	10
Germany	8	15
Australia	9	6
Switzerland	10	5
Ireland	11	11
United States	12	4
Taiwan	13	16
Sources: KAM, Worldbank		

Even after the global financial crisis, Taiwan could be characterized by relatively low unemployment rates.<sup>11</sup> One of the reasons behind the success lies in the policy of focus on jobs with high added value.

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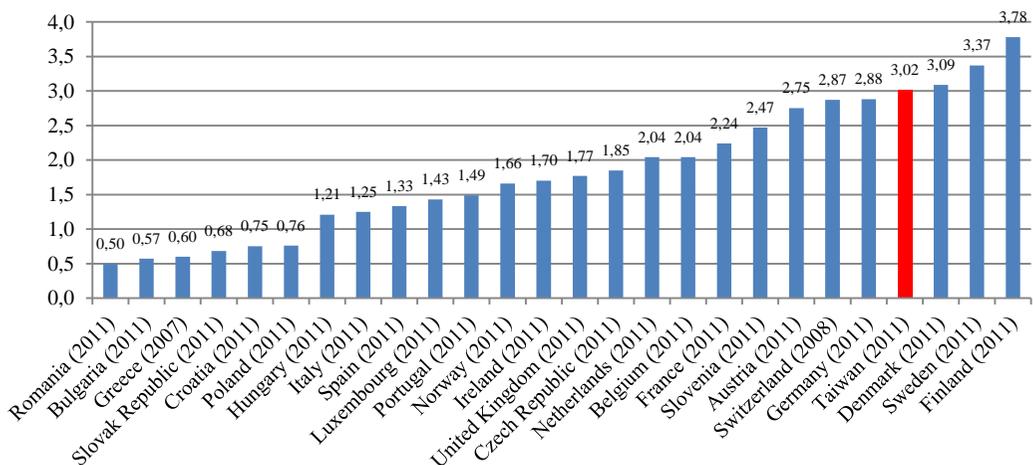
<sup>11</sup> The peak point of unemployment after the global financial crisis only reached 5.9% in 2009. Since then, unemployment dropped below 4% in July of 2014, while monthly unemployment was up by 11.5% in the Eurozone. But this difference doesn't apply in the long run; looking at long term series, by and large unemployment rate in Taiwan remained higher, only after the eruption of the eurozone crisis did European rates become significantly higher.

However, differences in economic structures indicate that there is enough room for Taiwan to boost the process of servitization. The share of services in GDP is 68.9% in Taiwan, while the same figure is 72.8% in the EU, and 79.4% in the United States. (2012) However, the share of services in Germany is lower than the European average, and most of the new Member States of the EU have similar economic structures in this respect.)

However, maintaining a central position in the global supply chains is dependent on Taiwan's capability of running a service economy. Taiwan was ranked the 13<sup>th</sup> most knowledge-intensive economy in 2012, and most of the West-European countries ranked in the top 30, which gives these countries an obvious opportunity to cooperate. Other figures can be mentioned as well, one of the most impressive statistics is the number of patents divided by the number of the population. Between 2006 and 2012 Taiwan had the highest patent density in the world. (San 2013, p. 3) In 2012, Taiwan spent 3.06% of its GDP on research and development! EU 2020 plan, EU's growth strategy for the decade to come sets the goal to exceed the 3%; however, most of the European countries struggle to meet this goal, which indicates that deeper cooperation in this particular field would benefit both parties. (Figure 6.)

Figure 6

R&D as of GDP



Source: own Science and Engineering Indicators 2014

Despite the great efforts and results, moving up the value added chains is demanding<sup>12</sup> because it requires the building of own brands too. Although there are analogies between Taiwan, South Korea, and Japan with regard to economic development policy, Taiwan has been different in many respects. Taiwan had not imposed severe restrictions on FDI, only on the imports of goods, while Japan and South Korea had resisted both FDI and imports, in the emerging phase of their economic development. As a result, there are not so many big brands and firms in Taiwan. However, Acer is not the only notable exception. Companies like D-Link, Acer, and ASUSTek have put more focus on brand marketing. The existing lack of brands is addressed by the Branding Taiwan Plan.

The lack of brands is another reason why Taiwan's economy is being misinterpreted. These Taiwanese firms had been working as suppliers to large European and American brands manufacturing goods requested by them. But in the late 90s the model had changed and Taiwanese firms had begun focusing on the management of the supply chains and on network orchestration. This strategic change can be demonstrated in the ICT industry best.

#### THE ICT INDUSTRY IN TAIWAN

The country has specialised in the ICT sector, which accounts approximately for one third of the manufacturing GDP; around 40% of manufacturing exports is attributable to the ICT sector. The concentration of the research and development expenditures is even higher with around 70% of the manufacturing R&D funds being spent in the ICT sector. (Chen, Wen, Liu 2012, p. 91)

Originally, the ICT sector of Taiwan was built as an outstanding example of local clustering (Hsinchu Science Park) with strong connections to the US (Silicon Valley), however, this sector has transitioned from manufacturing to an innovation centre, while instead of producing final products the country can be seen as a producer of important intermediate goods. (Chen, Wen, Liu 2012, p. 92) Along with this process, Mainland China has become one of the most important offshore production sites to Taiwan, in particular in the PC

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<sup>12</sup> Da-Nien and Hui-Tzu argue that there has been a steady deteriorating in Taiwanese terms of trade, which can be traced back to an increasing reliance on OEM (original equipment manufacturer) firm strategies focusing on productivity of manufacturing rather than on research and development. (Da-Nien, Hui-Tzu, 2013)

and notebook production. Chen et al classify the types of R&D investment in Mainland China:

1. A significant part of Taiwanese firms concentrate their product development on Taiwan, while support and research and development related to production are concentrated in Mainland China. This is the most significant type of R&D portfolios in Cross-strait relations.
2. As a result of the investments, some firms carry out main research and development activities in Mainland China.
3. But some of the Taiwan-based firms relocate from Mainland China their software development services, which are strategically important to the firms, and should be kept within Taiwan.
4. It is another form of division of labour when firms keep their upstream R&D within the home country while China-based subsidiaries control downstream R&D. (Chen, Wen, Liu 2012, p. 96)

The fact that the most significant part of ICT R&D can remain in Taiwan reinforces the view that Taiwan's outstanding role is sustainable even in the case of R&D activities. The emphasis is put on services in the future economy; these knowledge-based services are the key drivers in the transformation of the Taiwanese economy. Hence the future growth in the world economy has increasingly been determined by knowledge, Taiwan's importance has been growing in the eyes of European partners as well. Chen et al highlight this analyzing the allocation of R&D: "There are even signs that China is playing a growing role in R&D. However, for most ICT firms, particularly the IC and LCD manufacturers, their R&D bases remain largely located in Taiwan. This together with the IC design industry makes Taiwan an innovation hub for the global ICT production network." (Chen, Wen, Liu 2011, p. 1)

## DEMOCRACY AND FREE MARKET ECONOMY

In recent years, ASEAN countries have become increasingly important to Taiwan, but not only as a destination of intermediate goods, but also because the export of final goods in these countries could accelerate at a much faster pace than exports to EU countries and the United States. That is one of the reasons why emphasis is placed on these countries in the short run, while European countries (in particular Western European and Scandinavian

countries) and the United States have remained important partners to Taiwan in the long run. The “soft argument” for deeper economic cooperation between the EU and Taiwan is based on the similarities of the parties.

Table 3. The connection between democracy and economic power (2013)				
	Free	Partly free	Not free	Total
Number of countries	90	61	48	199
Share of the country-group	45%	31%	24%	100%
The aggregate GDP (Current prices, US billion dollar, 2013)	29.371	6.594	1.519	37.485
Share of the country-group	78%	18%	4%	100%
Source: own compilation based on Freedom House’s report (Freedom in the World 2014) and on IMF database. Notice: Only the countries in the IMF database were considered in the compilation.				

There are similar features in the way the economy and politics are interconnected in these countries. Taiwan and the EU can be viewed as examples of success with regard to economic development. In explaining the successes of the West, a number of researchers stress the importance of institutions – in a broader sense of the word. They argue that the way institutions within the society are organized is decisive in the outcome, in the productivity of the economy and the well-being of citizens. (Acemoglu, Robertson 2012)

An outstanding historian, Ferguson summarizes all these explanations under six headings: competition, science, property rights, medicine, the consumer society and the work ethic. (Ferguson 2011, p. 12) These “killer apps” not only characterize Western European countries,<sup>13</sup> but Taiwan as well, which has been able to avoid the “middle income trap”.

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<sup>13</sup> Central European countries have a different position. Based on these explanations it is assumed that the connection between political and economic institutions may be a crucial element in explaining Central Europe’s long term economic backwardness. The competition

Economic benefits of running a free market economy and of having a democratic society are clear. (Table 3) When one looks at the share and the economic power of countries that are democratic in global comparison, an accurate picture of the economic success of democratic countries can be arrived at.<sup>14</sup> Not free countries are usually unstable politically, which has an impact on their economic relations as well. This is the reason why one-sided reliance entails numerous risks to both the EU and Taiwan.

#### THE THREATS OF THE ONE-SIDED ECONOMIC POLICY

There are several reasons for including Mainland China in the analysis: (a) the deep integration with Mainland China along with great economic benefits pose economic threats to Taiwan and (b) the Taiwanese model is partly under strain because of changing circumstances in Mainland China. (c) European firms entering the Mainland market, often consider Taiwan as a springboard and sourcing base.<sup>15</sup>

In the last twenty-five years, Mainland China has become an important investment location and trading partner for both Taiwan and the European Union; there is a growing dependence in both cases, but there is a significant difference between the EU and Taiwan with regard to the extent of reliance. In cross-Strait relationship, the biggest push came from the Economic Cooperation Framework signed in 2010. It not only had an enormous effect on the improvement of the trade relations, but it also emits a strong signal about the political stability of the region. Trade between Taiwan and Mainland China has been growing at an annual growth rate of over 18% since 2000! Now, Mainland China is Taiwan's largest trading partner, accounting for some 40% of Taiwan's exports. Taiwan's foreign direct investment is also directed at Mainland China; approximately 80% of the total FDI. (Wilson, 2014)

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among Western European countries is complemented with the tradition of free market economy and democracy. Many of the Central European countries are not mature democracies and the market does not work properly partly due to historical reasons.

<sup>14</sup> However, it is important to underline that "*The state of freedom declined for the eighth consecutive year in 2013*" which suggests that the spread of democratic values and the flourishing of pluralistic societies is not an automatic process in which democratic societies cannot fail, and similarly that the democratic and free market economy model is not something undemocratic societies will inevitably resort to. From time to time, changes in international political and economic relations may change the trend of democratisation. (Freedom House, 2014)

<sup>15</sup> There are political risks too! (Morrison, 2014)

Against the backdrop of the changing Chinese economic model, it is easy to see that there is a need to adjust the industrial and trade policies in Taiwan. Hard-landing of the Chinese economy could have devastating effects on the world economy, but the most diverse implications would be evident in the Taiwanese economy.

1. The short term economic risks of deepening economic integration with Mainland China may stem from the 'hard landing' of the Chinese economy as expected by many analysts. Whether this crisis will take place in the near future or not at all is difficult to forecast with precision. (Elliott, 2014) There are diverging prospects for China's economy, for example, Elliott argues that "[...]anyone who has seriously studied China realizes that the leadership of the Communist Party and of the government is very smart and has analyzed the issues carefully. The path to power and wealth in China generally runs through the State and consequently most of the best minds compete hard for these positions." However, the latest Chinese economic data have indicated a definite slowdown of the economy; industrial production, fixed investment has been hit by the processes of the last months. Recent data on the property market and lending have confirmed the deterioration of economic conditions.
2. In the long run, China is going to be a middle income country by 2020. The so-called middle income country trap poses long term threats to the Chinese economy unless the capacity of the Chinese political elite to continue political and economic reforms improves. (Aging population, eroding competitiveness due to increasing labour wages, growing social tensions, weak rule of law, political tensions caused by surging inequality within the society, etc. present threats to the Chinese economy in the long term.)
3. Technological changes taking place in recent years pose a medium term risk; they mark a shift in industrial structure, which creates new winners and losers within society. The growing significance of global supply chains along with the 'servicification' process is already strengthening the cooperation of advanced economies, this radical shift redefines the role of cheap labour in business decisions and it questions the sustainability of the rise of China.

## GRINDING MULTILATERAL TRADE NEGOTIATIONS

In recent years, the deadlock of the Doha Round negotiations has forced countries to find new alternatives. And as a result, more and more regional economic integration initiatives have already found support of the countries, and many of them are presently being negotiated. In 2000, there were only 3 bilateral and multilateral economic agreements in force in the Asia Pacific region, but the number has increased to 119 in 2014.

Several large free trade agreements, such as the Transatlantic Trade and Investment Partnership (TTIP), the Regional Comprehensive Economic Partnership (RCEP) and the Trans-Pacific Partnership (TPP) have emerged in the past few years. The TTIP and TPP are both initiatives of the United States. Initially, the TPP started out as a free trade agreement between Brunei, Chile, New Zealand, and Singapore in 2005, but its widening into a 12 country agreement<sup>16</sup> would encompass an area which produces 40% of the world GDP. The TTIP is an attempt to widen further economic cooperation between the US and the EU, which share similar market ideologies. All of these initiatives aim to go further than WTO rules. These initiatives do not only cover trade issues (tariffs), but also deeper issues of trade integration (investment, property rights, environmental regulations, etc.)

This new kind of trade integration has led to the growing economic isolation of Taiwan. For example, the EU signed a comprehensive economic agreement with South Korea, the agreement entered into force in 2011. The EU started negotiations with Japan in 2013. Both countries are strong competitors of Taiwan, while Taiwan is confined to WTO regulations in its trade relations and being a member of the WTO, it finds it difficult to break out of the diplomatic isolation as a result of the 'One China policy' accepted by the US and the EU member countries.

Wilson describes this isolation and its ramifications as follows: "Isolated economically, Taiwan will be increasingly harmed by the FTAs' trade-diversion effect. Its exports will lose out in FTA markets, due to increased competition from imports from other FTA partners. The successful completion by Korea—a competitor with Taiwan across a wide range of

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<sup>16</sup> Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, United States and Vietnam.

products—of FTAs with the European Union and United States provides a useful example of some of the costs to Taiwan of not participating in these Asian FTAs. (In total, Korea has managed to sign eight FTAs covering forty-six countries.)” (Wilson, 2014)<sup>17</sup>

Taiwan would definitely benefit from taking part in one of these economic areas. Leaf states that “One lever is the Trans-Pacific Partnership (TPP) – a free trade agreement that is being negotiated amongst twelve Pacific Rim countries, including the United States, Japan, Vietnam, and Australia. It aims to promote economic growth through investment, trade, and job creation. Indeed, the twelve countries currently negotiating the TPP account for approximately 40% of global output and over one-third of world trade. And given that exports make up 70% of Taiwan’s economy, increased trade with TPP countries would reduce Taiwan’s reliance on the Chinese market.” (Leaf, 2014)

The recipe, i.e. the diversification of economic relations is always a good policy, but it is difficult to follow the recommendation when on the one hand, one of the partners (Mainland China) is rising economically, and the cooperation delivers overwhelming benefits, and on the other hand, the trade policy is constrained due to the political reasons!

## CONCLUDING REMARKS

Not only does Taiwan but so does the EU need to diversify their economic relations. In the Taiwanese presidential election campaign, Ma Ying-jeou “[...] spoke of going to the world via Mainland China, while Ing-wen insisted the other way around, going to Mainland China see the world.” (San 2001, p. 12) As far as the EU’s China-policy is concerned, up to this point the EU has gone to Taiwan via Mainland China. This policy needs reconsideration from the European side and more efforts from the Taiwanese side.

The hard argument for the desirable change in policy in Europe is that technological changes have devalued economic activities with low added value and the pace of these changes will only accelerate the decline of classic manufacturing activities (assembling, machining etc.), while high added

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<sup>17</sup> The classic book of Jacob Viner (*The Customs Union Issue*, 1950) clearly showed that economic integrations can have diverse effects on countries not participating in regional trade agreements.

value, down- and upstream activities (engineering, marketing, sales, research and development, design, etc.) will gain further in importance. In this context, it is easy to understand how and why cooperation, in particular in the ICT industry, can benefit both Taiwanese and European firms.

The necessary diversification of Taiwanese economic relations is the other side of the coin. In this process, a comprehensive economic agreement (CEA) with the EU would be the most important step. European interests in the CEA include:

- Taiwan is important as a springboard to enter the Asian markets. This aspect is more important to Western European firms, while Taiwanese firms could serve as a source of capital and knowledge to Eastern European firms, in particular in the ICT industry). Earlier, Taiwanese firms had operated as suppliers to large European and American brands manufacturing goods requested by them. But in the late 90s the model had changed and Taiwanese firms had begun focusing on the management of the supply chains, on network orchestration. Taiwanese firms were successful in creating supply chains, even in being nodes of the structure. Today, the argument for cooperation can clearly be found in the special role Taiwan and Western European firms play in global supply chains. This is the reason why Taiwan is more important to the EU than what seems to be the case based on macroeconomic data and the sheer share, and size of international trade between the EU and Taiwan.
- Although Taiwan has only been the 25<sup>th</sup> export destination of goods, in recent years, export to Taiwan has grown faster than in any other trade relations. With respect to European exports to Taiwan, we find a 42% increase in the export of goods between 2008 and 2013 while European export to the world was only able to expand by 32% in the period considered.
- Taiwan's significance as a mature, sophisticated market is growing too. As a result of the catching up process of the past several decades, today Taiwan has reached/overtaken the average income level of the core European economies. The purchasing power of the economy is growing, which, along with openness makes Taiwan an important

partner to the European countries. As a result of the expanding trade relations, European trade deficit has decreased in recent years, which is a clear indication of improving investment and trade opportunities for European firms.

The importance of common values must be underlined; democracies, free market economies can serve as appropriate frameworks of long-term stable economic relations. This soft argument combined with the hard arguments can lay the foundations for a comprehensive economic agreement between Taiwan and the European Union which would serve the interests of both parties.

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