Prospects for Taiwan's Outward Investment in China

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Abstract

The similarities in language and culture have given Taiwanese companies an edge in employing ethnic ties through personal connections or “*guanxi*” to overcome competitive and resource disadvantages. Such relational linkages facilitate Taiwanese investment in China. Since Taiwan has orchestrated a very efficient production network to serve its customers, cross-strait investment and trading activities have driven the formation of close collaborative relationships between Taiwanese and Chinese industries. China is now developing its domestic market to promote economic growth. This is bound to affect cross-strait industrial division of labor, which is not only accelerating the localization of Taiwan businessmen in the Mainland, but also further weakening the connections between Taiwanese businessmen and their parent companies in Taiwan. In the financial sector, Taiwanese banks would do well to find their own niche markets and formulate appropriate strategies, instead of following the practices of large international banks.

Keywords: Taiwan’s outward investment in China; global supply chain; business strategies; globalization

JEL Classification Nos: F15, F21, F23

1. Introduction

With the continuing trend towards economic globalization, more and more business enterprises have been investing overseas to improve their growth and earnings performance. These firms may be seeking to secure access to natural resources, mature technology, or a large market. In the early stages, small and medium-sized enterprises (SMEs) constituted the bulk of Taiwanese companies going overseas. Unlike Western multinational companies (MNCs), these SMEs do not possess strong firm-specific, such as technological or marketing, capabilities (Chen and Ku 2002).

Taiwanese investment in China is motivated chiefly by cheap production factors, low-cost labour, in particular. Taiwan-based companies began their overture to the China market in 1983. The relaxation of restrictions on Taiwanese citizens visiting relatives in China in 1987 triggered a massive wave of investment. Since the 1990s, China has figured strongly as a destination for Taiwanese overseas investment. With China emerging as both a production network and a final export market for the East Asian region, China-Taiwan trade and investment have surged. Cross-strait economic and trade activities are continuously on the rise, as is Taiwan's dependence on China's imports and exports.

With cross-Strait economic and financial cooperation becoming increasingly critical and distinctive, the two sides have sought to normalize cross-Strait economic relations and establish a framework for institutionalized economic cooperation. On 29 June 2010, Taiwan signed with China, the Economic Cooperation Framework Agreement (ECFA). Which came into effect on 12 September 2010. As ECFA is only a framework agreement, its provisions that have produced an immediate benefit in terms of tariff reductions are namely the "Early Harvest" provisions.

The Early Harvest items that became effective on 1 January 2011 involved only 539 product items, or around 6% of all tariff items, which China undertook to reduce tariff rates on imports from Taiwan. In 2011, Taiwanese exports to China of these Early Harvest items accounted for 16% of Taiwan's total exports to China, or a growth rate of 9.88%, compared to 8% for Taiwanese exports to China as a whole. In return, Taiwan undertook to reduce tariff rates for 267 Early Harvest items for its import of China products.

As of 2011, Chinese exports to Taiwan of these Early Harvest items accounted for 11.7% of China's total exports to Taiwan, or a growth rate of 27.56%, compared to a growth rate of 21.26% for Chinese exports to Taiwan as a whole. These data show that the tariff reductions have helped to boost trade in both Taiwan and China, but impact has been minimal.

Taiwan is a small and open economy, that has become more open and liberalized due to the effect of globalization. The expansion of foreign direct investment (FDI) from the emerging economies turned out to be a salient feature of globalization beginning in the early 1980s. The Democratic Progressive Party's (DPP) landslide victories in both the 16 January 2016 presidential and legislative elections have profound effects on the path of Taiwan's economic development and cross-Strait economic relations.

Therefore, this study uses the case study of Taiwan to explore the prospects for Taiwan's outward investment in China. The remainder of this paper is organized as follows. The next section presents the changing investment patters of Taiwan-based companies. The third section described the evolution of Taiwan's government regulations on investment in China. The fourth section described business strategies used by Taiwanese businessmen in China. The fifth section presents new division of labor model for Taiwan-based companies. The sixth section presents the operation of Taiwanese banks in China, and the final section presents the conclusion drawn from this study.

2. Changing Investment Pattern

The Chinese business community functions in a relationship context, with business networks and social ties playing a crucial role in China (Chen and Chen 1998). As Taiwan and China share similarities in language and culture, Taiwanese companies can use their ethnic ties through personal connections or "*guanxi*" to overcome competitive and resource disadvantages (Tseng Kuo 2008; Jean, Tan and Sinkovics 2011). Such relational linkages further facilitate Taiwanese investment in China.

Economic relations between Taiwan and China have developed rapidly. According to statistics compiled by Taiwan's Investment Commission, Ministry of Economic Affairs, from 1991 to March 2016, the Taiwanese government had granted approval for a total of 41,766 Taiwanese investment projects in China, involving a combined total of US$157,573.4 million in Taiwanese investment.

As shown in Table 1, China is the main recipient of Taiwan's overseas investment, accounting for around 61.4% of the total. In particular, there has been a marked increase in investment by large enterprises, and the structure of Taiwanese business operations in China has shifted towards the electronics and electrical appliance industries. Owing to the geographical proximity of the China market and contract manufacturing, peaceful cross-Strait development will have a significant impact on economic growth in Taiwan as it facilitates regional economic integration.

Table 1 Taiwan's Approved Outward Investment by Country

Unit：US$ million, %

Period	2013			2014			2015			1991 to March 2016 Accumulated		
Country	Cases	Amount	Per cent	Cases	Amount	Per cent	Cases	Amount	Per cent	Cases	Amount	Per cent
China	554	9,190.1	63.7	497	10,276.6	58.5	427	10,965.5	50.5	41,766	157,573.4	61.1
British Caribbean	69	233.1	1.6	99	3,084.0	17.6	80	2,897.5	13.3	2,337	32,107.9	12.4
USA	67	416.0	2.9	83	282.3	1.6	53	362.5	1.7	5,057	12,970.7	5.0
Singapore	10	158.3	1.1	17	136.8	0.8	19	230.0	1.1	514	11,024.4	4.3
Vietnam	25	1,736.5	1.2	12	646.5	3.7	22	1,227.5	5.7	516	8,159.0	3.2
HK	42	316.4	2.2	76	423.4	2.4	70	492.1	2.3	1,407	5,399.4	2.1
Japan	25	170.5	1.2	50	680.0	3.9	35	303.8	1.4	669	3,869.7	1.5
UK	2	14.3	0.1	4	651.5	3.7	10	1,699.8	7.8	179	2,925.6	1.1
Thailand	9	78.3	0.5	22	82.8	0.5	15	774.9	3.6	352	2,751.1	1.1
Malaysia	9	103.4	0.7	18	31.8	0.2	11	103.6	0.5	31	2,401.0	0.9
Australia	3	1,241.3	8.6	7	177.4	1.0	1	9.7	0.0	79	1,987.4	0.8
Samoa	18	40.4	0.3	26	118.1	0.7	26	48.4	0.2	500	1,573.1	0.6
Philippines	10	58.9	0.4	3	40.9	0.2	3	644.3	3.0	149	1,380.1	0.5
South Korea	14	61.0	0.4	7	171.2	1.0	15	336.1	1.5	199	1,240.4	0.5
Indonesia	6	28.5	0.2	13	116.7	0.7	10	404.8	1.9	211	1,119.4	0.4
Canada	0	0.6	0.004	3	7.7	0.04	2	1.0	0.0	81	413.8	0.2
Germany	8	10.7	0.1	4	32.8	0.2	12	77.0	0.4	178	307.0	0.1
Others	56	564.2	3.9	49	609.9	3.5	78	1,132.3	5.2	1,612	10,857.7	4.2
Total	927	14,422.4	100.0	990	17,570.3	100.0	889	21,710.7	100	55,837	258,060.9	100

Notes: 1. The figures may not add up to the total due to rounding.
2. Up-to-date investment amount based on amount accumulated.
Source: Investment Commission, MOEA, Taiwan.

As of the end of 2015, a total of 1,170 Taiwanese listed companies had invested in China, accounting for 77.23% of all 1,515 companies traded on the Taiwan Stock Exchange (stock market) and the Taipei Exchange (over-the-counter market).

In 2015, due to China's economic slowdown, investment income from China totaled NT$206.7 billion, down by NT$70 billion since 2014. The accumulated China-bound funds reached NT$2.149 trillion in 2015 (Financial Supervisory Commission 2016). Indeed, avoiding the Chinese market or giving up on it is not beneficial for Taiwanese enterprises or Taiwan's economic development in general.

Table 2 shows that from 1991 to April 2016, the bulk of Taiwanese investment was concentrated in the southeastern coastal region stretching from the Pearl River (Zhujiang) Delta up to the Yangtze River (Changjiang) Delta region that includes Shanghai, southern Jiangsu and northern Zhejiang (Yang and Hsia 2007), as well as the Bohai Gulf region (including Beijing and Tianjin).

The spatial distribution of Taiwanese investment has primarily been focused on the eastern China region, with Jiangsu (31.5%), Guangdong (18.9%), Shanghai (15.3%), Fujian (7.4%) and Zhejiang (6.23%) as the top five regions in terms of Taiwanese investment. This market concentration is partly due to the geographical advantages of these regions and the opportunities presented for Taiwanese companies to develop and penetrate the Chinese domestic market.

As Taiwanese firms investing in China increasingly go as part of a "central hub-satellite" system in which several connected enterprises establish themselves in China together, this agglomeration effect has stimulated the formation of new industry clusters and comprehensive industry value chains that integrate upstream, midstream and downstream operations.

Although Taiwan-based companies in China are, for the most part, still producing mainly for export, there is a growing tendency for various activities to be localized. Localization is most pronounced in the area of human resources, but there has also been a significant degree of localization in the sourcing of raw materials and components, sales channels, funding sources, marketing activities and the like.

Since Taiwan has orchestrated a very efficient production network to serve its customers, cross-strait investment and trading activities have driven the formation of close collaborative relationships between Taiwanese and Chinese industries. Both cross-strait service trade agreements and goods trade agreements will further enhance this trend.

Table 2 Taiwan's Approved Investments in China by Area

Unit: US$ million, %

Period	2013			2014			2015			1991 to April 2016 Accumulated		
Area	Cases	Amount	Per cent	Cases	Amount	Per cent	Cases	Amount	Per cent	Cases	Amount	Per cent
Jiangsu	125	2,310.9	25.1	132	2,457.9	23.9	92	2,288.7	20.9	6,879	49,782.4	31.5
Guangdong	126	1,478.5	16.1	75	1,161.0	11.3	81	1,469.7	13.4	12,929	29,950.1	18.9
Shanghai	97	2,392.8	26.0	90	1,352.7	13.2	63	1,286.9	11.7	5,878	24,226.0	15.3
Fujian	42	573.6	6.2	49	1,891.4	18.4	30	850.4	7.8	5,655	12,263.3	7.8
Zhejiang	46	425.8	4.6	33	463.3	4.5	34	659.3	6.0	2,218	9,729.0	6.2
Sichuan	12	256.7	2.8	11	769	7.5	17	75.0	0.7	509	3,851.5	2.4
Shandong	14	176.2	1.9	11	283.4	2.8	11	915.5	8.3	1,051	4,224.6	2.7
Beijing	23	176.2	1.9	22	139.2	1.4	22	1,428.2	13.0	1,306	4,130.0	2.6
Tianjin	8	126.8	1.4	9	95.7	0.9	10	151.5	1.4	954	2,825.7	1.8
Chongqing	6	156.9	1.7	9	185.3	1.8	7	57.2	0.5	287	2,290.5	1.4
Hupei	12	239.7	2.6	8	250.3	2.4	18	218.7	2.0	603	2,139.9	1.4
Henan	7	378.8	4.1	8	408.8	4.0	3	161.3	1.5	291	1,571.7	1.0
Jiangxi	6	49.7	0.5	7	146	1.4	5	64.5	0.6	282	1,164.2	0.7
Hebei	2	23.1	0.3	4	34.7	0.3	3	38.5	0.4	339	971.8	0.6
Hunan	2	19.8	0.2	2	20.3	0.2	2	179.0	1.6	339	819.7	0.5
Jilin	4	56.3	0.6	4	45.9	0.4	1	131.2	1.2	101	350.3	0.2
Others	22	348.3	3.8	23	571.8	5.6	28	989.9	9.0	2,170	7,824.4	4.9
Total	554	9,190.1	100.0	497	10,276.6	100.0	427	10,965.5	100	41,791	158,115.0	100

Notes: 1. Figures include lagged reports and approvals.
2. The figures may not add up to the total due to rounding.
3. Up-to-date investment amount based on the amount accumulated.
Source: Investment Commission, MOEA, Taiwan.

Nevertheless, following President Tsai Ing-wen's assumption of office in May 2016, China has been dissatisfied with Tsai's dodging of the one-China policy and has suspended the communication mechanism with Taiwan. This suspension will hinder the progress of the goods trade agreement. The possible economic pressure from China will certainly not help Taiwan's economic outlook due to the cooling of cross-Strait relations.

China is currently adopting a "new normal" approach to rebalance its economy towards greater dependence on consumption as the driving force behind sustainable growth (Wong 2014a, 2014b). This approach is bound to affect the cross-strait industrial division of labor, which is not only accelerating the localization of Taiwan businessmen in the Mainland, but also further weakening the linkages between Taiwan businessmen and their parent companies in Taiwan. In a nutshell, in response to China's "new normal" of economic growth, Taiwanese businessmen would do well to change their operating strategy from focusing on defensive and export-oriented investment to gearing towards market-expanding investment.

3. Removing the Investment Cap

Since Taiwan-based companies have intensively invested in China, the government is concerned that such investments may involve the transfer of too much technology and capital to China, thereby hampering Taiwan's long-run technological competitiveness or causing Taiwanese manufacturing to hollow out.

To avoid becoming economically over-dependent on China, on 7 November 2001, Taiwan introduced a "proactive liberalization with effective management" policy, which restricted Taiwanese investments in China to 40% of a company's net worth. China is the only country affected by the Taiwanese government's investment restrictions.

The government's politically motivated restrictions on investment in China are inconsistent with a company's objective of profit maximization. The 40% rule has shaped the competitive environment in which Taiwan's companies operate and such companies have usually responded to the restriction by developing new strategies (Boddewyn and Brewer 1994; Globerman and Shapiro 1999).

Taiwanese investors have gone around the government's restrictions by channeling investments via British Virgin Islands, Cayman Islands, Panama and Hong Kong to China. Moreover, income-increasing earnings management has been used to circumvent the government's investment restrictions, thereby enabling companies to expand their investments in China (Duh, Hsu and Leung 2015).

Cross-strait relations have improved significantly since former President Ma Ying-jeou took office in 2008. In August 2008, the Taiwan government increased the annual ceiling on an individual's investment in China from US$2.5 million to US$5 million. The ceiling for SMEs was set at either NT$80 million or 60% of the investing company's net worth, whichever is higher. The investment ceiling for large companies was raised to 60% of its net worth. Under the new rule, Taiwan's 577 largest companies, including food producer (Uni-President Enterprises Co.), chip giant (Taiwan Semiconductor Manufacturing Co.) and bicycle maker (Giant Manufacturing Co.), can invest as much as 60% of their net worth in China.

4. Adjusting Business Strategies

In recent years, the protectionist restrictions to China's domestic market have gradually been relaxed and the legal framework for business operations in China has become more transparent. Taiwanese firms hence find enormous market potential in the China market as their Taiwanese knowledge of the Chinese market and their experiences of operating in this market have increased.

As a result, the importance that Taiwanese electronics firms attach to the China market has grown steadily and so have their ambitions for developing the market. As the overall business environment has changed, Taiwanese companies are adopting different business models in response.

The availability of cheap labor and the opportunity to gain access to China's domestic market continue to be the most important factors driving Taiwanese electronics manufacturers' investment in China. Due to rising wages, China's labor is no longer as big an attraction as it once was and Taiwanese companies are starting to divert their investments to business areas that are less labor-intensive.

Since China's low-cost advantages could be replaced by other countries such as ASEAN, Taiwan-based companies in China have also set up subsidiaries in these countries (i.e., Malaysia and Vietnam), leading to an increase in intra-firm trade between these subsidiaries. They produce upstream products in China and ship them to ASEAN countries to support their downstream operations (Chen 2013).

Investing in China can evidently help manufacturers increase their competitive advantage, enjoy economies of scale, establish and leverage relationships with local Chinese companies, strengthen their position in the Chinese domestic market and develop new marketing channels. Developing the Chinese domestic market, rather than focusing on costs, is now the key issue. In spite of the 33% corporate tax rate on domestic enterprises and the 15% tax rate on foreign-invested enterprises (increased to 25% for both since 2008), tax incentives do not appear to be an important motivating factor, while the need to conform to customers' requirements and the desire to retain existing customers have become more significant.

Furthermore, on 9 December 2014, China's State Council issued the *Notice Regarding Cleaning-up and Regulating Various Taxes and Other Preferential Policies* (Guofa [2014] No. 62) to instruct all local governments to remove their preferential policies for investment (i.e., tax incentives) in order to set up a united investment administration system for the central government. Some of these preferential policies had led to local protectionism and unfair competition. Local governments were required to take appropriate action by 31 March 2015.

As can be seen from Table 3, from 1991 to April 2016, electronic parts and component manufacturing was ranked first (18.6%) in terms of total amount invested in China, followed by computers, electronic and optical products manufacturing (13.3%), finance and insurance (7.4%), electronic equipment manufacturing (6.7%), wholesale and retail trade (6.3%) and non-metallic mineral products manufacturing (4.5%).

Investment by the Taiwanese electronics industry in China has been heavily concentrated in the Yangtze River (Changjiang) Delta region such as in Shanghai, Kunshan and Suzhou and in the Pearl River (Zhujiang) Delta region such as in Shenzhen and Dongguan. This is because of not only the geographical advantages of these regions, but also the desire to develop the Chinese domestic market.

Taiwan's electronics manufacturers do not enjoy a significant advantage in the area of technology; they do not control core technologies, and neither do they enjoy the benefits that a global brand would bestow (Fuller, Akinwade and Sodini 2003). Basically, Taiwan is a contract manufacturing center. While Taiwanese enterprises are good at processing, they are weak in marketing and branding. The Chinese market is like a home market for Taiwanese companies and its business opportunities can help Taiwanese companies improve on these two weak areas.

Table 3 Taiwan's Approved Investment in China by Industry

Unit：US$ million, %

Period	2013			2014			2015			1991 to April 2016 Accumulated		
Industry	Cases	Amount	Per cent	Cases	Amount	Per cent	Cases	Amount	Per cent	Cases	Amount	Per cent
Electronic Parts and Components Manufacturing	45	1,026.7	11.2	61	1,613.0	15.7	54	1,231.5	11.2	2,879	29,415.1	18.6
Computers, Electronic and Optical Products Manufacturing	18	1,174.7	12.8	21	1,330.2	12.9	16	1,107.9	10.1	2,837	21,068.0	13.3
Electrical Equipment Manufacturing	31	460.1	5.0	23	300.7	2.9	16	492.7	4.5	3,160	10,608.7	6.7
Wholesale and Retail Trade	151	1,035.9	11.3	113	1,095.6	10.7	116	679.9	6.2	3,001	9,886.6	6.3
Finance and Insurance	20	1,901.0	20.7	33	1,659.0	16.1	24	2,785.9	25.4	349	11,651.5	7.4
Fabricated Metal Products Manufacturing	13	168.9	1.8	12	220.4	2.1	8	363.3	3.3	2,639	6,622.6	4.2
Non-metallic Mineral Products Manufacturing	10	190.4	2.1	8	683.3	6.6	3	1,007.2	9.2	1,612	7,045.5	4.5
Machinery and Equipment Manufacturing	20	314.9	3.4	28	317.8	3.1	13	258.6	2.4	2,090	6,043.3	3.8
Plastic Products Manufacturing	17	186.4	2.0	8	107.6	1.0	16	216.4	2.0	2,408	5,698.0	3.6
Basic Metal Manufacturing	8	310.5	3.4	6	393.8	3.8	3	330.2	3.0	698	4,128.3	2.6
Real Estate	9	289.3	3.1	12	325.3	3.2	1	319.5	2.9	202	4,140.8	2.6
Food Manufacturing	10	125.9	1.4	14	135.0	1.3	6	52.2	0.5	2,379	3,197.4	2.0
Motor Vehicles and Parts Manufacturing	10	152.5	1.7	11	203.2	2.0	21	217.6	2.0	696	2,737.5	1.7
Information and Communication	21	222.9	2.4	26	113.3	1.1	12	116.5	1.1	957	2,333.2	1.5
Professional, Scientific and Technical Services	39	163.4	1.8	42	209.9	2.0	41	264.0	2.4	776	1,929.8	1.2
Leather, Fur and Related Products Manufacturing	8	69.1	0.8	3	47.9	0.5	3	43.1	0.4	1,536	1,536.6	1.0
Others	124	1,397.3	15.2	76	1,520.5	14.8	74	1,208.9	11.0	13,572	30,072.1	19.0
Total	554	9,190.1	100.0	497	10,276.6	100.0	427	10,965.5	100.0	41,791	158,115.0	100.0

Notes: 1. Figures include lagged reports and approvals. 2. An approved case number of 0 indicates the capital-raising of a past case, and therefore only the amount of investment is indicated while the number of cases is not. 3. Financial holding companies have been calculated as part of the finance and insurance sector from January 2013. 4. Up-to-date investment amount based on amount accumulated.

Source: Investment Commission, MOEA, Taiwan.

Nevertheless, Taiwanese electronics firms do possess strong management and coordination capabilities, first-rate product planning capabilities and the advantage that comes with easy market access. They have close relationships with leading international information technology (IT) and electronics vendors, and benefit from comprehensive trans-national information and communications networks that give them the capability to integrate product development and business management.

5. New Division of Labor Mode

Technological progress has long been regarded as a critical ingredient for achieving sustained economic growth. Companies with core competencies in manufacturing and processing technology have an advantage in using research and development (R&D) to increase their production technology thanks to their technological skills and experience.

In order to attract producers and manufacturers in heavy and basic industries to China and to raise the level of China's R&D in science and technology, China encourages the use of foreign resources in the establishment of R&D organizations and centers and grants foreign companies income tax incentives. As a result, substantial numbers of MNCs such as IBM, Microsoft, Motorola, Intel and Nokia have set up over 1,800 R&D centers in China.

Taiwanese and Chinese companies have different focuses in terms of R&D. Chinese companies are stronger in basic R&D, whereas Taiwanese companies are stronger in the R&D of market applications. On the other hand, Taiwanese companies are better than Chinese companies in terms of the product application development stage and see technology as being central to their competitiveness in the production of their products. This will give Taiwanese companies an advantage compared to that of the Chinese companies (Liu and Chen 2012).

Taiwan's manufacturers of electrical and electronic goods top Taiwanese industries in China. Manufacturers of electronic goods have already established R&D centers, IC design centers and software development bases in China. They include Inventec, Acer (Shanghai and Guangdong), Quanta (Shanghai), FIC (First International Computer) (Shanghai), ASE (Advanced Semiconductor Engineering) (Shanghai), Asus, BenQ, Arima (Suzhou and surrounding areas), Foxconn (Tianjin), Macronix and Unitech Printed Circuit Board. To boost its production of smartphones and tablet computers, Taiwan's leading personal computer maker, Acer, spent US$4 million to set up a global R&D center in Chongqing in 2011.

The setting up of R&D organizations in China is to take advantage of China's trained professionals with low wages in the high-technology area. Taiwanese firms may also benefit from China's leapfrogging potential in specific areas, such as software. China also has enormous inherent market potential, particularly in areas such as communications (Yang and Hayakawa 2015).

However, with more multinational businesses setting up R&D organizations in China, the level of China's industrial technology will definitely rise and the international competitiveness of China's products will be enhanced. Chinese products are thus likely to replace Taiwanese products in the international market, especially in the case of middle- and high-end technology products.

The setting up of R&D and manufacturing organizations in China will also entice processing manufacturers and component suppliers from around the globe to invest in and move to China, especially now that China is the largest manufacturer and exporter of IT products in the world.

The manufacturing links of the IT industry between Taiwan and China are remarkable. For example, more than 85% of the monitors produced for the world's desktop computers and more than 90% of all laptop computers are made by Taiwan-based companies in China (Knowledge@Wharton 2016).

The new industrial linkages between Taiwan and China combine both competition and cooperation. For example, the cooperation between Taiwanese chip designer MediaTek and Chinese handset maker Xiaomi is an integration of Taiwanese technology with China's mass market. MediaTeck is the 10th largest semiconductor brand supplier in the world and Xiaomi is the world's third-largest smartphone vendor after Apple and Samsung.

In November 2014, MediaTek signed an agreement to invest RMB300 million (US$48.9 million) in a Chinese government fund initiated by the Shanghai city government and Chinese venture capital firm – Summitview Capital.

6. The Operation of Taiwanese Banks in China

As a result of the signing of the Memorandum of Understanding (MOU) between China and Taiwan and the ongoing negotiations related to the supplementary agreement of the Economic Cooperation Framework Agreement (ECFA), cross-strait relations have improved since 2009. Since the MOU took effect on 16 January 2010, Taiwanese banks have been expected to establish more branches in China, further enhancing the integration of financial markets between Taiwan and China.

As shown in Table 4, as of June 2016, 14 Taiwanese banks were operating 26 branches, 12 sub-branches and two subsidiaries in China. They are located mostly in well-developed coastal cities such as Tianjin, Shanghai, Kunshan, Suzhou, Nanjing, Shenzhen and Dongguan.

In 2014, the net profit of Taiwan-based banks in China jumped to NT$5.2 billion, an 88% increase from 2013. Due to China's economic slowdown, for the January–May 2016 period, this figure fell to only NT$870 million compared to NT$1,890 million for the same period in 2015.

Taiwanese banks may draw valuable lessons from their overseas experience to develop their own niche markets and formulate appropriate strategies. Although Taiwanese banks may not be able to compete with international banks in terms of the scale of their operations, they have advantages related to their cultural and geographical proximity (Ball and Tschoegl 1982; Grosse and Goldberg 1991).

With the ongoing financial deregulation that has presented Taiwanese banks with new business opportunities, most Taiwanese banks are already eyeing the Chinese financial market as the next main area to expand their business operations.[1] The rapid increase in trade and investment flows between Taiwan and China offers significant growth potential to corporate banking services.

Since foreign financial institutions have already been active in China and their scales of operations are relatively large compared to those of Taiwanese financial institutions, Taiwanese banks would need to adopt optimal strategies when entering China's market.

[1] A foreign bank must have maintained a representative office in China for at least two years before it could apply to set up a branch.

Table 4 The Status of Taiwanese Banks in China, June 2016

Bank	Branch (Sub-Branch), Subsidiary: Opened	Branch (Sub-Branch), Subsidiary: Approved	Representative Office
First Bank	Shanghai branch Chengdu branch Shanghai Pilot Free Trade Zone Sub-branch Xiamen branch	12 village banks in Henan province	—
Cathay United Bank	Shanghai branch Shanghai Minhang Sub-branch Shanghai Pilot Free Trade Zone Sub-branch Shanghai Jiading Sub-branch Qingdao branch	Shanghai subsidiary Shenzhen branch Xiamen branch	—
Chang Hwa Bank	Kunshan branch Kunshan Huaqiao Sub-branch Dongguan branch Fuzhou branch	Nanjing subsidiary	—
Land Bank	Shanghai branch Tianjin branch Wuhan branch		—
Taiwan Cooperative Bank	Suzhou branch Suzhou New District Sub-branch Tianjin branch Fuzhou branch	Changsha branch	Beijing Representative Office
Hua Nan Bank	Shenzhen branch Shenzhen Baoan Sub-branch Shanghai branch Fuzhou branch		—
CTBC Bank	Shanghai branch Guangzhoub Shanghai Pilot Free Trade Zone Sub-Branch	Xiamen branch CTBC Bank International (subsidiary) Shanghai Hongqiao sub-branch	Beijing Representative Office
Mega International Commercial Bank	Suzhou branch Suzhou Wujiang Sub-branch Ningbo branch Suzhou Kunshan Sub-branch		—
Bank of Taiwan	Shanghai branch Shanghai Jiading Sub-branch Guangzhou branch Fuzhou branch	Shanghai Pilot Free Trade Zone Sub-branch	—
E. Sun Bank	Shenzhen subsidiary (branch) Dongguan branch Dongguan Changan Sub-branch		—
Taiwan Business Bank	Shanghai branch Wuhan branch		—
Bank SinoPac	Bank SinoPac (China) / (Nanjing, subsidiary)	—	—
Taipei Fubon Bank	Fubon Bank (China)/(subsidiary)	—	—
Industrial Bank of Taiwan	—	—	Tianjin Representative Office

Source: Banking Bureau, Financial Supervisory Commission, Taiwan.

As China's four state-owned banks account for around 60% of the market share, foreign banks that are not sufficiently large in terms of their assets would find it hard to compete in China's market. However, driven by smaller profit margins and intense competition at home, more Taiwanese financial institutions are still likely to take the challenge head-on in China.

These smaller Taiwanese banks however have one advantage, that is, their link to Asian banks. Asian banks are more likely to survive in China rather than non-Asian banks (Leung, Rigby and Young 2003). The cultural and geographical proximity generates savings in information and other transactions costs such as those related to negotiations, bargaining and monitoring for business ventures operating in China (Leung and Young 2005).

Given the large number of Taiwanese businesses in China and their preference for Taiwanese banks instead of Chinese banks, Taiwanese banks entering the Chinese market would do well to locate their branches near to where Taiwanese businesses are mostly located.

Meanwhile, many Taiwan-based banks have aggressively expanded their business operations in China, which in turn has resulted in an increase in China-related credit exposure. Taiwan's Financial Supervisory Commission has therefore raised the general provision requirement for China-related credit to 1.5% to maintain a robust financial market.

For foreign banks, to set themselves apart from their Chinese competitors, foreign banks tend to focus more on their non-traditional business. The strict regulatory licensing requirements have constrained foreign banks' ability to innovate as evidenced by their slightly decreasing and lower profitability. These banks are waiting to see how regulatory changes would play out. In particular, those with higher capital adequacy ratios and larger capacity for risks see the potential of reaping long-term profits as China's financial market evolves.

The road ahead for Taiwanese banks in China is thus bumpy and uncertain. Only Taiwanese banks which are prepared for the prudent growth, limited profit contribution and manageable risks are likely to survive the competition in China in the next few years.

7. Conclusions

Meanwhile, Chinese suppliers are gaining a strong foothold in their fast-growing domestic market and drastically altering the industry supply chains. They are also increasingly replacing their

Taiwanese counterparts in the global supply chain. However, China's economic growth fell to a twenty-six-year low of 6.7% in 2016. China's economic slowdown is likely to impose a substantial impact on the Taiwan economy due to the strong linkages between investment, trade and finance.

The recent expansion of production networks in China has led to a wave of overseas production where Taiwan-based companies receive export orders at home and produce them overseas. Meanwhile, Taiwanese companies' increased overseas production has upped unemployment among domestic lower-skilled workers.

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