

Economic Relationships and Outlook of China, U.S., and Taiwan

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ABSTRACT

In this paper, we first reviewed the economic development of China and Taiwan, then the economic interrelationship among China, U.S. and Taiwan were discussed in some detail. Then economic outlook of U.S., China, and Taiwan has been explored.

JEL: A1, F4

Keywords: Economic development; Reconstruction; Export expansion; Economic outlook; Foreign investment; Political risk; Economic risk

I. INTRODUCTION

I am one of the Chinese-American professors participating in Economic Reform in the People's Republic of China since 1982. For the last nineteen years I have represented the U.S. Department of Commerce, the World Bank, United Nations, the University of Illinois at Urbana-Champaign, and Rutgers University to teach managers, government officers, professors, and students in China. In addition, I research the financial markets and economic development of the U.S., Taiwan, China and other Asian countries. I have actively participated in financial market and policy reform in Taiwan, and in 1994, proposed a strategy to develop Taipei as a regional financial center with Governor Fai-Nan Perng and other government officers. I am also actively consulting with companies and universities in Taiwan and other Asian countries. In Section II, Economic Development of China and Taiwan is discussed in some detail. In Section III, the economic relationships among China, U.S., and Taiwan will be explored. Section IV discusses the economic outlook of the U.S., China, and Taiwan. In Section V, Foreign Investment Analysis for Taiwan will be analyzed and Section VI will predict Taiwan's economic prospective. Section VII summarizes the paper.

II. ECONOMIC DEVELOPMENT OF CHINA AND TAIWAN

In this section, we will first briefly review the economic development of China in the last twenty years. Then, the economic development of Taiwan in the last 50 years will be discussed.

1. Economic Development of China

After the 1949 Communist Revolution, China's economic performance was very poor because the Socialist economic planning system did not give individual and company incentive to perform economic activities. In China, almost everything is nationalized until the early 1980s. The Chinese leader XiaoPing Deng proposed reforming the Chinese economy in 1979, since then, it is worthwhile to note that the economic growth of China has improved substantially. Chinese economic development has gotten the help of World Bank, IMF, Hong Kong, United States, Japan, Taiwan, and other foreign countries during the last 20 years. The Chinese economic development can be classified into three periods for the last 20 years as follows¹:

- a. Period 1 (1979-1985) is the learning by doing period. During this period, reform group and conservative group had struggled to determine whether the new socialist market type of economy or old planning type of economy should be undertaken in China. Finally, the new socialist type of market system economy has been accepted as the principle of the Chinese Economic Reform. By 1985, the growth of GDP had reached 13.5%; however, the inflation rate increased to 8.8%.
- b. Period 2 (1986-1992) is a fluctuation period. During these 7 years, government had relaxed the price control and the private enterprise of rural area had played

an important role in economic growth. In 1988, the inflation rate had reached 18.5% and the daily life of poor people became miserable. In addition, the corruption of government and business sectors had reached a very severe situation; therefore, the Tianamin Square revolt occurred on June 4, 1989. Since then, the government started to control economic activity again. In 1990, the GDP growth rate had decreased from 11.3% in 1988 to 3.8% in 1990. Simultaneously, the inflation rate also decreased from 18.5% in 1988 to 2.1% in 1990. Then, the economic reform was kicked off again in 1991 and the growth rate of GDP was recovered up to 14.2%. The economic reform has gone back on the right track.

- c. Period 3 (1993-2000) is a steady growth period. The GDP growth rate of the first three years was maintained at about 10% in the same period, the inflation rate was maintained at about 13%. To reduce the pressure of inflation, premier RongJi Zhu used macro policy to control the economic growth and to reduce consumer price. In 1996, the inflation rate was reduced to 6.1%. During the Asian Financial Crisis in 1997 and 1998, China's economic growth still maintained 8.8% and 7.2% respectively. Finally, in 2000 the GDP growth rate in China is 7.7%. Based on the forecasts of WEFA, World Economic Outlook, the economic growth of China will be 7.6% in 2001. The economic growth rate of China during 1994-2001 can be found in Table 1.

2. Economic Development of Taiwan

Now we will discuss the economic development of Taiwan. In the last 50 years Taiwan has successfully developed their economy. We generally call this kind of economic success as "an economic miracle". During these 50 years, I would like to classify Taiwan's economic growth into five periods as follows:

- a. Reconstruction (first import substitution) Period (1950-1959)
During this period, Taiwan first developed agriculture sector to earn the foreign exchange, then the Taiwan government imported machines to develop labor-intensive industry such as textile and plywood products to substitute the import of these products. Overall, economic growth is about 8% and the average inflation rate is about 4.4%.
- b. Export Expansion Period (1960-1969)
To solve the problem of the limitation of domestic market for both agriculture and light industry products, Taiwan government employed economic policy to improve the domestic investment environment and promote export. Due to the improvement of international economic environment, the export of Taiwan has increased dramatically and average export growth rate has exceeded 25%. It is worthwhile to note that the percentage of manufacture sector in GDP has exceeded the percentage of agriculture sector by 1969

Table 1
GDP growth in selected Asian nations in recent years (1994-2001)

Unit: %

	Thailand	Malaysia	Indonesia	Philippines	South Korea
GDP Growth Rate					
1994	8.6	8.7	9.2	7.5	4.4
1995	8.9	8.7	9.5	8.2	4.8
1996	7.1	6.0	8.2	7.8	5.5
1997	5.5	-0.4	7.7	4.6	5.2
1998	-7.0	-8.0	-7.5	-15.3	0.2
1999	-1.10	1.0	-2.0	-3.4	2.5
2000	8.9	5.0	6.0	4.0	3.8
2001*	5.8	5.0	6.0	5.0	2.4

	Hong Kong	The People Republic of China	Singapore	Taiwan	Japan
GDP Growth Rate					
1994	12.7	0.7	5.3	10.5	6.5
1995	10.5	1.3	4.7	8.8	6.0
1996	9.7	3.7	4.9	7.0	5.7
1997	8.8	0.0	5.3	7.8	6.8
1998	7.2	-1.9	-5.0	0.7	5.1
1999	6.6	0.3	-1.0	-0.8	5.2
2000	7.7	1.9	10.0	7.9	6.47
2001*	7.6	1.6	8.8	5.9	5.25

Source: WEFA, World Economic Outlook

*Estimates of 2001

c. Second Import Substitution Period (1970-1979)

To deal with the problems of oil crisis, shortage of food, and the devaluation of U.S. currency, Taiwan government employed "Ten Constitution projects" to increase domestic investment and demand. After the inflation situation had been under control, Taiwanese government then employed stimulation economic policy to maintain median economic growth. To reduce the dependence of import, Taiwan government has developed heavy chemical industry and machinery industry. During this period, the percentage of heavy industry product has exceeded the percentage of light industry products.

- d. Liberalization and Internationalization period (1980-1990)
Due to continuously increasing trade surplus of current account, Taiwan government has liberalized the import to meet the domestic demand and reduce the trade surplus as demanded by the trade partners such as the U.S. The effective tariff rate has decreased from 12.25% in 1972 to 5.6% in 1990. Taiwan government has abolished the current account control of capital flow movement. Since the “Plaza Accord Agreement” of industrial countries, the NT \$ has appreciated almost 50%. In 1987, Taiwan government has opened its economic relationship with China and abolished the Marshall Law. In 1988, the domestic demand of Taiwan has exceeded its export of commodity and service. The value of principal exports of Taiwan is presented in Table 2. Table 2 indicates that the capital-intensive commodity exports have gradually replaced the labor-intensive commodity exports during the period from 1990-2000.
- e. Upgrading the Industry and Improve International Competitiveness period (1991 to present)
During this period, Taiwan government started its six-year economic planning (1991-1996). Government starts the Hsin Chu Industrial Park and developed the electronic industry. Right now the total value of electronic products of Taiwan has ranked only next to U.S. and Japan. In 2000, the export of electronic products had reached US\$ 31,673.7 million. It is about four times of the export electronic products in 1990. In addition, Taiwan has started to develop its financial sector. In 1994, I have helped Taiwan government to develop Taipei as regional financial center (See Lee, 1994)². Currently, I am also participating in the strategy of reforming the financial sector and the strategy of dealing with economic relationship between Taiwan and China. I suggest Taiwan government use “Taiwan is the root and Mainland China is the leaves” strategy to deal with the foreign investment strategy (see Lee, 2001). This issue will be discussed in Section D in some detail. A detailed discussion of current economic and financial condition of Taiwan can be found in Central Bank of China (2000).

III. Economic Relationships Among China, U.S. and Taiwan

1. Economic relationship between China and U.S

Since the 1980s, the economic growth of China heavily relied upon both direct and indirect help from the United States. By this time, the direct foreign investment in China from the U.S. has been ranked number four and China has become the number 4th trade partner of the United States. More than 20% of Chinese products have been exported to the United States. The trading value between the U.S. and China has increased more than 30 times from 1980-2000.

Table 2
Value of principal exports unit
US\$ million

Period	Total	Fishery Products	Chemicals	Plastic Products	Rubber and Articles Thereof	Plywood	Textile Products (Excepts Garments)	Garments	Footwear And Parts	Ceramic Products
1990	67214.4	828.7	1282.0	3918.1	511.9	176.5	7094.2	3190.3	3528.3	616.9
1991	76178.3	815.7	1569.7	4580.9	590.3	137.8	8478.6	3518.6	3810.8	626.1
1992	81470.3	773.4	1769.4	4815.1	639.9	117.0	8713.3	3128.5	3703.6	618.4
1993	85091.5	784.8	1937.1	5011.4	681.6	93.0	9271.4	2768.0	2772.6	463.8
1994	93048.8	1012.1	2404.0	5650.4	752.2	113.3	11461.4	2538.1	1726.4	377.2
1995	111658.8	1198.3	3238.1	7101.2	973.3	133.1	13272.0	2350.0	1404.2	306.6
1996	115942.1	1092.6	3257.4	6685.1	1028.7	151.4	13381.8	2286.1	1209.8	256.7
1997	122080.7	1101.5	3277.6	6636.8	1079.4	139.5	14209.9	24550.7	1002.1	215.4
1998	110582.3	988.0	2857.2	5901.1	969.0	59.0	12208.1	2337.8	719.0	146.4
1999	121590.9	950.4	3266.9	6514.8	1009.5	46.4	12052.6	2119.9	687.4	134.8
2000	148320.6	1042.8	4044.0	7949.1	1106.1	42.1	13006.1	2213.4	604.3	133.0

Period	Basic Metal and Articles Thereof	Electronic Products	Machinery	Electrical Machinery Products	Info & Communication Products
1990	5215.3	7725.3	5776.9	2207.7	5023.6
1991	5805.9	8183.3	6794.7	2538.6	5588.8
1992	6464.5	8682.2	7533.0	2783.6	6423.5
1993	7133.1	10259.2	7045.6	3217.9	6439.5
1994	8075.0	12333.9	7207.5	3446.6	6790.8
1995	10026.8	16250.4	8349.7	3998.6	9906.8
1996	10245.7	16631.6	9482.3	4224.5	12545.9
1997	11530.7	18024.1	9651.5	4767.5	14441.6
1998	10870.2	16900.6	7807.3	4351.4	13757.8
1999	11607.3	21832.5	7921.1	4601.1	15141.7
2000	13518.6	31673.7	9665.5	5371.1	19561.9

Table 2 (continued)

Period	House-hold Electrical Appliances	Transportation Equipment	Precision Instruments	Toys, Games & Sports Requisites Parts & Accessories	Furniture
1990	903.5	3449.4	1536.1	2906.4	1445.8
1991	1006.0	3929.2	1856.4	3044.5	1695.3
1992	1034.8	4199.9	2000.5	3318.7	1840.1
1993	874.9	4677.0	1945.7	2816.2	1839.8
1994	825.7	4816.6	2063.8	2704.4	1801.7
1995	875.8	5361.8	2336.1	2746.4	1767.5
1996	890.1	5215.4	2294.2	2671.2	1738.5
1997	828.1	5587.6	2492.3	2382.8	1700.6
1998	663.8	5216.1	2216.8	1901.3	1576.7
1999	690.9	5151.9	2728.8	1781.1	1718.8
2000	650.3	5752.8	3896.9	2210.6	1766.7

Source: Taiwan Statistical Data Book, 2001

2. Economic Relationship between Taiwan and U.S

By 1970, the economic development of Taiwan has heavily depended on the economic aid of U.S. Since 1965, the United States is the main export market for Taiwan as presented in Table 3. Right now, Taiwan is become the 13th Trade partner with the U.S. Taiwan has constantly maintained a large amount of trade surplus with the U.S. since 1976 as presented in Table 3.

3. Economic Relationship Between Taiwan and China

Since 1987, the economic relationship between China and Taiwan has increased dramatically. By this time, Taiwan's exports to China are second only to the exports of the U.S. Officially, Taiwan has invested more than 60 billion U.S. dollars in China; unofficially, Taiwan has invested more than 120 billion U.S. Dollars in China. However, from this kind of economic relationship, Taiwan has also enjoyed a large amount of trade surplus with China (Hong Kong) since 1980 as presented in Table 4. In the next section, risk and return relationship of Taiwan's investment in China will be analyzed in detail.

Table 3
Percentage of Taiwan's export to United States and Hong Kong (China) (1965-2000)

Period	U.S.A.	Hong Kong
1965	21.3	6.2
1970	38.1	9.2
1971	41.7	7.8
1972	41.9	7.7
1973	37.4	6.6
1974	36.1	6.0
1975	34.3	6.8
1976	37.2	7.5
1977	38.8	6.8
1978	39.5	6.8
1979	35.1	7.1
1980	34.1	7.8
1981	36.1	8.4
1982	39.4	7.0
1983	45.1	6.5
1984	48.8	6.9
1985	48.1	8.3
1986	47.7	7.3
1987	44.1	7.7
1988	38.7	9.2
1989	36.3	10.6
1990	32.4	12.7
1991	29.3	16.3
1992	28.9	18.9
1993	27.7	21.7
1994	26.2	22.9
1995	23.7	23.4
1996	23.2	23.1
1997	24.2	23.5
1998	26.6	22.4
1999	25.4	21.4
2000	24.2	21.3

Source: Taiwan Statistical Data Book, 2001

Table 4
Taiwan's commodity trade with United States and Hong Kong (China) (1980-2000)

Unit: US \$1000

Period	U.S.A.			Hong Kong		
	Exports	Imports	Balance	Exports	Imports	Balance
1980	6760300	4673486	+2086814	1550610	249921	+1300689
1981	8163099	4765763	+3397336	1896959	308912	+1588047
1982	8758918	4563266	+4195652	1565348	307398	+1257950
1983	11333713	4646433	+6687280	1643628	298892	+1344736
1984	14867717	5041650	+9826067	2087134	370361	+1716773
1985	14773373	4746273	+10027100	2539718	319677	+2220041
1986	19013878	5432594	+13581284	2921305	378655	+2542650
1987	23684790	7647962	+16036828	4123315	753785	+3369530
1988	23467169	13006725	+10450444	5587070	1922086	+3664984
1989	24036214	12002788	+12033426	7042278	2205206	+4837072
1990	21745853	12611827	+9134026	8556243	1445867	+7110376
1991	22320844	14113788	+8207056	12430520	1946753	+10483767
1992	23571604	15771032	+7800572	15414978	1781388	+13633590
1993	23587325	16722624	+6864701	18452603	1728757	+16723856
1994	24336757	18042642	+6294115	21262326	1532958	+19729368
1995	26407389	20771393	+5635996	26105855	1842873	+24262982
1996	26866357	19971851	+6894506	26787641	1704663	+25082978
1997	29551755	23233847	+6317908	26688053	1996134	+26691919
1998	29376361	19678880	+9697481	24819665	1952346	+22867319
1999	30901521	19693076	+11208445	26012064	2092876	+23919188
2000	34821035	25126729	+9694306	31355917	4774652	+26581265

Source: Taiwan Statistical Data Book, 2001

IV. Economic outlook of U.S, China, and Taiwan

Asian countries have relatively successfully developed their economies. This can be evidenced by the GDP growth rates presented in Table 1. From this table, we found most of the countries, with the exception of Japan, have high GDP growth rates until the 1997 Asian Financial Crisis. After the financial crisis, only Taiwan and the Peoples Republic of China maintained positive growth rates in 1998 and 1999³. However, most of the countries GDP growth rates recovered in 2000.

From June 30, 1999 until May 16, 2000 the Federal Reserve Bank of the United States has raised interest rates six times as indicated in Table 5. The main purpose of this interest rate increase was to cool down the U.S. economic growth and to avoid inflation. During February 1994 to February 1995 the Federal Reserve Bank has had seven interest rate increases as presented in Table 6 to promote a soft landing to the economy. The monetary actions during 1994 and 1995 have successfully made the

economy of the United States soft landing. Unfortunately, the economic conditions faced in 1999-2000 is quite different from those faced during 1994-1995. The main difference between the two periods are: 1) Crude oil prices were lower during the 1994-1995 period in contrast to prices that exceeded \$30 per barrel during the 1999-2000 period and 2) The “new” economy has become much more important for 1999-2000 period than the earlier period.

Table 5
Interest rate increases in the United States (June 1999-February 2000)

Date	Discount Rate	Rate Change
99/6/30	5.00	1 basis point
99/8/24	5.25	1 basis point
99/11/16	5.50	1 basis point
00/2/2	5.75	1 basis point
00/3/21	6.00	1 basis point
00/5/16	6.50	2 basis points

Table 6
Interest rate increases in the United States (February 1994-February 1995)

Rate	Discount Rate	Rate Change
94/2/4	3.25	1 basis point
94/3/22	3.5	1 basis point
94/4/18	3.75	1 basis point
94/5/17	4.25	2 basis points
94/8/26	4.75	2 basis points
94/11/15	5.50	3 basis points
95/2/1	6.00	2 basis points

After the recent Federal Reserve monetary action the U.S. interest rates have exceeded those in both the Asian and European countries. Therefore, the U.S. dollar exchange rate has strengthened relative to the Euro-dollar, Japanese yen and other currencies. As a result, U.S. product exports have declined due to the unfavorable exchange rate effect. Since October 2000, the profits of U.S. corporations have reduced dramatically. After the presidential election, from the beginning of December 2000, profit warnings from large U.S. companies such as Dell, Compaq, Intel, Microsoft, Chase, General Motors, etc. have become common. Therefore, the stock market has been adversely impacted. For example, the NASDAQ index has been down more than

50% from the high's of the year and is approximately down more than 42% on December 31, 2000 from the beginning of the year. Asian stock markets have also been affected by the downturn of the U.S. markets as presented in Table 7.

Table 7
Stock Indexes for Taiwan, New York, Japan, South Korea, London, Hong Kong, Thailand, and Singapore

Year	Taiwan Index	Dow Jones Index	Nikkei Index	South Korea's Kospi Index	London's FTSE Index	Hong Seng Index	Thailand's Set Index	Singapore's Strait Times
1988	5119.11	2168.57	30159.00	907.20	1455.30	2687.44	386.73	1038.62
1989	9624.18	2753.20	38915.87	909.72	1916.60	2836.57	879.19	1481.33
1990	4530.16	2633.70	23848.71	696.11	1673.40	3243.30	612.86	1154.48
1991	4600.67	3168.83	22983.77	610.92	1891.30	4297.33	711.36	1490.70
1992	3377.06	3301.11	16924.95	678.44	2185.20	5512.39	893.42	1524.40
1993	6070.56	3754.09	17417.24	866.18	2559.50	11888.39	1565.12	2425.68
1994	7124.66	3834.44	19723.06	1027.37	3065.50	8191.04	1360.09	2239.56
1995	5173.73	5117.12	19868.15	882.94	3689.30	10073.39	1280.81	2266.54
1996	6933.94	6448.27	19361.35	651.22	4118.50	13451.45	831.57	2216.79
1997	8187.27	7905.25	15258.74	376.31	5135.50	10722.76	372.69	1529.84
1998	6418.43	9181.43	13842.17	562.46	5882.60	10048.58	355.81	1392.73
1999	8448.84	11497.12	18934.34	1028.07	6930.20	16962.10	481.92	2479.58
2000	5544.18	10971.14	14539.60	514.48	6438.40	14895.34	271.84	1976.54

By March 31 this year, the Federal Reserve Bank had reduced the discount rate by 1.5%⁴. Exchange rates and stock markets of Asian countries have been dramatically affected by the decline in the U.S. markets. If the U.S. economy has a hard, instead of soft, landing, then it is likely the Asian Financial Crisis might re-occur in 2002. Therefore, it seems to me to be very important that the Federal Reserve Bank reduces interest rates further as soon as possible. In addition, it might also be helpful for the Bush administration to cut the income tax as he promised in his presidential campaign speeches. If both of these actions were to occur, then the period of the U.S. recession can be shortened and potential financial crisis in Asia can be avoided.

During the last ten years, Asian countries have tried to develop Tokyo, Taipei, Shanghai, Sydney, Seoul, Hong Kong, Singapore, Kuala Lumpur, Bangkok, Jakarta and Manila into either global or regional financial centers. However, the 1997 financial crisis has slowed down this process and has led many of the countries to evaluate how realistic it is for this ambitious goal to be achieved. Most recently the economic slowdown of the U.S. and other Asian countries has made this kind of ambitious policy less feasible. Therefore, I would like to restate my position of Asian country's economic policies. That is, Asian countries, which include China and Taiwan, should first develop their industries and then gradually develop their financial markets. In the

Wealth Magazine (1994), I have recommended a strategy entitled “Industries as Roots and Finance as Leaves” for Taiwan to develop Taipei as a regional financial center.

Overall, from the historical experience and the most recent worldwide economic condition, the economic business outlook for China, Taiwan, and other Asian countries might not be as bright as people expect before the 1997 financial crisis. For the Asian economy to develop more smoothly in the new century, Asian countries should not use short cuts to develop their economy. In other words, they should spend more money on research and development. In addition, Asian countries should avoid the political and military conflicts and spend less money on defense. For example, the potential conflict between North and South Korea, between the People’s Republic of China and Taiwan, between India and Pakistan, between Singapore and Malaysia should be avoided. Finally, both economic policy and financial market reforms should be continually pursued. Then, the Asian economic outlook in the new millennium will be relatively bright. As a final word, it appears to me that most of the Pacific Basin countries have been strongly influenced by the Chinese culture. As a result, politicians and economists in this area frequently posture without taking action. For example, for the last several years, many people have said the 21st century is the Asian century or the 21st century is the Chinese century. This kind of unrealistic statement might damage the future of economies and financial markets for China, Taiwan, and other Asian countries. Therefore, this type of unrealistic statement should be abandoned as soon as possible for Taiwan.

V. Foreign Investment of Taiwan

In this section, the current foreign investment situation and strategies of Taiwan especially the strategy of Taiwan’s investment in China will be discussed in accordance with risk return trade-off principle. In other words, the business, financial, and political risk faced by Taiwanese companies invested in China will be carefully scrutinized. Most foreign investments of Taiwan have been concentrated in south Asian countries and Mainland China. Total foreign investments of Taiwanese companies in south Asian countries and Mainland China are apparently 70% in 1998. Overall, Taiwan’s foreign investments in Asian are ranked only second to Japan. In 1998, Taiwan’s investment in China was only next to Hong Kong and Japan. Both the government and the private sector estimate that Taiwan’s investments in Mainland China might have exceeded 120 billion U.S. dollars. This implied that Taiwan’s investments in China might exceed 50% of its foreign investment. We now analyzed the strategies of Taiwan’s investments in Mainland China in accordance with the risk-return trade-off principle.

As discussed in the previous section, the economic development of China has progressed remarkably in the last 20 years as discussed in section A. Therefore, this is a good opportunity for Taiwanese businessmen to invest in China. Currently, Taiwan’s exports to Hong Kong (China) have exceeded 21% of the total exports (see Table 3). However, it is important for Taiwan’s businessmen and government to assess the risk of investing in China. Now, we analyze the risk from 1) aggregated environmental risk, 2) industrial structure risk, and 3) operating risk and 4) financial risk.

1. Aggregated environmental risk

This kind of risk can be classified into a political risk, economic risk, legal risk and cultural risk. I believe that the first three risks most important for Taiwanese businessmen's investment in China. We now discuss in some detail as follows:

a. Political risk

In international economic and finance, political risk refers to the potential loss of a company investing in foreign countries due to war, change of regime and riot of foreign countries. In addition to these risk, Taiwanese businessmen investing in China face a very unique political risk, which is not faced by other foreign companies investing in China. In other words, other foreign companies investing in China have been protected by a clear international legal investment agreement. However, the Chinese government treats Taiwan as part of China. Therefore, the legal protection enjoyed by Taiwanese companies is next to nothing. Furthermore, the owners of Taiwanese companies investing in China are expected by Chinese government to directly or indirectly influence the Taiwan government to change policies, which politically favor China. Sometimes, they are forced to act to betray the interest of Taiwanese people. This kind of action might be good for an individual company in short-term. However, it frequently will hurt Taiwan as a whole. This kind of risk certainly is an important issue to be studied by academicians, businessmen and government policy makers in Taiwan.

b. Economic risk

Economic risk refers to the potential loss of a company investing foreign countries due to inflation, devaluation of currency, increase of interest rate, and trade condition change. For example, the loss of Singapore's investment in Su-Zhou industrial park and Asia Pulp and Paper Company's (APP) investment in China are two important examples for Taiwanese investors. In accordance with the Wall Street Journal's report entitled "China's Rough Investment Seas Rock APP" [see Wall Street Journal, April 3, 2001, p. 21].

The report can be summarized as follows:

The focus of one of Asia's biggest debt workouts is shifting to China, highlighting once again the risks of underestimating the roadblocks that China's economy can throw at investors. When Asia Pulp & Paper Co. based in Singapore began investing in China in 1994, its goal was to dominate papermaking in a land beset by thousands of outdated and polluting paper mills. The Singapore-based company, controlled by Indonesia's Widjaja family, plowed nearly \$4 billion into modern paper plants and sales offices across China - a spending spree that APP hoped would give it command on one of the world's fastest-growing paper markets.

Today, APP's China dream is unraveling. Nowhere is that more evident than in Zhenjiang, an industrial town outside Shanghai, where APP built its flagship paper plant for China, Gold East paper Co. Inventories at the \$1.8 billion plant are piling up. Workers are being furloughed and senior management is being shuffled. Now, at the

Widjajas scramble to restructure the \$12 billion in debt APP took on to finance its expansion throughout the region, the family might be forced to sell its prized and expensive China ventures.

c. Legal risk

Legal risk refers to the risk due to the change of fiscal and monetary policy, price control, foreign exchange control, trade control and unsound legal system. It is well known that the legal system in China is out of date and still to be improved. The inconsistency of laws of central and local government can cause problems for foreign investors. As mentioned in item (a), Taiwanese companies investments in China are not protected by international law as enjoyed by other foreign companies. This is an additional legal risk faced by Taiwanese companies investing in China.

d. Industrial Structure Risk

This kind of risk refers to the loss due to the change of customer demand and the change of competition structure.

e. Operating Risk

This kind of risk refers to the loss due to sales, manufacturing and human capital.

f. Financial Risk

This kind of risk refers to the loss due to depreciation of currency, cost of capital and taxation.

It should be noted that industrial structure risk, operation risk, and financial risk faced by Taiwanese investors in China might be higher than they expected.

VI. TAIWAN'S ECONOMIC PROSPECTIVE

Taiwan's economic prospects appear brighter this year despite the dramatic plunges in the stock market and investors' fears that the conflict between the Executive and Legislative branches of governments is dragging government performance. Smart investors knew that the stock market's poor performance was caused by the fall in the technology-heavy NASDAQ in New York in 2000. Taiwan's investors closely follow the NASDAQ's performance and often use it to guide them in the buying or selling of shares. Several Taiwan companies in the computing business have close ties with America's technology companies. I believe the future of Taiwan depends on how the Legislative Yuan will be reformed. By the end of March this year, Taiwan's stock market has performed very well in comparison with other markets.

Last year, the opposition alliance instigated a campaign to boot President Chen out of office after the Cabinet decided to abandon the US\$5.4 billion fourth nuclear power plant project. Following a council of Grand Justices' ruling that there were

procedural flaws in the Executive Yuan's decision to halt its construction. Therefore the Executive Yun has decided to restore the project. I think the business community's call for Taiwan to establish direct links with the mainland should be done gradually. We can't do it overnight, I agree that the mainland market has a huge potential, but we also have to weigh the risks of opening direct links with China as discussed in the previous section⁵.

Taiwan opened mini direct links between its frontline islets of Kinmen and Matsu and China's Xiamen and Fuzhou on January 1. Direct transportation between the main island of Taiwan and China however is still banned, a restriction that Taiwan businesses consider a major hurdle to their operations.

President Chen has said he would push for direct links and normalized trade with the mainland after the two join the World Trade Organization later this year. If government follows a realistic economic policy, the economic future of Taiwan will be brighter than most people think.

VII. CONCLUSIONS

In this paper, we first reviewed the economic development of China and Taiwan, then the economic interrelationship among China, U.S. and Taiwan were discussed in some detail. Then economic outlook of U.S., China, and Taiwan has been explored.

To deal with the economic and foreign investment policies faced by Taiwan, we discussed Taiwan's foreign investment in Asia and China in accordance with risk-return trade-off principle. We suggest that Taiwanese government should carefully evaluate the political risk faced by Taiwanese Companies invest in China. Finally, if Taiwan government employs right economic policy to improve the invest environment and upgrade the production technology, then Taiwan's economic future will be bright.

If government of China, U.S., and Taiwan can reasonably cooperate they're economic instead of trying to compete in weapon, then they will contribute to world wide economic growth.

NOTES

1. See Lee (2000) for further discussion
2. In a report by Cheng Few Lee et al (1995) we suggested that the control of capital accounts should not be liberalized immediately.
3. See Brennan and Aranda (1999), and Hunter, Kaufman, and Krueger (1999) for detailed discussion about Asian Financial Crisis
4. The Federal Reserve has cut discount rate .5% on Jan, Jan 30, and March 20 respectively.
5. In Lee (2001), I proposed a strategy for Taiwanese government and business to deal with the economic relationship between Taiwan and China.

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