ECIPE OCCASIONAL PAPER • No. 3/2012

AFTER CROSS-STRAIT RAPPROCHEMENT:
A conceptual analysis of potential gains to Europe from China-Taiwan economic cooperation

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EXECUTIVE SUMMARY

- Taiwan is not part of the group of countries with whom the European Union is negotiating Free Trade Agreements (FTAs), or equivalent accords to free up bilateral trade. This paper, which builds on a 2010 study by ECIPE scholars on the potential gains from a EU-Taiwan free trade accord, argues that the EU should revisit its approach towards Taiwan and take account of recent developments as regards cross-Strait rapprochement.

- In mid 2010, Taiwan and China signed an Economic Cooperation Framework Agreement (ECFA) that progressively will open up for trade and investments between them. It is difficult to exaggerate the political and economic significance of the ECFA. After decades of charged commercial-policy relations, the relation is now defrosting. If ECFA delivers on its promises, Taiwan will especially benefit by obtaining access to one of the biggest markets in the world. Taiwanese businesses have been active in China for a long time, but predominantly through investments. Now more direct trade and commercial relations can be agreed. An estimate by the Peterson Institute suggests that Taiwan could benefit from ECFA to the tune of a 4.5% increase of Gross Domestic Product by 2020.

- The ECFA also puts Taiwan in a different light for the European Union and other third parties. First, the ECFA process confirms that Taiwan – as a member of the World Trade Organisation – can sign bilateral trade accords with other WTO members. Hence, other countries should judge an FTA with Taiwan on its individual merits, and not – as today – take for granted that China will react negatively and possibly retaliate in one way or the other. Other countries, like Singapore, are already in the process of negotiating an FTA with Taiwan.

- Second, the ECFA means that Taiwan becomes a more interesting destination for European investors that want to locate investments in a region that could provide improved access to China's market. In fact, production in Taiwan will through ECFA get preferential access to China. Consequently, Taiwan will improve its investment attractiveness to a significant degree. For European firms that serve Asian markets predominantly through production in Asia – like many service producers – Taiwan is increasingly becoming a very attractive investment destination as the preferential access to China also extends to them. Given the high degree of intra-industry trade in EU-Taiwan trade relations, it is likely that European firms in sectors like ICT, energy and medicine will use Taiwan as a base for production and innovation for the Asian markets.

- Third, ECFA will establish institutions and procedures for settling disputes, which is an attractive proposition for those firms that have experienced legal difficulties in China, especially as regards access to courts and dispute settlement.

INTRODUCTION

Taiwan was not part of the group of countries that the European Union in 2006 invited to negotiate free trade agreements (FTA). To those versed in Europe's policy towards Taiwan – and, equally important, China – this did not come as a surprise. Even if the economic conditions for selecting Taiwan as a candidate for an FTA was as strong as those for other Asian countries that did get selected, cross-Strait politics (and interpretation of cross-Strait politics) stood in the way. Even if the legal issues of negotiating bilateral trade or commercial agreements with Taiwan never should have been a concern, the controversies in cross-Strait relations were seen by officials as reason enough to avoid deepening trade-policy cooperation through an FTA.

Yet the situation has changed. And the main change is that Taipei and Beijing in mid-2010 signed an Economic Cooperation Framework Agreement (ECFA), which has defrosted commercial and commercial-policy relations between Taiwan and Mainland China to a remarkable degree. Political relations are also improving steadily, and the recent re-election of President Ma in Taiwan has been interpreted as a reinforcement of the cross-Strait rapprochement. Notwithstanding uncertainties over China's political direction after the change of Beijing's top leadership later in 2012, the approach on both sides is clearly to continue deepening commercial exchange through a raft of new agreements under the ECFA umbrella.

Taiwan is also intensifying its trade and investment relations with other countries in the Asian region. Apparently, these countries have few qualms about China's reaction to them signing bilateral trade and investment agreements with Taiwan. And perhaps the fear of trespassing on forbidden territory through policy agreements with Taiwan has always been exaggerated. It is clearly not in China's long-term interest to cut off Taiwan's trade relation with other parts of the world. Taiwan is already a member of the World Trade Organisation (WTO), and as such is entitled to sign bilateral trade agreements as long as they comply with WTO standards. To remain an economy that generates a significant part of its wealth through its commercial relations with the rest of the world, Taiwan needs to find ways to improve its bilateral relations at a time when almost every country in the world is engaged in bilateral trade negotiations. If the rest of Asia engages in FTAs, Taiwan will certainly be disadvantaged if it is not allowed entry into similar arrangements. Taiwan, like many other countries, would also benefit from improved access to other countries' markets as it progressively improves the value-added structure of its economy, a development naturally associated with obtaining new market-access interests. External pressures preventing Taiwan from signing free trade agreements could in effect 'starve' it from the diet it has used since the 1960s to increase prosperity – cross-border trade and investment integration.

Is it time for the European Union to revisit its trade policy strategy towards Taiwan? This paper takes a closer look at the potential effects on EU trade and investment that are likely to emerge as a consequence of deepened commercial relations between Taiwan and Mainland China. Although Taiwan is not one of Europe's top trading partners, it is an important trading partner and it plays a critical role in the Asia Pacific region, especially through its dense production networks that have spearheaded the explosion in intra-regional supply-chain trade. It is an export intensive economy with stable GDP growth – and now also with rapidly expanding trade relations with Mainland China. Taiwan also has a triangular trade relation with Europe and China as Taiwan has been a leading investor in assembly factories in China that export to Europe. Its close cultural ties with, and increasing economic presence in, Mainland China create interesting opportunities for European business to integrate with the larger Chinese market via Taiwan. Taiwan is increasingly also an innovation hub in other electronics, where it has a strong profile, and other sectors that are of interest to Europe. EU-Taiwan trade and investment relations have grown in the recent past. However, the growth potential remains significant and there are still barriers to trade and investment that prevent both sides from exploiting that potential.

The question is: could a bilateral trade and investment accord between the EU and Taiwan free the commercial relations from those barriers? The aim of this paper is to present and analyse the bilateral trade relations between the European Union and Taiwan – and to obtain a better understanding of current cross-border integration and the new opportunities presented for the EU and other third parties by the cross-Straits rapprochement. It builds on a previous study done by ECIPE scholars in 2010.[1] That study was based on pre-crisis data and was published before Taiwan and China had signed the ECFA agreement. This paper looks at the development post the financial crisis in 2008-9, and examines in greater detail what the ECFA agreement could imply for European firms.

BILATERAL ECONOMIC RELATIONS BETWEEN THE EU AND TAIWAN

There are many interesting aspects of EU-Taiwan trade. The high complementarity of manufacturing exports and the increasing importance of services trade are two of them. Since Taipei and Beijing signed the ECFA in late June 2010, the liberalisation of bilateral relations impacts new trade possibilities for EU investors and producers in Taiwan. ECFA was a milestone for Taiwan, and improves its capacity to engage in trade and investment cooperation also with third countries. It reinforces economic ties with the biggest regional market, since long the main investment destination for Taiwanese firms. The framework agreement is of importance as it allows greater movement of goods and services across the Strait and increases two-way investment trends. It also presents an appealing case to third countries to integrate with Taiwan.

Formal policy cooperation with Taiwan has been a complicated story for many countries. Taiwan has formal diplomatic ties with 23 countries. It maintains, however, informal relations through 91 representative offices in 57 countries around the world[2]. Despite the fact that most of the countries do not have diplomatic relations with Taipei, there are 68 commercial and economic representative offices on the island. A member of the WTO, Taiwan is also a part of the Asian Development Bank and the Asia-Pacific Economic Cooperation (APEC) forum. It has the status of observer at the Organization of Economic Cooperation and Development (OECD). The EU, like many others, follows a Beijing-oriented policy and does not have diplomatic or formal political relations with Taiwan. However, it supports Taiwan's participation in multilateral cooperation, especially when Taiwan's participation is important to the EU and global interests.

As Taiwan is not recognized as a sovereign state, its economic relations with other countries are organised in somewhat different formats. Usually, the agreements are in the form of memorandums of understanding or economic cooperation accords. Until recently, before Taiwan signed the ECFA with mainland China, the economy was only involved in free trade agreements with countries that recognized its official status, namely Central American countries such as Honduras, Guatemala, Nicaragua, Panama, and El Salvador. Yet these trade agreements are of less importance to Taiwan's overall trade profile. In 1994, however, Taiwan signed the Trade and Investment Framework Agreement as a platform for a Taiwan-U.S. dialogue on trade-related issues in the absence of formal diplomatic ties. After these dialogue meetings, contacts were rather limited as pressure was put on Taiwan to accede to the World Trade Organization.

But what about the situation now and in the medium-term future? It is obvious that Taiwan has entered a new phase with heightened interest on the part of other countries to sign trade and investment agreements with it. It is negotiating a bilateral trade accord with Singapore, known as ASTEP. It is exploring, through government-to-government feasibility studies, bilateral trade and economic cooperation agreements with other countries such as New Zealand, India, Indonesia and the Philippines. Taiwan, too, has jumped on the FTA bandwagon.

A bilateral investment agreement between Taiwan and Japan came into effect early in 2012. The arrangement will further enhance the already strong bilateral investment between the two countries and help Taiwan in its ambition to become a high-technology hub in the region[3]. It is the first comprehensive investment agreement with one of its main trading partners for Taiwan. It includes a significant negative list of exemptions but the two sides have committed themselves, however, to working for a step-by-step reduction of the negative list.

The increasing interest in bilateral trade agreements is in many ways a response to increased FTA activity generally in the Asian region. In addition, new European and American agreements with South Korea, perceived as a regional competitor to Taiwan, have added a sense of urgency to get on the FTA bandwagon. And there is now a strong willingness on the part of Taiwan to start negotiations with the EU and the US, two economies of critical importance for Taiwan's trade.

The EU and Taiwan's bilateral economic relations

Economic relations between the EU and Taiwan are growing and both economies have mutual interests in many areas. Taiwan is the 7th largest partner for the EU in Asia[4]. One of the 'Asian Tigers', Taiwan went through rapid industrialisation and recorded fast economic growth in the 1960-1980 period. The growth rates stagnated and the economy, as well as economic policy, had to go through a period of structural change. Taiwan has increased its competitiveness and experienced an annual 6.2% growth rate in the last decade. Even if growth has moderated as the post-crisis recovery cycle has diminished, the growth projection for the next 5 years remains at the 6% level. Taiwan is estimated to become one of the richest countries in the world. The average standard of living is one of the highest in the region, with a skilled labour force, high quality of living and household incomes, low inflation and unemployment levels.

Taiwanese high-income levels translate into a high share of private consumption in the economy, now standing at around 60 percent of GDP. Taiwan is increasingly seen as an attractive market for consumer goods. The trade between the EU and Taiwan has been increasing in recent years. The EU has a trade deficit with Taiwan in goods that is only partly offset by its surplus in services trade. Taiwan is a highly trade-dependent economy with an estimated 60-70% of GDP growth in the last decade to have come from trade[5]. Total trade exceeded gross domestic product and the trade sector stands at approximately 130% of GDP. Like other trading nations, Taiwan's economy, especially the trade sector, was hurt by the global financial crisis, but it recovered fast.

European investments in Taiwan are increasing, too. The stock of investment remains comparatively low, and growth has been somewhat muted in the recent past, but it is going up. Part of the reason is that foreign multinationals face market-access barriers in several sectors. And reforms of the regulatory system remain central to Taiwan's effort to attract more inward investments from abroad.

Bilateral trade in goods and services

Let us break down these general observations. Although Taiwan is a comparatively small economy, it is the 14th largest trading partner for the EU. EU exports to Taiwan reached US$20bn (23rd place) and imports accounted for US$32bn in 2010 (see Table 1). This makes the EU Taiwan's 4th largest export destination, with a share of 10% of total exports ((after China and Hong Kong (40%), the United States (12%) and Japan[6])). As for imports, Taiwan has stronger ties with regional partners than with Western economies: imports from the EU and the US accounts for 8% and 9%, respectively. As a manufacturing hub in East Asia, Taiwan tends to import mostly from Japan (19%) and China (15%). In total, 67% of Taiwan's imports, and 82% of its exports, are with APEC countries.

TABLE 1. EU KEY TRADING PARTNERS, 2011

	Export US$ BN	Import US$ BN	Total US$ BN (share)
1. US	320.74 (18%)	224.41 (11.4%)	545.15 (14.5%)
2. China	149.75 (8.4%)	373.54 (18.9%)	523.29 (13.9%)
3. Russia	114.53 (6.4%)	205.20 (10.4%)	319.72 (8.5%)
6. Japan	57.86 (3.2%)	85.90 (4.3%)	143.8 (3.8%)
9. Korea	37.04 (2.1%)	51.14 (2.6%)	88.18 (2.3%)
14. Taiwan	19. 54 (1.1%)	31.92 (1.6%)	51.46(1.4%)
World	1 784.93	1 975.72	3 760.65

Source: COMTRADE

Europe has a negative trade balance with Taiwan, representing US$12bn, as a result of its deficit in goods trade. Despite the trade deficit, the EU and Taiwan have complementary production profiles and experience few trade frictions. The European top export products to Taiwan are nuclear reactors, boilers & machinery; electrical machinery, equipment parts; vehicles, railways, tramways and roll-stocks. These product groups are exactly the same top 3 products that the EU imports from Taiwan.

Europe has particularly strong trade advantages in pharmaceutics, chemicals and optical, photo, cinema, measurement and checking devices, and agricultural products such as beverages, spirits and vinegars. As for Taiwan's trade advantages vis-à-vis the EU, they are strong in ICT technologies, auto parts, articles of iron and steel; tools and cutlery; mineral fuels and oils as well as toys, games and sport equipment. However, major differences remain under these broad categories. The EU top export products are individual function machines and mechanical appliances and parts thereof, used for Taiwan's manufacturing base (15% of total), followed by motor vehicles (4.7%) and retail medicaments for therapeutic use (3%). Taiwan's top export products to the EU are ICT components – PV semiconductors and light emitting diodes (7%), transmission apparatus incorporating reception apparatus (7%), parts of transmission apparatus, radar or TV receivers (5%), and parts and accessories for automatic data processing machines (5%).

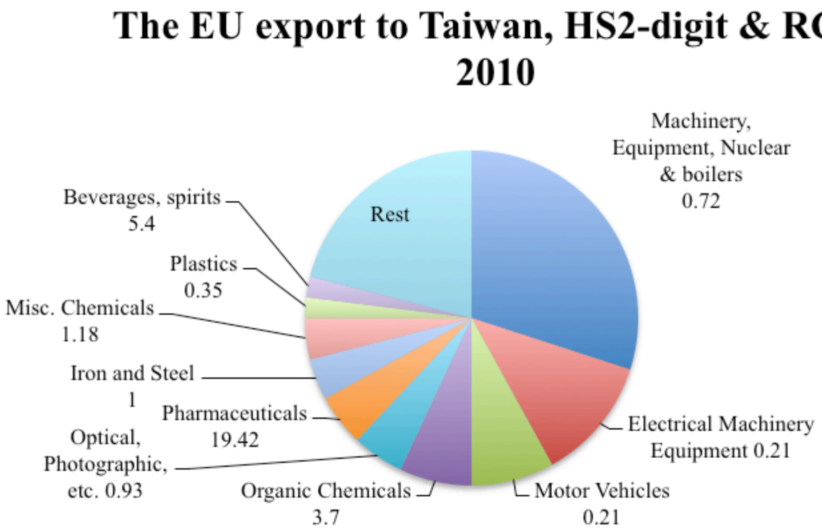
TABLE 2. EU-TAIWAN, TOP EU EXPORT PRODUCTS, HS6

Product	Product Code	Value (1000 USD)	Share of total
Machines having individual functions, other mechanical appliances	847989	2997261	15.92%
Passenger cars, fuel 1,500-3,000 cc	870323	586891	3.12%
Other medicaments or products for therapeutic use, retail sale	300490	574000	3.05%
Chemical elements doped for use in electronics - silicon wafer 2'-12'	381800	438189	2.33%
Electronic Integrated Circuits (IC), other IC parts, monolithic, bimos technology	854219	382260	2.03%
Monolithic Integrated Circuits, digital	854211	382033	2.03%
Waste & scrap of stainless steel	720421	331379	1.76%
Heterocyclic compounds with nitrogen hetero-atom(s) only, 6-Hexanelactam (epsilon-caprolactam)	293371	323407	1.72%
Passenger cars, fuel >3,000 cc	870324	314977	1.67%
Aromatic ethers & their halogenated, sulphonated, nitrated or nitrosated derivatives	290930	279519	1.48%

TABLE 3. EU-TW, TOP TAIWAN EXPORT PRODUCTS, HS6

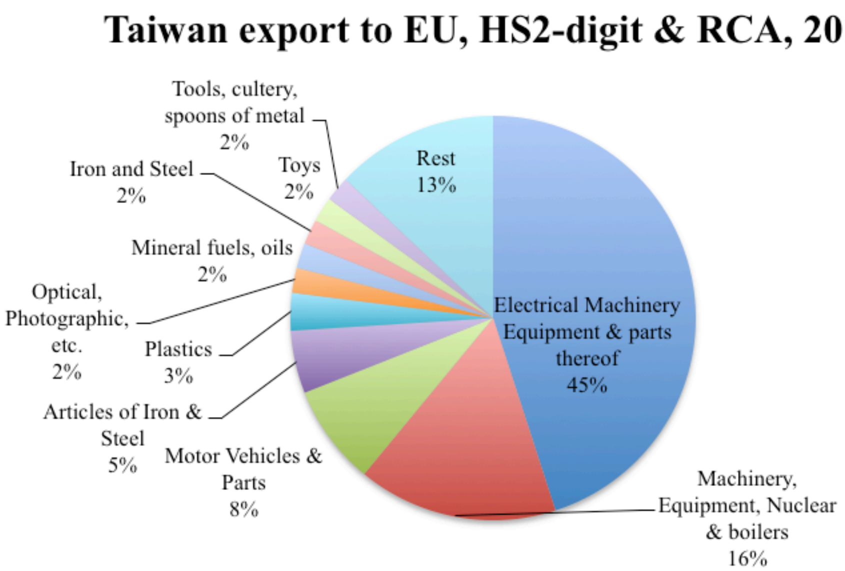
Product	Product Code	Value (1000 USD)	Share of total
Photosensitive semiconductor devices; light emitting diodes	854140	2356645.958	7.45%
Transmission apparatus incorporating reception apparatus	852520	2232613.762	7.05%
Other Parts of Transmission Apparatus, Radar Apparatus or Television Receivers	852990	1778594.357	5.62%
Parts & accessories of machines of heading 84.71 (automatic data processing machines)	847330	1698695.941	5.37%
Monolithic Integrated Circuits, digital	854211	1390458.265	4.39%
Other Monolithic Integrated Circuits	854219	1247879.824	3.94%
Bicycles and other cycles (including delivery tricycles), not motorized	871200	762476.579	2.41%
Other Prepared Unrecorded Media for Sound Recording	852390	540954.275	1.71%
Petroleum Oils, Oils Obtained from Bituminous Minerals, Preparations thereof	271000	516587.325	1.63%
Digital Automatic Data Processing Machines	847120	473710.783	1.50%

GRAPH 1: THE EU'S EXPORT COMPOSITION TO TAIWAN AND RCA[7] ON HS 2-DIGIT CLASSIFICATION



Source: ComTrade

GRAPH 2: TAIWAN'S EXPORT COMPOSITION TO THE EU AND RCA ON HS 2-DIGIT CLASSIFICATION



Source: ComTrade

The European Union maintains a surplus in trade in services with Taiwan; it recorded a surplus of US$1.35bn in 2010 (Table 4). Despite a relatively weak presence of EU services in Taiwan trade in services is increasingly important for bilateral relations, especially in comparison with its regional peers. Nonetheless, Taiwan's liberalisation in certain sectors has spurred EU export, particularly in financial services. Financial services are now the single biggest export category, accounting for €1.7bn in 2010, ahead of traditional transportation services worth €1.2bn, business services, among them merchandising and trade-related, professional and technical services add another €1bn each year. The most dynamic sector in terms of EU export growth is computer & information services (32% CAGR), now accounting for €0.5bn.

Taiwan's services export to the EU has been expanding at a slower rate. The main components of its services export are transport services (53%), followed by finance (18%) and business services (16%). Taiwan generally has weaker comparative advantage in services trade than the EU and has a low growth rate in key services sectors. Yet during the recent financial crisis, the service sector was a driving force of growth in Taiwan. Hence, Taiwan is making inroads to becoming a regional service centre, modelled on Hong Kong or Singapore, specialised in banking, insurance and business services. And some of the underlying conditions for expanding services are in place. Taiwan has a high share of domestic consumption, outgrowing regional peers (apart from Japan and Hong Kong). High trade surpluses have generated vast foreign currency reserves, third only to China and Japan in accumulated value (but higher than for instance Germany's). This makes Taiwan a fertile ground for development of value-added services. Attracting foreign investment and facilitating trade is seen as a key to improving services sector efficiency and specialisation to complement the industry, gain access to financial capital and kick-off with new industrial initiatives.

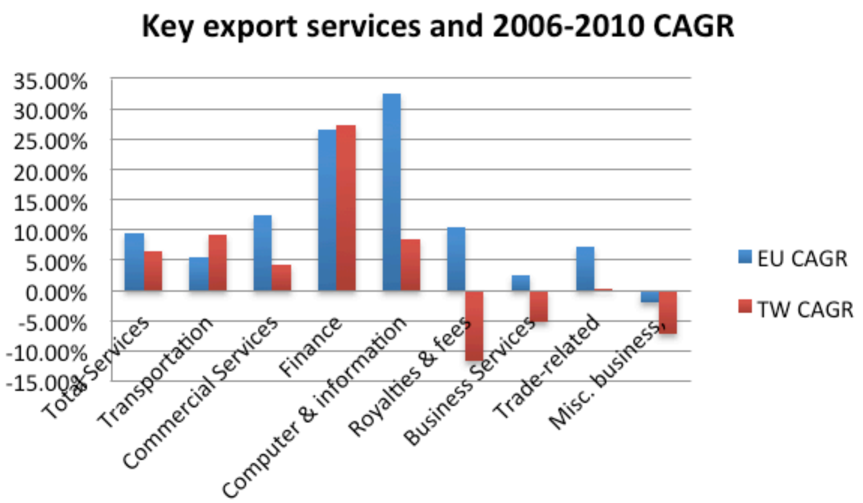
TABLE 4. TAIWAN'S TRADE IN SERVICES WITH KEY PARTNERS, 2009, US$ BN

	Imports	Exports
HK	1.828	3.836
Japan	3.763	6.734
Korea	0.991	1.258
US	5.357	6.923
EU	3.288	4.666
Total (2009)	29.783	31.774

Source: WTO

Taiwan's ambition of becoming a regional financial and knowledge hub will provide opportunities for EU service exports, particularly in finance, insurance, ICT, royalties and business services. Taiwan is growing into a major marketing and services hub for companies operating within the region; services such as R&D, business and logistics are of crucial importance for managing global and regional supply chains. Financial sector liberalisation is the key to unleashing capital formation and foreign access to the financial sector. Taiwan is rich on capital, with large currency reserves, but the regulatory framework is still distant from international standards and hampers efficient capital allocation. As trade with China continues to increase rapidly, the country will soon have to develop a better financial infrastructure for offshore RMB activities, which will put greater pressure on financial sector reform.

GRAPHS 3 & 4. TRADE IN SERVICES IN THE EU AND SELECTED ASIAN COUNTRIES.



Source: EUROSTAT

Trade and Investment barriers

A 2007 STUDY by Copenhagen Economics estimated the potential gains from a trade agreement between the EU and Taiwan at 40% of the gains from the EU-Korea FTA, which translates into equal relative gains if economic differences between Korea and Taiwan are taken into account[8]. Nonetheless, indirect benefits for the EU can be higher than in standard models of estimating gains from trade and investment, especially those models that err on the side of caution in accounting for dynamic gains. And there are some good reasons to expect that gains would be higher than estimated.

First, even if Taiwan has already lower average weighted tariffs on goods than Korea, there are a few peaks in the tariff structure that apply to European goods, particularly in transport equipment, non-electrical machinery, petroleum & chemicals, clothing and agricultural products. Slashing them would increase the competitiveness of EU exporters vis-à-vis Taiwanese producers.[9] Sizeable gains are to be experienced also in pharmaceuticals, electronics and machinery – as well as in beverages, spirits and liquors – where various forms of trade barriers have a disproportionate effect on trade.

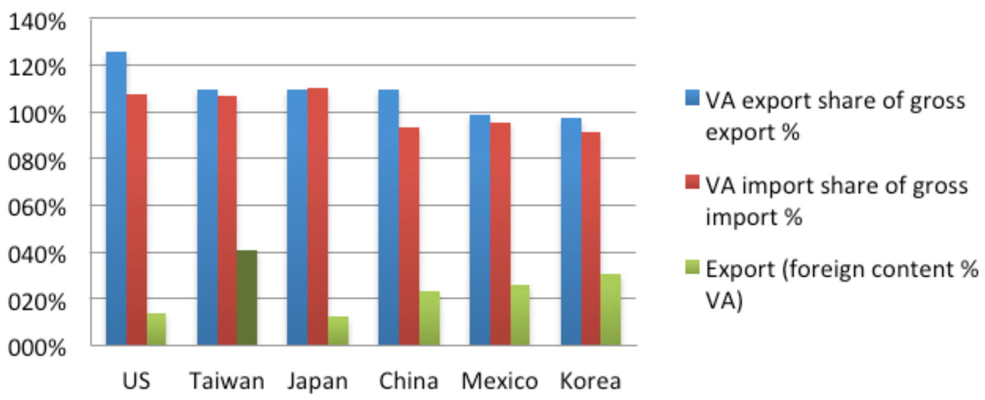
Second, standard models will for good reasons omit triangular trade effects, but in the case of Taiwan that will have a decreasing effect on the estimated gains. Triangular trade is an important part of Taiwan's trade and investment profile. Neglecting that part will miss some of the dynamic effects from trade liberalisaiton.

Third, it is difficult to gauge the full effect of NTB liberalisation. Just as in the case of the European FTA with Korea, the greatest estimated gains from trade in goods will come from NTB reductions and aligning the regulatory frameworks. Taiwan has some regulations that disproportionately dampen trade – for example regulations on labelling, cosmetics, dietary supplements, pharmaceuticals[10] or cumbersome double testing on automobiles. Importantly, NTBs are a major obstacle to trade openness and Taiwan maintains many country-specific standards and TBTs, not fully compatible with internationally accepted procedures, which raise the cost of trade and business activity. This particularly affects sectors where the EU has competitive advantage vis-à-vis Taiwan, such as selected agriculture products and manufacturing of chemicals, automobiles, pharmaceuticals and medical and electrical equipment and engineering where domestic standards are the least convergent with international equivalents.

Taiwan is about to become an interesting hub for companies looking to expand its trade with China. The growing R&D base in Taiwan makes its innovation, design and manufacture process increasingly sophisticated, plus easily adaptable for emerging market and import penetration of cost-to-performance products. Soon China will become the largest market in the world in the ICT sector, and Taiwanese firms have an advantage in positioning themselves on the Chinese markets. This is also what has attracted Western firms that have established themselves in Taiwan. Taiwan has helped Western firms to break through cultural barriers by being a test market for many new technology consumer goods and their revenue model. Taiwanese businesses have extensive experience and contacts on the Mainland, which makes them more successful in China than many Western companies.

Taiwan is also a hub for processing and manufacturing of high value-added products. The value-added component in Taiwan's export is high, representing approximately 110% of gross exports, which is much higher than in Korea (see Graph 5). The high value-added component in Taiwan's export profile comes largely from investment by multinational firms in Taiwan; foreign companies account for 40% of value-added in the manufacturing sector. The value-added content of gross exports is one of the highest in the region and Taiwanese firms remain the largest producers of consumer electronics such as laptops, scanners, routers and LCD monitors. For example, Taiwan's products account for 80% of globally installed Windows PC equipment and networks. Taiwanese products rank high internationally; Taiwanese firms make up to 70% of the global supply in several areas of high-tech goods and enjoy strong comparative advantage[11]. Taiwanese Public Data Networks (PDNs) that are used in telecommunication equipment, LCDs, OLED panels and finished Integrated Circuits (IC) are estimated to represent between 20% and 50% of the world market[12]. As a specialised ICT manufacturer, the share of electronics components and parts in total trade stands at 23%, with semiconductors as the single biggest traded component[13].

GRAPH 5. VALUE ADDED EXPORT AS A SHARE OF GROSS TRADE (2005)



Source: Foster, Stehrer & de Vries (2011)[14]

EU-Taiwan investment integration is unfinished business. The overall pattern is that EU FDI in Taiwan is much higher than Taiwan's FDI in Europe. Foreign direct investment in Taiwan is highest in sectors like finance, insurance and real estate (US$29.7bn), electronic parts & components manufacturing (US$16bn) and wholesale & retail trade (US$10bn). The EU Foreign Direct Investments presence in Taiwan is larger than the US (US$ 29.8bn and US$20.8bln, respectively)[15]. Despite declining growth in investment flows to Taiwan, European FDI remains strong, accounting for almost a half of total inflows between 2006 and 2010. Taiwanese investment flows and stocks in Europe remain weak. The EU accounts for 4.2% (US$2.7bn) of Taiwan's non-China outward investment stock (if China is included, the EU represents only 1.7%), which is far less than Taiwanese investment to the Americas or Asia.

The EU agenda for improvements

Although the investment climate is friendly, and Taiwan is placed high in rankings of competitiveness and business climate more generally, there are still barriers for foreign traders and investors. Improvements have been made. In 2009, for example, Taiwan acceded to the WTO Government Procurement Agreement, which – along with other initiatives – reflects Taiwan's increasing desire to become further integrated into the global economy. Taiwan was ranked as 13th in the 2011 World Economic Forum's (WEF) ranking of competitiveness[16]. It was among the top 20 economies in nine pillars of the WEF ranking, but its performance in three pillars holds Taiwan back from its full competitiveness potential: institutions (4.82), financial market development (4.63), and labour market efficiency (4.74). The quality of the institutional framework and financial market development continue to improve, although at a slow pace. The third area of relative weakness is its labour market (ranked as 34th), especially its insufficient labour market flexibility. Improvements in these areas would elevate Taiwan in this ranking and several others that have pointed to the same problems.

Since the tariff level is already relatively low, non-tariff barriers and other regulations remain the biggest obstacles for European producers entering the Taiwanese market. The burden of government regulations, according to the World Economic Forum index, stands at 3.7 out of 7 (where 7 represents a lack of burdensome regulations). A ban exists on European producers exporting from China to Taiwan. The requirements for double testing in electric and engineering equipment, price regulations of pharmaceuticals, the rejection of EC certificates for cars, and technical barriers to trade for European food products, are amongst the biggest obstacles for European companies and exporters. The importing of food from European countries is restricted due to problems in getting Taiwan to approve EU control procedures and food implementation systems. The island also requires the additional documentation from countries that have been already declared disease free by the World Organisation for Animal Health. Accepting EU standards, which are among the worlds' most stringent, and accrediting European test laboratories for all tests, would remove the technical barriers to trade listed above.

Better protection of intellectual property rights is also seen by investors as critical. Improvements have been made to the legislation governing the filing and protection of trademarks. However, changes to the trademark law which removes a reference for calculating the minimum level of damages for IPR infringements runs contrary to the long-standing concerns rights holders have expressed about the failure of Taiwan's courts to award adequate damages to serve as a deterrent and to compensate a rights holder for harm suffered. The European Chamber of Commerce Taipei (ECCT) also remains concerned with Taiwan's continuing struggle to enact new patent law amendments that are sufficiently stringent to put to rest the complaints over licensing that have been a bone of contention in EU-Taiwan talks.

In a White Paper from 2011 published by the Asian Corporate Governance Association (ACGA) in Hong Kong, areas such as cloud computing, smart living technology, innovation & research, healthcare, tourism and cultural creativity are outlined as essential for the country's development. On the industry side, Taiwan strives to develop smart technology and manufacturing based on intelligent automation and new materials to improve efficiency and productivity. Taipei has also set ambitious targets for the expansion of green technology sectors such as PVs (solar panels), EVs (electric vehicles), energy storage, lighting and display technology. These sectors are areas of comparative strength for Europe, which would like to see increased export and investment going into Taiwan. There is also a potential for improved direct trade and FDI flows that remains unexhausted.

"TRIANGULAR TRADE": THE EU – TAIWAN - CHINA

Cross-strait relations: Taiwan and the Mainland

Taiwan resumed civilian contacts with China in 1980. The presence of Taiwanese businesses in the Mainland has increased radically since then. Although official diplomatic relations between Taipei and Beijing are still sensitive, Taiwan has relaxed restrictions on unofficial contacts with the People's Republic of China and cross-Strait interaction has increased substantially. The breakthrough started in 2001, when Taiwan and China began to normalise economic ties. It started with the opening of so-called 'three mini-links' (direct trade, travel and postal links) and continued in 2002 when direct cross-Strait trade was permitted. In the years that followed, China agreed to allow Taiwan carriers to fly non-stop and establish charter flights every weekend. In December 2008, a direct cross-Strait charter flight service and a cargo flights service began; direct shipping and postal service and bilateral cooperation on food safety issues were added. As a result of the rapidly increasing demand for direct flights, operators on each side have increased the number of flights per week, recording up to 550 flights in 2011[17].

China is Taiwan's largest trading partner, and Taiwan is China's seventh largest. Trade generally runs in Taiwan's favour and continues to grow, providing another engine for growth in the island's economy. The volume of investments is increasing as well as the number of parties interested in opening business in Mainland China. In 2008 the volume of actual flow of investments increased by 7% from the previous year (reaching US$1.9 billion). The accumulated inflow up to December 2008 accounted for US$47.66 billion, which made Taiwan China's 5th largest source of investments. Moreover, according to the estimates, Taiwanese investment on the Mainland ranges from US$110 billion to over US$300 billion, making Taiwan and Hong Kong by some measures the two largest investors in China. Foreign investors established in Taiwan have the same right to invest in Mainland China. This opens the opportunity for European business to expand investment relations with China through Taiwan.

TABLE 5. TAIWAN'S FDI FLOWS

FDI flows, US$ 100 mn	2008	2009	2010	2011
Approved Inward Investment	82.37	47.98	38.12	49.55
Approved outward investment (excl. China)	44.6	30.06	28.23	36.97
Approved indirect Mainland China investment	98.43	60.58	122.2	131.01

Source: Economic Indicators, Ministry of Economic Affairs, ROC.

Since Taiwan and China concluded the ECFA, foreign interest in Taiwan has been growing as the agreement opens new possibilities to establish closer trade relations with Taipei without strong opposition from China. Yet many trade partners are still cautious about engaging in economic negotiations with Taiwan. Those with an eye for the legal complexities have noted that the ECFA agreements never mentioned the word 'state'; the agreement refers to parties as shore-to-shore partners, which has been seen by some as supporting the supposition that the EU or others cannot engage in formal bilateral trade and commercial policy agreements with Taiwan.[18]

It is, however, highly unlikely that China would interfere in efforts by Taiwan to negotiate a trade agreement with the EU. In fact, there are solid reasons to believe the improvements in cross-Strait relations to be part of a larger trend of Taiwan improving its trade relations with its key trading partners.

Taiwan is already party to several government-to-government economic agreements in areas like taxation and intellectual property rights. It is a member of the WTO. Last year, a first 'arrangement' on investment protection was signed with Taiwan, which could be a milestone for further trade deals. Furthermore, Taiwan is currently negotiating an economic cooperation accords with New Zealand and Singapore, and has initiated talks with India and the Philippines. The New Zealand negotiations are in the form of an economic cooperation agreement (ECA) and have already yielded an investment arrangement on venture capital. With negotiations scheduled for completion by 2013, both countries are well positioned to reach an economic cooperation agreement that deepens trade integration. There are no legal obstacles for the Taipei government to conclude an agreement under WTO rules.

The Economic Cooperation Framework Agreement between Taiwan and Mainland China

On June 29, 2010, following 6 months of negotiations, the Taiwan and China signed the ECFA, which aims at bringing about liberalisation of cross-Strait trade in products and services, and eventually creating a relationship based on free trade. The agreement came into force on September 12, 2010. A two-year phase-in period began on January 1, 2011 for bilateral reduction and elimination of tariffs affecting more than 800 products. ECFA was in part also launched as a result of the increasing cooperation between China and other Asian countries. Since the establishment of the ASEAN-China Free Trade Agreement in 2003 products from Taiwan have to face more competition from ASEAN countries in China. Since the Chinese market is one of the main destinations for Taiwan companies, the possible future expansion of free trade zones in the Asia and Pacific region will increase the competition from such countries as Japan or South Korea.

The Taiwanese government considers ECFA as a critical first step in avoiding regional economic marginalisation and paving the way for expanded trade relations with other major trading partners. As mentioned above, the number of cross-Strait flights is increasing rapidly. More than 1.72 million Chinese citizens visited Taiwan in 2011, including 1.31 million tourists, according to statistics released by the Mainland Affairs Council. In 2011, Taiwan agreed to open “free and individual tours” for citizens residing in Beijing, Shanghai, and Shenzhen. A total of 15,533 P.R.C. citizens entered Taiwan between June and October 2011 for “free and individual tours.” Many senior Chinese officials, including the minister for culture, a vice-minister of public security, the mayor of Shanghai, and numerous provincial governors and Communist Party leaders have visited as part of an effort to improve Mainland China’s image among a generally wary Taiwanese population. For someone not versed in the history of cross-Strait relations, this may not sound impressive. For those who are, however, this is a remarkable development. Not that long ago, the border between the two sides was absolute.

Hence it is difficult to overstate the significance of this rapprochement. After decades of very charged relations, and increasing barriers to commercial exchange between Taiwan and China, governments on both sides have changed track and now eye a new form of relationship based on free and voluntary exchange. The economic significance of this agreement is of course bigger for Taiwan, which is a smaller economy than China. Acquiring much improved access to the biggest market in the region will not only improve the conditions for direct trade, and trade-led growth, it also positions Taiwan as a market that now can work as a base for multinational firms expanding their presence in East Asia and especially China. There are many firms that supply the Chinese market from other countries in the region. Until recently, Taiwan has not been in a good position to attract such investments. If the ECFA process continues according to plan, Taiwan will soon be much better placed than other regional peers to serve as a hub for penetrating the Chinese market.

Trade between the two economies has also increased and China is now the biggest export destination for Taiwan, accounting for 40% of all exports and 15.5% of imports. China is also the biggest recipient of Taiwanese outward direct investments (ODI), representing 70% of the total ODI stock. Cross-Strait cooperation is a big opportunity for Taiwan as it improves access to one of the biggest consumer markets in the world. Improved access to China gives key niche sectors new opportunities to expand. There are six product categories within 10 top products where China’s MFN tariff rate is zero and there is no competition from the FTA signed between China and third countries. Five of these items fall under the HS85 tariff code chapter (electromechanical products), and one falls under the HS84 chapter (electronic products). However, in the case of the remaining four product items, Taiwan faces a severe competitive threat from Japan and South Korea (IFRI, 2012).

Without the ECFA, Taiwanese companies might be left behind the growing competition from its neighbours. Take for example LDC panels. Taiwan is the second largest exporter to China, but its share in the Chinese market is about 6 percentage points lower than South Korea's. There is a similar situation in terephthalic acid – Taiwan's seventh largest export product - where Taiwan is second to Korea with an eight-percentage gap. In LDC devices, Taiwan is more competitive than South Korea but Japan is only five percentage points behind. What is more, the average tariff rate in China is 6.5% or higher for all these products.

The ECFA provides full openness to trade in many goods and services sectors. The first wave of liberalisation, the 'Early Harvest', included 1004 tariffs scheduled for elimination by 2013 on the Chinese side. The bulk of these tariffs have already been eliminated, and their export value has been estimated at US$14 billion (approximately 10-15% of total trade volume). Taiwanese obligations were initially far smaller, covering 267 tariffs scheduled for elimination in 2011, as had been demanded by China. Agricultural goods continue to be a contentious issue on the Taiwanese side and have been substantially carved out from the agreement. Key sectors for liberalisation are petrochemicals, plastics, auto parts, raw materials, instruments and meters, metallurgy or medical care. The full 'Early Harvest' list included 539 items with a total estimated trade value of US$14bn on the Taiwanese side[19].

In subsequent rounds of negotiations, tariff reductions on a further 5824 goods and 100 items in the services sectors have been and will continue to be reviewed[20]. Taiwan is obliged to open its services sectors, particularly in business and movie services. In return, China will open computer services, airline maintenance and medical sectors, followed by tariff cuts on petrochemicals, plastics, cars and parts, textiles, machines tools and medical equipment goods.

According to the estimation made by Institut Français des Relations Internationales (IFRI) Taiwan's exports would grow by 5.13%, while imports would increase by 7.26% as a result of ECFA.[21] It is the first trade agreement that Taiwan signed that will have significant positive impact. The previous FTA signed with Central American countries does very little trade, less than 0.1% of Taiwan's total foreign trade, so the economic benefits were insignificant.

The biggest changes from ECFA are in the manufacturing sector. The liberalization of manufacturing trade will benefit the production and export of chemicals, rubber and plastic product industry, machinery and equipment, textile industry and ferrous metals industry. The first three groups of products have also undergone profound changes in trade and production profiles as a consequence of the ASEAN-China FTA. China is Taiwan's main export market in these sub-categories, accounting for 47.71% of the total exports of the Taiwanese chemical, rubber and plastics industry; 49.42% of the total exports of the machinery industry; 48.06% of the total exports of the ferrous metals industry; and 33.51% of the total exports of the textile industry. However, modelling results indicate that the electronic equipment, transportation equipment (NEC), wood products, and manufactures (NEC) industries will experience the largest decline in output and exports.

Services are a big part of new and future efforts to liberalise trade. It started as a liberalisation of air passenger and cargo transport services, followed by improved access to tourism, travel, maritime and postal services. The Early Harvest on services improves access to China's finance, insurance and securities sectors, and complementary memoranda of understanding (MOUs) on co-operation within these sectors have established regulatory platforms for further integration. Improved access to China has also been confirmed in business services such as accounting and auditing, computer and information technology, airline maintenance, entertainment and medical services (such as hospital establishment).

Taiwan is a crucial port of investment to Mainland China. In August 2010, both economies established a global investment task force to coordinate efforts to solicit investment in Taiwan by foreign multinational corporations as well as overseas-based Taiwanese firms[22]. Starting in Xiamen, located just across the Strait, Taiwanese direct investment has played an important role in China's economic modernisation. Expanding production networks along the coast and inland, Taiwan directs 70% of total outward investment flows to China. Taiwan established lower-end production and assembly sites in electronic parts and components (24% of the investments), computer electronics and optical products (11%), electrical equipment (4%) and other sectors (36%)[23].

Taiwanese companies remain strategic investors in China, accounting for about 10% of the total stock (yet this figure omits important amounts of Taiwanese investments in China that have been routed through Hong Kong)[24]. In fact, out of US$473bn inward stocks in China, Taiwan's indirect stock has been estimated at US$97.3bn, which makes a 20% share. Currently, around 37,000 Taiwanese firms are present in China. Along with big original equipment manufacturers such as Foxconn and Compal, there are many small and medium firms that are taking advantage of cultural proximity and family links.

The ECFA gave a boost to Taiwanese investment in China; a 100% increase from the 2009 level has been recorded (Table 5). However, there is no equivalent development with Chinese investment to Taiwan. China's investment in Taiwan remains marginal and accounted for only 2% of total inflows to Taiwan in 2010. Part of the reason behind the weak Chinese FDI into Taiwan is investment protections in Taiwan directed at Mainland China.

ECFA has also increased the number of companies interested in investing on island. Japanese firms, such as optical film manufacturing Toray has announced that it would establish a new factory in Taiwan, while Furukawa Electric signed an MoU on investment in Taiwan with Taiwan's Ministry of Economic Affairs (MoEA) in early October 2011. Also, other Japanese companies like Sony, Mitsubishi, TDK and NEC are also discussing new investment projects in Taiwan. According to statistics compiled by Taiwan's Investment Commission, the total amount of approved inward investment by Japanese companies in August 2011 was nearly US$100 million (IFRI, 2012).

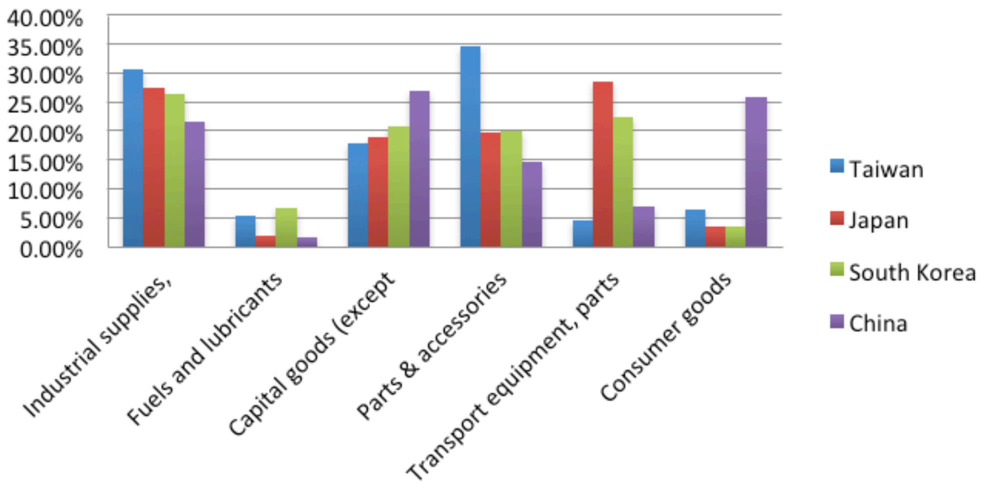
But Chinese outward investment flows to Taiwan have expanded in recent years, and are expected to further increase in coming years as Chinese firms seek to acquire information and knowledge to the value-added component in its production. The ethnic and geographical proximity to Taiwan is likely to direct attention to the island, especially so as Taiwan has pledged to open its market to investment in more than 100 sectors as part of the economic co-operation with China[25]. Undoubtedly, a big portion of China's forthcoming investment in Taiwan will be in the ICT sector. Currently, 90% of Taiwan's exports to China are in components and semi-finished goods; half of that value represents exports destined for the US after assembly in China. Furthermore, 70% of Chinese ICT manufacturing comes from Taiwanese-owned plants[26].

Two-way trade between Taiwan and China has averaged 16% annual growth in the past decade. Total trade volume reached $105 billion in 2008, with a trade surplus of $44 billion for Taiwan. Although cross-Strait trade contracted sharply in 2009, like global trade overall, it recovered in 2010[27].

Taiwan's geographical, cultural and economic position vis-à-vis China has attracted large transnational companies to establish their East Asia region base on the island. The triangular trade and investment network between Taiwan, China and Western countries is already of great importance – and has been ever since Taiwan's investment in the Mainland took off. Taiwan's export to China is specialised in parts and components, which are exported for assembly and later re-exported to the EU or the US. Taiwan's share of processing input export is almost twice as big as for regional peers.

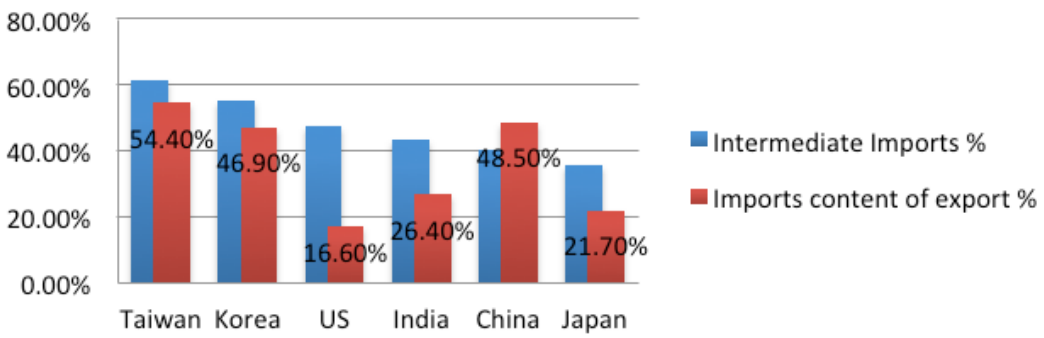
Consequently, Taiwan's domestic investments rely heavily on external demand for its manufacturing sectors and import content of exports. With volatile external demand, and an increasing share of import content, domestic investment velocity has been on the decline. The gross fixed capital formation was down for 3 years in a row between 2007 and 2009, a decline of 40%. It is therefore central for Taiwan to attract foreign investment to spur new industries and investment in the country. The sort of investors that Taiwan aims to attract is foreign investors with an interest in triangular exchange that involves China. To that end, Taiwan has cut its corporate tax rate to 17% and made several efforts to offer good cost conditions for foreign investors[28].

GRAPH 6. SHARE OF EXPORT FOR SELECTED EAST ASIAN COUNTRIES, 2010



Source: COMTRADE

GRAPH 7. TAIWAN'S ICT IMPORT IN 2005



Source: OECD

ECFA and triangular trade with the European Union

THE IMPROVED ECONOMIC relations between Mainland China and Taiwan will have a positive impact on the European Union's trade with both economies. Economic integration through triangular trade is already extensive, and it is likely to continue to grow fast in the medium-term future. The EU is already a critical market for Taiwanese firms whose product assembly is based in China. The fact that cross-Strait relations are improving will add a new element of stability and predictability, which is helpful for Europe's import stability.

There are several types of benefits that the EU could achieve through a free trade accord with Taiwan. Several of them relate to China – and, consequently, could be obtained by an equivalent agreement with China. But that is not a realistic option for the next two decades. The EU has too many defensive interests against China, and the European Commission would not get the political support from member states if they were to initiate such a process. Similarly, China has defensive interests against the EU, and is yet unconvinced about the merits of trade liberalisation that cuts behind-the-border barriers to a significant degree, especially when such liberalisation exposes the domestic market to substantial competition. In other words, and to put it in somewhat impolite terms, a trade agreement with Taiwan could for the EU be a proxy for a trade agreement with China – yet one that would not force Europe to open its markets to China to the same degree as in a direct FTA.

In conceptual terms, the EU would benefit from closer trade relations with Taiwan in multiple ways. By abolishing tariffs and reducing other trade barriers, trade in both ways will be less costly and less subject to bureaucratic rules. Consequently, the EU can improve its supply chain efficiency thanks to cheaper access to the Taiwanese market. Moreover, more favourable conditions for investment will make EU companies more prone to invest in and further align its presence in Asia with regional markets. In other words, there is likely to be import and export as well as investment-related gains.

As already alluded to, the EU will gain better access to Mainland China because of ECFA and the preferential access to China that exports from Taiwan enjoy. Taiwan plays a significant role in the EU ICT value chain in Asia, and its Taiwan-based exposure to China has been increasing in recent years. It is likely to that this exposure will continue to increase – and at a faster pace in the future as value-added content in Taiwan is built up and makes rules-of-origin restrictions less tangible.

Taiwan is also of growing importance in services trade. Since signing the ECFA, services trade has grown significantly. This is attractive for many European services firms. The rise has mainly been seen in banking, retail, and real estate sectors. Moreover, Taiwan's banks are planning to expand its position within Mainland China by establishing leasing companies, e-commerce, and equity investments. Chinese banks are also eager to make their presence felt in Taiwan. Bank of China and Bank of Communication has recently received approval to open branches in Taiwan. This expansion of trade in banking services is estimated to be of critical importance for Taiwan, in direct terms as well as the attraction it generates for foreign banks. As trade with China expands, there is also greater demand for RMB-related banking services and in the not-so-distant future Taiwan will become a significant trading centre in RMB. As Taiwan's financial sector is in the early development stage, the growing demand for more advanced financial instruments and specialist expertise present an appealing case for European banks.

A second important aspect of the ECFA's potential effect on the EU is based on the high-degree of complementarity in production profiles between Europe and Taiwan. The complementarity in manufacturing, especially the ICT sector, is already significant. The same applies to trade; intra-industry trade is comparatively strong in EU-Taiwan trade. This is of interest in view of a trade accord between the EU and Taiwan. Trade relations with a high degree of intra-industry trade enable countries to reap the benefits of trade reforms at a faster pace. In this case it is of crucial importance as Europe's as well as Taiwan's trade profile with China is significantly strong in the same sectors. In other words, the potential gains related to triangular trade – and improved conditions for Europe's access to the Chinese market – can be reaped fairly quickly.

A third aspect of importance from the vantage point of the EU is the opportunities created by the ECFA to establish more predictable and transparent conditions for trade with China. This agreement provides better security for the investors both in Taiwan and in the Mainland. In the first place, reducing the risk of political disputes improves the conditions for trade and investment. Moreover, new institutional structures to handle disputes are of critical importance to EU firms, many of which have experienced legal and institutional difficulties in China. The importance of the transparent dispute settlement mechanism that has been negotiated between the two sides, and the IPR agreement that was signed in 2010, extends also to firms outside Taiwan. Taiwan and China have agreed to enhance cross-strait information exchanges and cooperation relating to the protection of patents, trademarks, copyrights, and plant patents on a reciprocal basis. Furthermore, the planned agreement on a dispute settlement resolution mechanism will provide better access to China's judicial system in case of law infringement. Also, the recently signed Cross-Strait Investment Protection Agreement will provide protection for Taiwanese companies and investments in China, and vice versa. By concluding this agreement the countries have established an improved framework for cross-border investment and a mechanism that will lessen the concerns about the security of investments, e.g. compensation for nationalisation, personal security, labour disputes or the lack of certainty that every dispute body and court will interpret the same way. All of these institutional aspects are of interest to EU firms. They change the competitive relationship between Taiwan and other countries in the region that attract European investors, who want to expand on the Chinese market from a base in another Asian country.

CONCLUDING COMMENTS

The overall benefits for Taiwan of the ECFA are substantial. An estimate by the Peterson Institute suggests that the ECFA will increase GDP by 4.5% by 2020. Similarly, FTAs with the EU, the US or the ASEAN would each bring 4.9% GDP increase to Taiwan[29]. Most importantly, normalised relations with China are a starting point for convincing external partners to establish trade agreements without upsetting Mainland China. Beijing has said that a completion of the ECFA will also open new opportunities for Taiwan to agree trade accords with other countries.

As a consequence, Taipei actively seeks new FTAs with many countries – and especially the bigger markets. The EU has been courted to start FTA negotiations, and the question that Europe needs to find an answer to is how it should respond. The conclusion of this paper is that there would be benefits to the EU from an FTA with Taiwan. Those benefits have become significantly bigger because of the ECFA and continued liberalisation of cross-Strait exchange. It is true that the estimated direct benefits for the EU of an EU-Taiwan FTA are modest in comparison with potential gains from trade agreements with bigger markets. Yet the factor that remains unaccounted for in these estimates is how the ECFA changes the conditions for integration with Taiwan. Such a trade accord is now, and even more so in the future, a strategic component in Europe's strategy to gain better market access in China.

The reality of Europe's strategy in concluding FTAs with Asian countries is that it needs to cast its net widely in order to reap the benefits. FTAs with small or mid-sized economies will themselves not generate substantial GDP gains for a big economy like Europe's. But the combination of FTAs, and the strategy's ability to capture regional supply-chain integration, expands the gains significantly. Europe has now made a strategic effort to get a better foothold on East Asian markets. An FTA with Korea has already been concluded. Together with Taiwan and Singapore, according to a study by the Citi, Korea is estimate to be the richest country by 2050. Improving market access now to ensure that it will be a part of the coming decades of rapid growth is important for Europe.

The EU is also discussing with Japan exactly how their trade relations in the future should evolve. China remains a big concern for Europe as it is already the biggest market for Europe's export and import with Asia – but also one that is mired with difficulties. In one way or the other, Europe needs to approach China for a cooperative approach to solving problems. In this context, it is critical for the entire strategy that Taiwan is not excluded by the EU – and that the EU uses the opportunities that Taiwan offers for dealing with China.

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