ECONOMIC ANALYSIS

More on Taiwan as magnet for corporations leaving China:

Not only salary convergence but also sound macro and abundant liquidity

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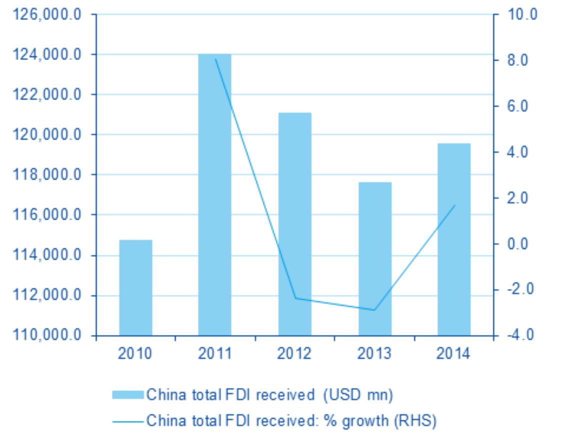
Summary

- As China's manufacturing labor cost continues to rise, companies are moving out of China, especially in the manufacturing and re-exporting processing sectors. We argue that Taiwan could be a good destination for some of the manufacturing-related FDI leaving China, especially the higher-end one.
- In addition to the reasons offered in our recent Asia Flash (March 31, 2015) for Taiwan to become a magnet for corporations leaving China, we review a few more below.
    - Taiwan's wage growth is slowing down while steadily converging with China;
    - Soft and hard infrastructures are solid in Taiwan. Regarding the soft infrastructure, Taiwan is a stable democracy with a sound rule of law. Human capital is also excellent according to OECD PISA standards and the high percentage of university graduates, especially on technical and science fields. On the hard infrastructure, both transportation and logistics facilities are excellent. Let's not forget that Taiwan has long been a major exporting power.
    - Taiwan's macroeconomic situation is sound and the income per capita is high enough to count with a large middle class talent pool as well. Precautionary savings are very high taking pressure of the government in terms of future contingent liabilities.
    - The high saving ratio and home bias have also allowed Taiwan to sit on a huge liquidity pool. Such lax financial conditions should clearly facilitate the funding of foreign corporations' operations in Taiwan.
    - In addition, Taiwan has worked hard to obtain better market access to mainland China. The Economic Cooperation Framework Agreement (ECFA) has increased trade and investment between China and Taiwan by over 250% from 2010 to 2014.
    - Finally, Taiwan is a major foreign investor, especially into China, actually much more than the official statistics really show. In fact, many Taiwanese firms normally circumvented the China approval process through the Ministry of Economic Affairs (MOEA) and registered their FDI projects in Hong Kong, which partially explains the large round-tripping between HK and China. We estimate that around 150 bn USD for Taiwan FDI to China at end-2014, compared with the reading of slightly less than 13 bn USD by MOEA.
- Looking ahead, we expect Taiwan to become more of a magnet of foreign corporations than it has been so far. Of course some black spots exist, which the Taiwanese government should work on, such as oligopolistic behaviour in some sectors and too much government interference. However, we believe these drawbacks are not larger than in most Asian countries, which are also set to attract part of the FDI leaving China.

China is attracting less and less FDI, especially for re-exporting manufacturing industries

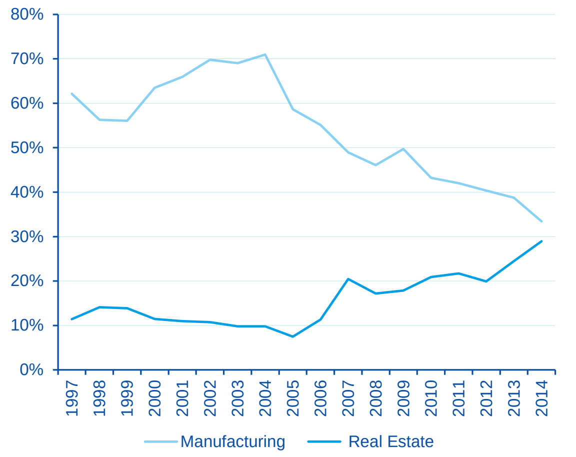
Rapid wage growth, rising land costs and the appreciation of the RMB have all contributed to China decreasing allure to Foreign Direct Investment, especially the one geared towards re-exporting. The recent downward trend in FDI is more pervasive for the manufacturing sector and has started much earlier, nearly a decade ago. At the same time, the share of processed exports to China's total exports to the US and Europe seem to have stalled (Figure 1, 2 and 3).

Figure 1
Foreign manufacturing companies moved out of China, leading to its received FDI decreasing



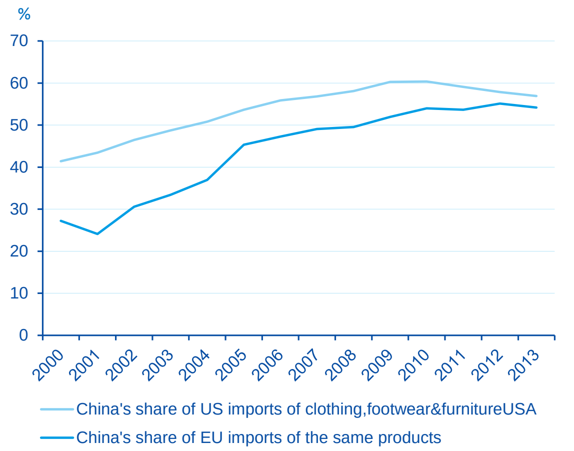
Source: CEIC and BBVA Research

Figure 2
China FDI inflows to the manufacturing sector is decreasing over time



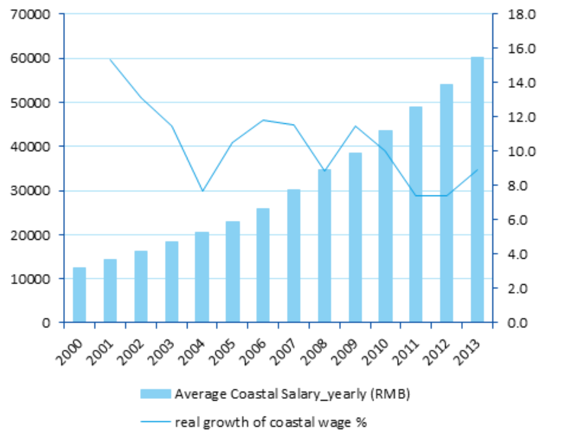
Source: CEIC and BBVA Research

Figure 3
China's share of processing exports has been decreasing as well



Source: CEIC and BBVA Research

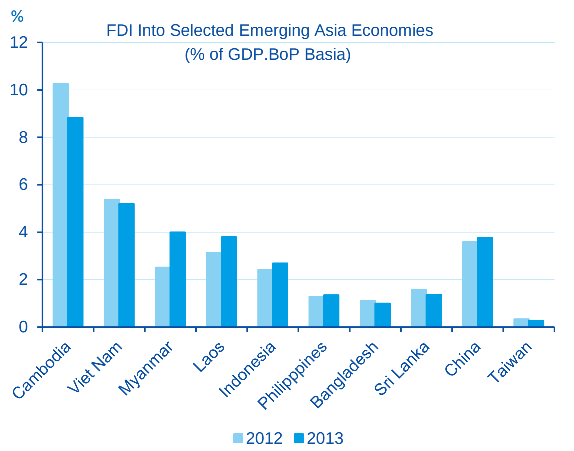
Figure 4
China's coastal province wage has been two-digital increasing over time



Source: CEIC and BBVA Research

As China's manufacturing labor cost continues to rise, many foreign companies are moving out of China (Figure 4). Some firms moved to other ASEAN countries in order to re-export. Some of the target countries have lower wages than China (Figure 5), while others have higher wages but are still attracting FDI. In this sense, Taiwan is a good case in point. There are a number of reasons why one could think of Taiwan as a good FDI magnet for those corporations leaving China. Some reasons have already been reviewed in a previous Asia Flash (published on March 31, 2015), but we would like to offer a more comprehensive picture in this Economic Watch. Taiwan's advantages can be classified in two key groups: first, Taiwan's own characteristics and the second, Taiwan's especial circumstances vis- a –vis China.

Figure 5
FDI into selected Emerging Asian economies



Source: CEIC and BBVA Research

Figure 6
Wages between Taiwan and mainland coastal provinces displays a converging trend

Source: CEIC and BBVA Research

As regards Taiwan's characteristics, the key is that its comparatively low growth rate of wage per capita, its good soft and hard infrastructure, a very sound macroeconomic situation and a huge pool of liquidity which could be invested in new ventures in Taiwan. Below we revise each of them separately.

Wage in Taiwan are converging with that of the coastal provinces of China

The wage of China's coastal provinces is converging with that of Taiwan, although there is still some way to go. China's average wage as a whole and coastal province wage have been increasing significantly over time, indeed at a much faster pace than that of Taiwan. Particularly, average wages in coastal provinces is catching up with Taiwan's average wages, although, the convergence process is still undergoing. (Figure 6)

Taiwan has good soft and hard infrastructure to attract FDI

On the soft infrastructure side, Taiwan has a stable political environment, well-functioning legal framework and high regulatory efficiency. The efficient business environment is facilitated by a competitively low corporate tax rate and the elimination of minimum capital requirements for incorporating a company owned by a non-resident. With no minimum capital required, it takes just simple procedures to incorporate a company. Completing licensing requirements is not time-consuming compared with other countries in Asia.

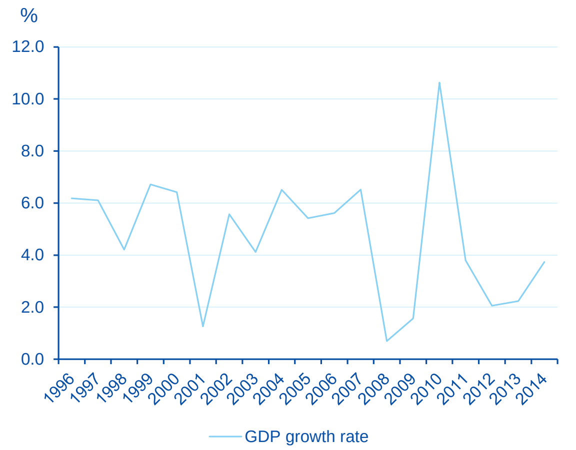
In addition, Taiwan has abundance of skilled labor force and strong R&D capabilities, illustrated by Taiwan's considerable upgrading of the educational qualifications, a sustained and systematic shift in the composition of the labor force from agriculture to manufacturing and services.

From the perspective of hard infrastructure, Taiwan has a considerable industrial and logistic fabric and world class international transportation facilities. Moreover, compared to other neighborhood countries, Taiwan provides quality and inexpensive utilities and telecommunication services, and the internet penetration rate is high.

Taiwan's macro situation is sound and stable

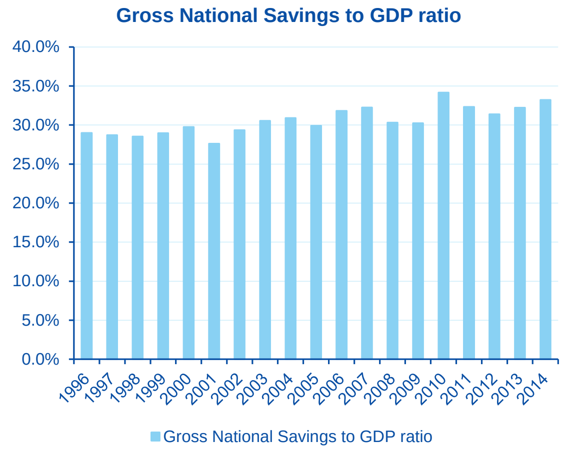
Taiwan is one of the richest countries in Asia. Its sound and stable macro economy provides the fundamental support for FDI into Taiwan. Taiwan's buoyant export growth has benefited from the strengthening global economic growth prospects in 2015 as well as the continuing promotion in advanced technology by semiconductor manufacturing sector and the business opportunities involving the Internet of Things (IOT).

Figure 7
GDP growth rate suggests Taiwan's macroeconomic condition is sound



Source: CEIC and BBVA Research

Figure 8
National saving rate has been around 30% over decades in Taiwan



Source: CEIC and BBVA Research

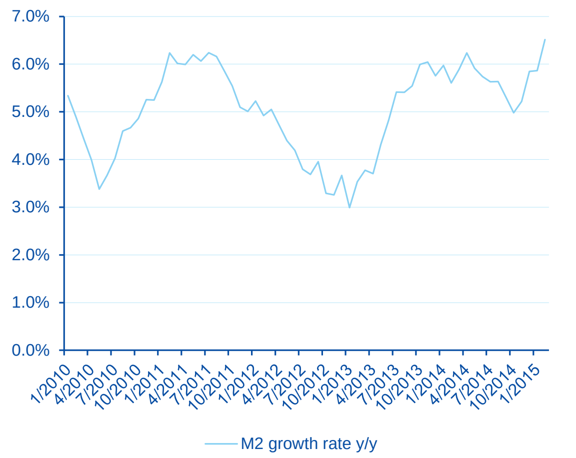
Moreover, Taiwanese economy is flooded with liquidity

Thanks to a very high saving ratio and a very high home bias by which most of the savings tend to stay at home, Taiwanese economy has accumulated ample liquidity which can be deployed for new projects. In that vein, the lax financial conditions should clearly facilitate the funding of foreign corporations' operations in Taiwan.

The nation's excess savings, defined as total savings minus total investments, reached an all-time high of NT$1.48 trillion (US$46 billion) in 2011, according to the Directorate-General of Budget, Accounting and

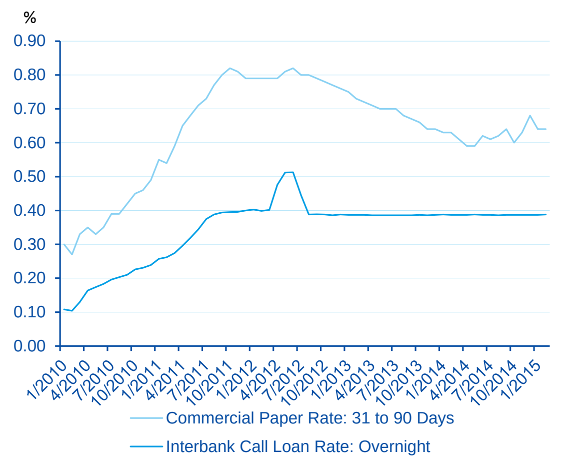
Statistics (DGBAS) in Taiwan, mainly driven by households' very high saving ratio. Moreover, the gross national savings to GDP ratio has kept around 30% in Taiwan for decades of years, indicating an overabundance of funds in the local economy (Figure 8). In that regard, the lcaInterbank overnight call-loan rate stood at 0.387% in January 2015, and commercial paper rate decreased to 0.64%, both reflecting the massively ample liquidity (Figure 10)

Figure 9
M2 growth rate in Taiwan indicates adequate liquidity in the economy



Source: CEIC and BBVA Research

Figure 10
…so does inter-bank rate and short-term bond rate



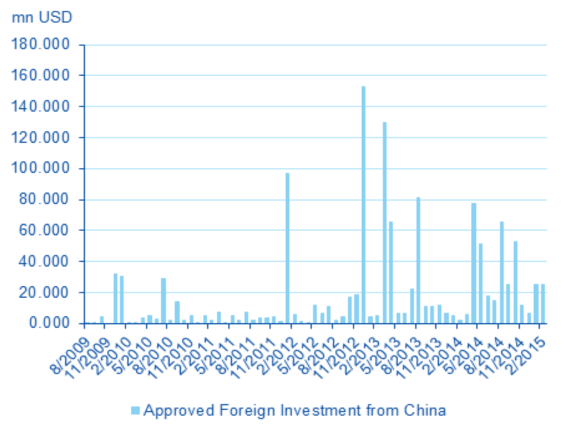
Source: CEIC and BBVA Research

Meanwhile, 2010 ECFA has helped Taiwan to attract mainland FDI

China's FDI to Taiwan has been virtually zero until recently. Except in a handful of cases since 2002, Taiwan did not permit FDI from China, ostensibly on national security grounds. The milestone case is the Economic Cooperation Framework Agreement (ECFA), which is a preferential trade agreement between the governments of mainland China and Taiwan that aims to reduce tariffs and commercial barriers between the two sides. The pact, signed on June 29, 2010, was deemed as the most significant agreement since the two sides split after the Chinese Civil War.

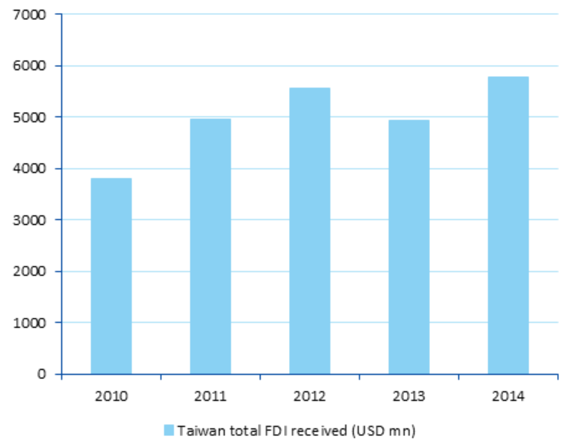
Actually, the 2010 ECFA has had significant effect on China's FDI to Taiwan. The approved FDI from China to Taiwan ballooned in July 2010, immediately after signing the ECFA in June. Moreover, the FDI to Taiwan has more than tripled the 2010's size in 2012, 2013 and 2014, indicating FDI from mainland China to Taiwan has increased significantly after signing the ECFA. Taken together, Taiwan has received around 350 mn USD more FDI from mainland China after 2010 ECFA. (Figure 11)

Figure 11
FDI from mainland to Taiwan has risen significantly after signing 2010 ECFA



Source: CEIC and BBVA Research

Figure 12
Taiwan's FDI received has been steadily increasing over time



Source: CEIC and BBVA Research

Taiwan's FDI into China which could be reshored back is larger than we think

FDI from Taiwan to China was explicitly prohibited until 1992 and still is tightly controlled by Taiwan today. But the reality is that flows have mushroomed for more than two decades, taken Hong Kong as the intermediate jurisdictions.

As with trade statistics, the real extent of FDI flows between China and Taiwan is obscured by the extensive use of third economies as intermediate jurisdictions, such as Hong Kong. The main motivation to use Hong Kong as the third party is because of the policy discrepancies between investing in mainland and in Hong Kong, the latter of which is much easier, set by Taiwan's Ministry of Economic Affairs (MOEA). Thus, Taiwanese firms normally circumvented the China approval process through the MOEA and registered their projects as FDI in Hong Kong. Another solid evidence of this under-reporting by Taiwanese businesses to their home authorities is the stark differences between Taiwan's approved FDI figures to China and the Beijing reported ones. Thus, we believe that the Taiwan's FDI to China has been underestimated significantly.

Actually, many researchers have tried to figure out the actual figures of Taiwan's FDI to mainland China, among which, we adopt the methodology of one of working papers of Peterson Institute for International Economics. Due to the shortcomings of MOEA data, they start with Taiwan's balance of payments data as a reference point. From late 1980s through the 1990s, outbound Taiwan FDI was overwhelmingly focused on China, and they assume that 80-90 percent of annual balance of payments outflows ended up in China. However, more recently, Taiwan firms have diversified into a greater range of markets and segments, thus, the share of China-as-destination is likely to have come down to 60-80 percent of total outflows in recent years. Based on this methodology, they arrive at a range of 130-150 bn USD for total Taiwan FDI to China at year-end 2008, compared with the figure of 10.7 bn USD provided by MOEA. Thus, the statistical discrepancy is around more than 10 times. Following this methodology, the end-2014 estimated amount of FDI from Taiwan to China is 150 bn USD, versus the MOEA's reading 12.9 bn USD.

Examples show that many foreign firms have already moved FDI back to Taiwan…

A lot of evidences show that there have already been many firms moving their FDI back to Taiwan, thus, Taiwan's FDI received has been increasing over time. (Figure 12) As we calculated in the previous section, there is potentially 150 bn USD of FDI from Taiwan to China at end-2014, among which, we estimate that 60-70% of them (around 96-105 bn USD) will reshore to Taiwan.

One good example of companies moving back to Taiwan is Forxconn, a large Taiwanese mobile subcontracting firm, which, starting from 2010, has been reducing the staff in mainland China and moved part of its factories back to Taiwan. The new production in Taiwan will be operated by the automatic producing lines. This move has taken consideration of labor cost increasing in coastal provinces of China even as well as some inland provinces and well as Taiwan's labor force skill set to run automatic production.

- In the same vein, the largest laptop subcontracting company Taiwan Quanta Computer Corp. is planning to move their production lines back to Taiwan. The vise board chairman of Quanta said that the labor cost of mainland would catch up with Taiwan by one year at quickest, while this time span will be further shorten if considering accommodation provided for employees. In addition, they will promote automatic production lines in Taiwan as well.
- INNOLUX Corporation, Taiwan's panel production company, has recently announced it will move 25%-30% of its production lines back to Taiwan, which will help promote the "re-industrialization" of panel industry there.
- Moreover, the largest semi-conduct company ASE Kaohsiung, the largest lens production company LARGAN PRECISION Co., the famous suitcase producing company EMINENT, etc. have moved their mainland production lines back to Taiwan and implemented automatic technology upgrading there.

Looking ahead, we expect Taiwan to become more of a magnet of foreign corporations than it has been so far. Of course some black spots exist, which the Taiwanese government should work on, such as oligopolistic behaviour in some sectors and too much government interference. However, we believe these drawbacks are not larger than in most Asian countries, thus it should not really prevent investment coming to Taiwan.

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