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ASIA PROGRAM



Woodrow Wilson
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Cross-Strait Economic Ties: Agent of Change, or a Trojan Horse?

ABSTRACT: This Special Report discusses both opportunities and challenges of cross-Taiwan Strait economic ties for domestic economic developments in China and Taiwan as well as their bilateral relationship. Ramon H. Myers of the Hoover Institution argues that Taiwan will gain economically, build friendship and trust, and pave the way for a long-term solution of the divided-China issue by engaging China. Terry Cooke of the Foreign Policy Research Institute maintains that economic globalization will bring about regional stability and reduce military and political tension across the Taiwan Strait. Tun-jen Cheng of the College of William and Mary suggests that the principal hazard for Taiwan because of the concentration of Taiwan's trade with and investment in China is recession or currency fluctuation on the mainland. While the three essays agree that Beijing is unlikely to use Taiwan's economic dependence on the mainland to coerce Taiwan politically, they differ on whether the growing cross-Strait economic ties will necessarily bring about economic benefits to Taiwan.

Introduction

Gang Lin

Despite pervasive political distrust and hostility across the Taiwan Strait, economic exchange between Taiwan and mainland China has developed swiftly in recent years. According to Taiwanese statistics, trade between the two sides of the Strait reached \$37 billion in 2002—accounting for more than 15 percent of Taiwan's total foreign trade—and China was Taiwan's number-three trading partner, next only to the United States (18 percent) and Japan (16 percent). Relying on Chinese statistics instead, the figure for cross-Strait trade is even higher, with \$45 billion trade value for 2002. While Taiwan's imports from China are not very significant for the island's total imports, China has surpassed the United States as the biggest market for Taiwanese exports. Taiwan's trade surplus with China far exceeds the island's total trade surplus. In other words, without trade surplus with China, Taiwan would be in trade deficit. In addition, Taiwanese investment on the

mainland has accumulated to about \$30 billion. Investment on the mainland has expanded from labor-intensive industries to capital-intensive and technology-intensive ventures. Taiwan's information technology industry, including high-tech semi-conductor production, has spread over China's Yangtze River and Pearl River areas. Hundred of thousands of Taiwanese business people now permanently reside on the mainland, particularly in Shanghai and the province of Jiangsu. Because 150,000 Taiwanese people reside in close proximity in the Jiangsu city of Kunshan, the city has earned the nickname of "Little Taipei."

What has been the impact of economic exchange between Taiwan and the mainland on the island's domestic economy, and on the bilateral relationship? Does the mainland pose an opportunity or a threat to Taiwan's development? To what extent has the mainland market helped sustain Taiwan's growth? Or, has overseas investment resulted in the island's economic hollowing out and increasing unemployment? Does the Taiwanese economy rely on China's market so heavily that Taipei

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has lost its leverage in dealing with Beijing politically? What is the rationale, if any, behind Taipei's cautious attitude toward the opening of the Three Links (postal, business, and transportation) across the Taiwan Strait? Are the Three Links a purely economic issue, as Beijing claims? Is the deepening economic relationship between the two sides a trap for Taiwan, or a way to soften Beijing's position on the political issues dividing the two? Is there any linkage between economic integration and political accommodation? To what degree will Taiwanese people living on the mainland serve as agents of change, influencing each side's perception of the other, as well as policies of Beijing and Taipei toward each other? What are the political inclinations of those Taiwanese people doing business with China on the issues of Taiwan's future, party identification, and cross-Strait relations? Will sufficient domestic support allow the leadership of Beijing and Taipei to deal with each other more flexibly? Does the United States have a role to play in promoting economic links across the Taiwan Strait? The following three essays discuss these and related issues.

In the first essay, **Ramon H. Myers** of Hoover Institute argues that no evidence suggests that mainland China has adopted trade policies that will force Taipei to accept Beijing's political demands. Expanding cross-Strait economic relations mutually benefit both sides. According to Myers, if the Taiwanese government can formulate a win-win strategy toward mainland China, it can retain its position in the emerging Chinese market, which is

expected to replace Taiwan as the world's largest manufacturing agent of high-technology products. By engaging China to influence its economic modernization, Taiwan will gain greater economic welfare, build friendship and trust, and pave the way for a long-term solution of the divided-China issue.

In the second essay, **Terry Cooke** of the Foreign Policy Research Institute observes that the global supply chain for Information Technology (IT) products has been extending steadily across the Taiwan Strait. This process has gradually led to regional and global integration that brings substantial benefit to both Taiwan and China. With a dominant share in China's export industry, a growing share in the local Chinese market, and strong R&D roots in Taiwan, the cross-Strait IT interaction is a win-win game for both sides. Leverage in the IT sector is not as much in the hands of politicians in either Beijing or Taipei as in the hands of Taiwan's globally-experienced IT firms. Economic globalization will bring about regional stability and reduce military and political tension across the Taiwan Strait.

In the third essay, **Tun-jen Cheng** of the College of William and Mary discusses Taiwan's three main concerns over doing business with China. First, China seemingly is in a position to use Taiwan's economic dependence on the mainland as leverage to coerce Taiwan politically and militarily. Second, Taiwanese businessmen in China may unwittingly become a political force championing the cause of unification on behalf of Beijing. Third, cross-Strait economic linkage may have an industrial "hollowing out" effect on Taiwan's economy. According to Cheng, in the foreseeable future, Beijing is unlikely to coerce Taiwan politically and militarily by flexing its economic muscle, as many Taiwanese fear. Taiwanese businessmen on the mainland are not agents of Beijing advocating pro-unification policies. However, because of the concentration of Taiwan's trade with and investment in China, a great hazard is recession or currency fluctuation on the mainland.

Rupert Hammond-Chambers of the U.S.-Taiwan Business Council offered commentary on these three essays when they were first presented at a November 3, 2003 seminar sponsored by the Woodrow Wilson Center's Asia Program. He argued that while China's open market has provided new opportunities for Taiwanese businessmen, the

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increasing competitiveness of Chinese industries has also posed a threat to Taiwan's economy and increased Beijing's voice in regional affairs. Moreover, by encouraging regional economic integration without Taiwan's participation, Beijing has tried to marginalize Taiwan's economic role in the Asia Pacific, Hammond-Chambers added.

In brief, this Special Report explores both opportunities and challenges of cross-Strait eco-

nomie ties for the two sides' domestic economic development as well as their bilateral relationship. While the three essays agree that Beijing is unlikely to use Taiwan's economic dependence on the mainland to coerce Taiwan politically, they differ on whether the growing cross-Strait economic ties will necessarily bring about economic benefits to Taiwan.

Taiwan-China Economic Relations: Promoting Mutual Benefits or Undermining Taiwan's Security?

RAMON H. MYERS

Has China since 1990 adopted trade policies with Taiwan that have or will force the Taiwan authorities to accept Beijing's political demands they now oppose?

Or have economic relations between Taiwan and China, because of the two sides' relatively comparative advantage, generated trade benefits for both sides, thus leading to dialogue and a resolution of the divided-China issue?

Answering these questions can explain how Taiwan-China economic relations have evolved and what kind of economic and political future the two regimes face.

TAIWAN-CHINA ECONOMIC RELATIONS

What are the special characteristics of Taiwan-China economic relations? First, we are referring to a short period of economic relations, namely from 1990 to the present. Second, cross-Straits economic relations are largely a one-way flow of economic activity. In the export-import trade conducted between Taiwan, Hong Kong, and China, Taiwan's exports to China far exceed its imports from China. Taiwan's exports rose from \$7.4 billion in 1990 to \$30.8 billion (4.1 times) in 2002, whereas imports only rose from \$2.7 billion to \$4.4 billion (1.6 times).¹

As for capital flows between Taiwan and China, little capital enters Taiwan, but an increasing amount of capital moves from Taiwan to China.² Taiwan's Ministry of Economic Affairs reported that between January and October 2002 the island invested \$10.09 billion abroad, of which \$6.72 billion or 66.6 percent went to China. Government official statistics, however, understate the real amount of Taiwanese investment flow to China.

Then there is the large tourist traffic from Taiwan to China. Few Chinese tourists visit Taiwan compared to the growing numbers of Chinese tourists to Hong Kong. Taiwanese workers and business people



in China send remittances and earnings to Taiwan, though we have no accurate estimate of these flows.

Finally, Taiwan's enterprises on the mainland produce for the China market as well as for export. In brief, Taiwan-China economic relations have greatly expanded in the past 13 years, but they are principally a one-way flow, and they impact upon the two societies in complex ways.

IS TAIWAN'S NATIONAL SECURITY THREATENED?

A nation's security can be threatened by the trade policies another regime adopts to coerce it to conform to that regime's demands. Those trade policies rely on the "supply effect"—using imports to augment power and coerce another regime—as well as the "influence effect"—using trade to mobilize friendly regimes to influence a rival regime.³

As an example of "supply effect" of trade policies, China could concentrate on importing goods for its military forces and accumulating large stocks of strategic materials, both of which could bring pres-

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sure to bear on Taiwan. China's decision to locate more than 400 missiles opposite Taiwan could be seen as using supply effects. But Beijing's decision to install these missiles did not begin to go into effect until 1995, when its leaders believed that the Taiwanese authorities might pursue the path of independence. Economic relations between Taiwan and China had only started to expand, and China's missiles were meant to intimidate Taiwan's voters into not electing Lee Teng-hui as president.

As an example of "influence effect" of trade policies, there is no evidence that China has repeatedly tried to redirect trade to neighboring politically friendly nations in an effort to increase its influence over Taiwan. Both regimes have tried establishing normal diplomatic relations with third countries so as to isolate the other internationally. But such efforts have been promoted ever since China's civil war became a cold war in 1949. Thereafter, both Chinese regimes proclaimed that they represented China to expand their legitimacy in the international order. That struggle continues as Beijing's leaders try to prevent any nations from recognizing Taiwan as a state separate from China.

As for further examples of the influence effect of foreign trade on a trading partner, China's authorities have not tried to make it difficult for Taiwan to dispense entirely of its trade with the mainland. Nor do we find evidence that China is creating vested interests among its trading partners to marginalize Taiwan in the world market economy.

THE MUTUAL BENEFITS OF CROSS-STRAIT ECONOMIC RELATIONS

China's endowments include abundant cheap labor and low-rent land. Taiwan's endowments consist of abundant capital and advanced technology. Taiwan's entrepreneurs also believed they could cheaply invest in factories and real estate in China by relocating their capital and technology, hiring low-cost mainland labor, and renting or buying land. They also were able to access the China market because of low transaction costs (shared cultural values and similar language and local dialect made for low-cost enforcement of contracts and access to information) and export via Hong Kong to the international market.

Because of the relative comparative advantages for trade, both sides expanded their economic activ-

ities. By 2002 Taiwan's exports to Hong Kong and the mainland as a whole had surged ahead of exports to the United States. The main Taiwanese exports to the China market were electronics and electrical products, machinery, chemicals, precision tools, textile products, plywood, basic metals, rubber, and plastic products. In 2002 electronics, electrical products, machinery, chemicals, and precision tools made up 51 percent of Taiwan's exports to China, compared to 33 percent in 1993.⁴

Taiwan's greatest export market in 1990 was the United States, which took 32 percent of Taiwan's exports; in 2002 the U.S. share of Taiwan's exports dropped to 20 percent. In that same year China (including Hong Kong) became Taiwan's number-one export market, taking 23.6 percent of its exports compared to only 12.7 percent in 1990.⁵

In 2002 Taiwan probably invested more in China than the United States and Japan did. In the first ten months Taiwanese business people invested \$6.72 billion in China, or 61.8 percent of Taiwan's total foreign investment, followed by 18.15 percent in the former English Caribbean colonies and islands off Central America, 6.00 percent in the United States, 1.61 percent in Hong Kong, 1.17 percent in the Philippines, 0.93 percent in Panama, and 10.32 percent in other nations. Taiwanese investments to different parts of China were as follows: 50.86 percent to Jiangsu, 14.32 percent to Guangdong, 8.01 percent to Fujian, 7.74 percent to Zhejiang, 4.56 percent to Hebei, and 4.51 percent to other areas.⁶

Given the one-way flow of economic activity from Taiwan to China, some might argue that Taiwan's economic dependency on the China market has greatly increased in recent years. In fact, Taiwan's investment in China has made local and regional Chinese firms more dependent on Taiwanese firms. For example, 60 percent of all semiconductors produced in China are made by firms receiving Taiwanese investment funds. These Taiwanese companies produce 70 percent of all electronic goods produced in China.⁷ Therefore, Taiwanese firms annually pay a huge amount of local and state taxes to the People's Republic of China, and these tax revenues increase as production and sales rise. Taiwanese firms also pay a large annual wage bill for skilled and unskilled workers, thus generating employment and income to local people. Moreover, many Taiwanese

firms in China, as well as those back home exporting to China via Hong Kong, sell intermediary products, such as electronic and electrical machinery, machine tools, and chemicals, to Chinese enterprises, thus increasing the latter's dependency upon Taiwanese suppliers. The contribution of Taiwanese firms to China's exports is also significant. For 2002, the export value of the largest eighteen Taiwanese enterprises operating in China accounted for 4.5 percent of total Chinese export value.⁸

Why have China's leaders tolerated this one-sided exchange? First, the Chinese economy has greatly benefited from cross-Straits economic relations. Second, China's leaders want to befriend Taiwan's people and persuade them to connect their future development to China's modernization. Third, Beijing officials, scholars, and business people believe that social interactions promoted by economic interactions will nurture Taiwanese pride to be identified with a great civilization and nation. More friendship and trust across the Taiwan Strait have induced hundreds of thousands of Taiwanese to move to China in the last ten years.

CROSS-STRAIT ECONOMIC RELATIONS AND TAIWAN'S ECONOMIC DEVELOPMENT

In the early 1950s, the trade that historically had taken place between Taiwan and China ended. Taiwan's officials introduced policies and institutional reforms to expand its global and domestic market. First, they launched significant institutional reforms that transformed Taiwan's command economy into a market economy. Second, they encouraged foreign investment and production facilities to locate in Taiwan. Taiwanese firms then copied the technology used in foreign firms. Third, they upgraded production capabilities of the island economy, increased the supply of professional and skilled manpower, and improved technology for low-cost adoption by Taiwan entrepreneurs. Fourth, foreign and Taiwanese firms not only competed for the same markets but developed complementary economic exchanges for mutual benefit. The government's ministries of finance and economics encouraged human, physical, and financial resources to shift into high value-added activities, thus restructuring the economy in every decade.

Taiwan's future economic survival depends on the island's ability to continuously upgrade itself

into a capital/technology-intensive economy that can maintain and develop new market shares in the global market, especially in China. In the early 1990s the government conceived an ambitious plan to convert Taiwan into an economic entity offering low-cost services to other economies, serving as a financial center to allocate capital flows, and improving its comparative advantage to invest and trade abroad, especially with China.

Taiwan's future economic survival depends on the island's ability to continuously upgrade itself into a capital/technology-intensive economy that can maintain and develop new market shares in the global market, especially in China.

But Lee Teng-hui's administration failed to carry out that plan, and it has yet to be realized. Taiwan thus missed a great opportunity in the 1990s and beyond to upgrade its economy into a dynamic and efficient service sector for the Asia-Pacific region. As a result, when global economic growth slowed in 2000, Taiwan suffered its worst recession since the 1940s and 1950s. In 1996 President Lee's administration limited Taiwanese firms to invest no more than \$50 million in China without its permission. After July 1999 relations between the two sides soured when Beijing's leaders terminated dialogue with Taipei's leaders because of President Lee's declaration that two separate states existed across the Taiwan Strait. Official dialogue never resumed during the Chen Shui-bian administration. Both sides offered proposals to encourage the other to agree to its solution for establishing "three direct links" or direct economic relations to replace the system that all traffic must flow through Hong Kong or Macao or a third country. In spite of political obstacles, trade and investment flows from Taiwan to China continued to expand.

PROSPECTS FOR THE FUTURE

Thus, despite the obstacles the Lee and Chen administrations have installed to discourage



Taiwanese entrepreneurs from investing in China—refusing to discuss with Beijing's authorities the establishment of direct transport and shipping links with the mainland under the "one China" principle or within an ambiguous framework of cross-Strait economic relations—Taiwan's business people continually transfer their liquid capital to China through offshore financial centers. For instance, in 2002 Taiwan's financial investments to former English Caribbean colonies and islands off Central America amounted to 18.15 percent of Taiwan's total overseas investments, with a significant amount of capital being transferred to China. Recent statistics for 2002 confirm that Taiwan leads all nations in capital flows into China; approximately 60 percent of that investment is in information-technology industries.

For Taiwan's entrepreneurs, China is only another sector of the global market for which Taiwanese business people have special advantages: a unique geographic location; long-term experience and famous achievements; an open society and transparent economic management; and cultural, historical, and language advantages.

If the Taiwanese government can formulate a win-win strategy to engage China in economic relations and political dialogue, it can retain its position in the emerging Chinese market.

To be sure, the fast-growing Chinese economy is both a challenge and a threat to Taiwan's administration and its people. It is a challenge for the Chen Shui-bian administration, which insists economic relations must be normalized as between two independent states. China's authorities have not accepted this proposal, and previous behavior by that regime indicates they will not agree to such demands. But the expanding Chinese economy is

also an opportunity beckoning the island's entrepreneurs to become agents of change. For these reasons, more Taiwanese entrepreneurs bitterly complain to their government to lower the transaction costs for them to participate in the Chinese market.

For political reasons, then, Taiwan faces a critical choice. Should it take advantage of China's rapid modernization as other Asian countries are trying to do? Or should it sit on the sidelines and run the risk of losing out in the intense competition for a share of the growing Chinese market?

Cross-Strait economic relations have always provided mutual benefits and will continue to do so in the future. If the Taiwanese government can formulate a win-win strategy to engage China in economic relations and political dialogue, it can retain its position in the emerging Chinese market, which is expected to replace Taiwan as the largest manufacturing agent of high-technology products.

By engaging China to influence its economic modernization, and opening its product and factor markets to mainland China to increase the gains from trade, Taiwan will gain greater economic welfare, build friendship and trust, and pave the way for a long-term solution of the divided-China issue.

ENDNOTES

1. Council for Economic Planning and Development, *Taiwan Statistical Data Book 2003* (Taipei: Council for Economic Planning and Development, 2003), 218.

2. *Cross-Strait Economic Statistics Monthly*, May 2003.

3. For a discussion and application of these concepts see Albert O. Hirschman, *National Power and the Structure of Foreign Trade* (Berkeley: University of California Press, 1945), 34–35.

4. *Taiwan Statistical Data Book 2003*, 223.

5. *Ibid.*

6. *Ibid.*

7. *Associated Press*, October 15, 2003.

8. *Liang'an jingmao* (Cross-Strait Business Monthly), July 2003, 30.

Cross-Strait Economic Ties and the Dynamics of Globalization

TERRY COOKE

Since March 2000, the global supply chain for Information Technology (IT) products has been extending steadily across the Taiwan Strait—the line of geographic and political cleavage separating Taiwan from China. What impelled this global supply chain of strategic significance to span one of the world's most sensitive political fault-lines? What are the specific dynamics underpinning this instance of growing economic interdependence between Taiwan and China? What are the economic and strategic implications of these developments for the United States?

Each of these questions revolves around a specific globalization dynamic. First, the extension of the global supply chain across the Taiwan Strait is the result of a technology dynamic. The second question, quite evidently, involves patterns of accelerating interdependence in a globalized world. Third, the question of what implications these developments in Asia have for U.S. interests relates to a global strategic balance. This paper will address each of these specific dynamics of globalization with a focus on the cross-Strait relationship between Taiwan and China.

TECHNOLOGY & THE MANTRA OF CHANGE: “CHEAPER, BETTER, FASTER”

From the sectoral perspective of the global IT business, China had not yet emerged on the center stage by early 2000. High cost structures kept the local market limited, if not off-limits, to the established global network of production and distribution. Big names in the global industry had, to be sure, all placed their bets on China's future development as a consumer market and were relying increasingly on their presence in China to support their worldwide production and profitability. But major elements of the global IT supply chain—high-performance chip producers, original design manufacturers (ODM) and high-volume original equipment manufacturers (OEM), to name a few—were mostly absent from China.



It was Taiwanese manufacturers of OEM components and hardware who, together with their U.S. brand-name partners in the Win-Tel fold (Windows Operating System and Intel), brought about change. The driving force for this change was exactly the same as that which had forged the iron-grip alliances between Taiwanese OEMs and their U.S., European and Japanese brand-customers during the IT boom years from 1987–2000: the Taiwanese OEM golden rule of producing “cheaper, better, faster.”

By mid-2000, four major trends were converging to begin linking China into the lower end of the global IT value chain: (1) Nasdaq's implosion in March 2000 signaled the end of the dot-com bubble, accelerating pressures of price commoditization already affecting the industry; (2) the impending World Trade Organization (WTO) accessions by both China and Taiwan promised significant dismantling of trade barriers between Taiwan and China; (3) China was earning recognition as the lowest-cost site of production in a newly emergent Asian production platform, able to compete and collaborate more directly with North America and Europe; and (4) the spring 2000 tran-

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sition between the outgoing KMT/Nationalist administration of Lee Teng-hui and the newly elected DPP government of Chen Shui-bian provided a political opening for the Taiwanese business community to accelerate the pace and scale of investments in China.

The community of Taiwan-based IT manufacturers was the bellweather of this change, unleashing a torrent of investment into China over the past three years. The fact that this community of manufacturers migrated to China *en masse* reflects exactly the same feature of Taiwan's high-tech industry that ensured its successful adaptation in the global IT ecology—the mantra of “cheaper, better, faster.”

As Taiwanese OEMs looked to China across the Strait in mid-2000, they faced a dilemma. Globalization dictated relocation of production as a pricing issue for global customers, but price only represented one of three key values that their global customers had come to expect.¹ As far as the other two values—quality and timeliness of delivery—were concerned, China's infrastructure still did not consistently meet world standards. Hyper-competitive practices and lack of judicial recourse underlay many of the problems with quality control in China. Despite contracts, foreign manufacturers working with local Chinese partners often lost control over their proprietary technologies, production methodologies and key personnel, and then found their former partner in direct competition, fielding a lower cost and a lower quality knock-off. Also, distribution and logistical services were one of the least developed areas of China's modernizing economy, hamstrung by worsening infrastructural problems and administrative inefficiency.

Thus, the dilemma. On the one hand, Taiwanese OEMs knew that without taking strategic advantage of China's emergence as the world's low-cost production platform, they would be opening themselves up to renewed competition from their traditional Electronics Manufacturing Services (EMS) rivals and also to a new generation of lower cost competitors. But on the other hand, Taiwanese OEMs knew they would no longer enjoy access to high return markets if they failed to deliver consistent, across-the-board performance for their highly successful, highly demanding brand-name customers, such as Dell. Direct reliance on Chinese suppliers and distributors would jeopardize that

access by posing unacceptable risks in the areas of quality control and timeliness of delivery.

The solution to this dilemma was, in essence, a new business model for China. Taiwanese high-tech firms would not follow the patient approach to the China market developed by globalized, brand-name multinationals from North America, Europe and Japan. Taiwanese firms could not wait a decade or more as local personnel were groomed for future management positions through MBA schooling abroad and rotations in various divisions of a corporation. Nor could Taiwanese firms afford to build up operations slowly, developing from scratch a network of reliable suppliers in China via expensive training and local industry support programs. Instead, they did what they were used to and worked with exactly the same network of suppliers that had supported their growth—first in the Hsinchu Science-Based Industrial Park in the 1980s and then in numerous export processing zones throughout Southeast Asia in the 1990s.

The shorter horizon for return on investment in Taiwan forced their high-tech firms to rely on China for its abundant supply of low cost inputs to the production process, while relying on their own existing network of suppliers and distributors to ensure quality and delivery.

In a nutshell, the shorter horizon for return on investment in Taiwan forced their high-tech firms to reduce the number of variables involved in their China investments. They would rely on China for its abundant supply of low cost inputs to the production process: land, labor and facilities. Beyond that, they would rely on their existing network of suppliers and distributors to ensure quality and delivery.

This, more than any other factor, explains the rapidity and scale of the migration of IT manufacturing across the Taiwan Strait in recent years.⁴ Individual firms were not making the decision to relocate. Instead, entire supply chains or sub-ecosystems were moving *en masse*. Local officials in Kunshan, Suzhou and elsewhere accommodated this influx with industrial processing zones tailored to the specific needs of this community of Taiwan IT firms.

THE DYNAMICS OF INTERDEPENDENCE

Economies and ecologies do not prosper in the absence of change and adaptation. While China's emergence into the global IT ecosystem has brought some disruption, the change also appears to be strengthening the global ecosystem as a whole.

Worldwide, consumers have clearly benefited from lower prices for quality IT goods. Meanwhile, U.S. brand companies at the top end of the value chain have consolidated their position and continue to reap the disproportionate return on investments, because of their brand-names. In the middle of the value chain, Taiwanese firms are squeezing a new revenue stream from their OEM playbook by replaying it in the Shanghai-Kunshan-Suzhou-Nanjing corridor. At the same time, they are sinking new tap-roots in Taiwan in fields as diverse as ODM, manufacturing-related research, and high-end production (e.g., advanced TFT-LCDs, O-LCDs and 12" wafer production).³ In China, local firms that have never previously participated in a meaningful way in the global economy are now supporting the low end of the global supply chain with component production and increasingly sophisticated assembly operations.

WTO accession offers perhaps the best example of the symbiotic benefits that the United States, Taiwan and China have all enjoyed from an expanded global value chain. Taiwan is now positioned to trade off, incrementally, its dominance of China's IT export market in return for substantially improved access to the smaller but potentially more profitable market on the mainland. China has gained limited access to high return foreign markets under the tutelage of a Taiwan partner who has two decades of experience in those markets. The United States, meanwhile, experiences consumer benefit, a steady supply of vital IT components and products, and a more efficient global pipeline for its own research-led innovation.

In sum, the limited available data shows not even marginal erosion of Taiwan equity control in the overall IT market since 2000.⁴ Whatever shifts in leverage may be occurring in the IT sector between Taiwan and China, they appear to be happening gradually and to involve balanced trade-offs in access to the foreign and domestic portions of the economy.

None of this is meant to suggest that globalization does not represent a real challenge for all partic-

ipants. As the SARS (Severe Acute Respiratory Syndrome) epidemic is demonstrating vividly, China cannot hope to enjoy the benefits of globalization (e.g., economic growth) if it is not also willing to embrace the responsibilities of globalization (e.g., transparency). In the United States, a legitimate debate about security threats is well established and a new debate about displacement of high-tech manufacturing to China is already emerging. In Taiwan, the fact that its firms have maintained a secure and lucrative position at the mid-point of the global IT supply chain does little to allay domestic anxieties about Taiwan being "bypassed" or "hollowed out."

ECONOMIC AND STRATEGIC IMPLICATIONS

The strategic triangle linking the United States, China and Taiwan is elongated, with the United States at the distant apex. This is entirely natural given the geographic distance of the United States from both Taiwan and China and the fact that China and Taiwan share a long and convoluted history of interaction, which U.S. policy prescriptions do not presume to master in intimate detail.

Interestingly, one area where Taipei and Beijing apparently share assumptions is cross-Strait economic engagement. Both governments assume that investments undertaken in China by Taiwanese firms are fundamentally and rapidly destabilizing to the cross-Strait status.

Given their estrangement and the zero-sum logic of their dialogue, Beijing and Taipei rarely find themselves in agreement in matters of political perception. Interestingly, one area where Taipei and Beijing apparently share assumptions is the issue of cross-Strait economic engagement. Both governments assume that investments undertaken in China by Taiwanese firms are fundamentally and rapidly destabilizing to the cross-Strait *status quo*.

Predictably, the political motivations for this convergent assessment are completely different in Taipei and Beijing. Beijing may have found the economic engagement issue to be a politically plausible, though



not an empirically proven, means to “climb down” from its previously aggressive posture and to adopt a more nuanced, two-track approach combining economic blandishments with the implied threat of a continuing missile buildup. For Taipei’s government, the specter of imminent economic absorption may be useful for mobilizing the society economically and politically in order to maintain a distinct orbit.

The United States has vital interests in the Taiwan Strait. Not only is this area key to the stability of the Asia-Pacific region, there are also vital economic interests now straddling this political fault line. Given the complexity of cross-Strait economic interaction and the United States’ distance from it, one might easily assume that this interaction is destabilizing simply because Beijing and Taipei both tell us so. But our interests in this area are too great for us to take this conclusion on faith, especially when accompanied by twin sets of political baggage.

Viewed from the perspective of globalization and of the relative comparative advantage on which global interdependence is built, a contrary outcome is suggested: growing economic integration between Taiwan and China is based on significant and mutual economic benefits which both enjoy. By the same token, shared interaction by Taiwan and China in the global IT supply chain is not, in itself, destabilizing. It may well contribute to improving regional stability.

Three basic points help bear out these generalizations. First, the cross-Strait IT interaction conforms to broader globalization trends. Obviously, globalization implies the stress of change and adaptation, but it also implies a higher degree of acceptance and support in an interdependent world. Second, evidence suggests that leverage in the IT sector is not as much in the hands of politicians in either Beijing or Taipei as in the hands of Taiwan’s globally-experienced IT firms. With a dominant share in China’s export industry, a growing share in China’s local market and strong R&D roots in Taiwan, this is not a zero-sum predicament for either Taipei or Beijing. Third, Taiwan manufacturers and managers are now bringing millions of Chinese workers into direct contact with global norms of business. This development would appear to directly support U.S. policy goals for the resolution of cross-Strait tension through sustained and peaceful interaction.

In conclusion, four policy questions need to be addressed:

- Since China is now following a two-track approach, the United States must understand on its own terms where both tracks lead.
- The economic track is not a fast-track to Taiwan’s absorption on China terms, as many hope or fear. In the IT field, it is a gradual path to regional and global integration which brings substantial and demonstrable benefit to both Taiwan and China.
- Leverage is not primarily in the hands of politicians on either side of the Taiwan Strait. It is in the hands of free enterprise working in a globalized system and bringing the benefits of globalization to millions of workers in China.
- As such, coherent U.S. attention to, and policy support for, the economic “globalization track” as a path toward stabilization will have the immediate and direct effect of further constraining either/both Taiwan and China from jumping the political/military track.

The old saying about dancing with your enemy captures a truth in the current cross-Strait situation. Economic engagement between Taiwan and China will not eliminate the chance of an outbreak of hostilities, but it will reduce that chance. Similarly, as globalization continues to push Taiwan and China into closer economic embrace, U.S. policy attention to the four key issues above can determine whether that embrace turns out to be mutually comfortable or injurious to one party.

ENDNOTES

1. The scale of this success can be measured by the fact that in 2000, Taiwanese firms delivered more than \$20 billion of products to four key U.S. companies.

2. The scale of this mass migration of IT production from Taiwan to China is consequential. For example, as China overtook Taiwan as number three in global IT production in 2001, Taiwanese investors became equity-owners of as much as three-quarters of China’s IT export production, while still controlling their own IT production on the island.

3. These research-led efforts, focusing on manufacturing innovation, represent Taiwan’s attempt to enter a new era. As production for these new technologies drops down the cost/volume curve, their manufacture will eventually be handed off to China. This will free up Taiwan, with its limited resources, to keep moving on to the next frontier of manufacturing-led innovation.

Doing Business with China: Taiwan's Three Main Concerns

TUN-JEN CHENG

Typically, trade and investment are minimal and minimized between political rivals. Yet, a dense economic nexus co-exists with deeply entrenched political conflict across the Taiwan Strait. On the one hand, the cross-Strait relationship remains shrouded in uncertainty, mistrust, intimidation, and defiance. Political thaws are ephemeral, while the security environment is easily disrupted. On the other hand, Taiwan's trade with and investment in China are huge, growing, asymmetrical, and largely unstoppable. Taiwanese policies aimed at withholding, deflecting, and restraining economic ties with China have all failed. It is not sure whether Taipei's current policy of managed liberalization will work.

Three concerns have often been raised regarding the potentially negative impact of cross-Strait economic ties on Taiwan. First, China is seemingly in a position to use Taiwan's economic dependence on the mainland as leverage to coerce Taiwan politically and militarily. It is feared that Taiwanese businessmen in China (or *Taishang*), so glued to the Chinese economy, could unintentionally become a liability for Taiwan's security and autonomy, creating a "hostage effect," a term used in Taiwan's public discourse. This essay submits that the probability for China to impose economic sanctions on Taiwan remains low in the foreseeable future, because of the high costs of replacing Taiwan's investment and suspending trade with Taiwan. Second, *Taishang* could unwittingly become a political force championing the cause on behalf of, if not at the behest of, Taiwan's political adversary. It is feared that *Taishang* might be unintentionally doing the bidding of the Beijing regime. This worry is probably unwarranted, as *Taishang* are not necessarily for unification. While their interests have led them to lobby the Taiwanese government for policy change, their behavior is akin to what other foreign enterprises do to their home governments. Third, cross-Strait economic linkage might cause harm to Taiwan's economy, called the industrial "hollowing out" effect in public discourse.



While the exodus of *Taishang* to China has entailed a beneficial industrial effect in Taiwan, the *Taishang*'s rush to China may now threaten to "hollow out" Taiwan's industry.

THE "HOSTAGE" EFFECT

Are *Taishang* giving China leverage over Taiwan? On a per capita basis, Taiwan has invested more than any other country in China. The Chinese leadership has publicly stated its intention to use economic linkage across the Strait for political purposes, and to use the private sector to "compel" the Taiwanese government to yield to the Beijing regime's plan for unification. Citing an internal document of the People's Liberation Army, Taiwan's Vice President Annette Lu has warned that China is deepening Taiwan's dependence on the Chinese economy, while preparing for a military showdown in 2010, by which time the resistance to unification is expected to be further enhanced. The worry about China's likely economic coercion over Taiwan for political subjugation is based on two considerations. First, in general, export dependence is more vulner-

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able than import dependence, as alternative export markets are more difficult to find than alternative import sources, oil being a notable exception. Export markets need to be nurtured and earned, while substituted imports can be easily secured if one is willing to pay a higher premium. In 2002, Taiwan depended on China to absorb 25 percent of its exports, while China depended on Taiwan for only 11 percent of its total imports. Beginning in 2002, China supplanted the United States to become the number one export market for Taiwan. Second, foreign direct investment (FDI) in one's political adversary is even riskier than trade dependence. In trade, two sides swap goods, but in FDI, firms are stuck in a host country. In general, foreign firms have bargaining power before making the location choice for their investment, but once the choice is made, the power shifts to the host government, as relocation is often costly and foreign firms' operations hinge on logistical support from the host country.

However, the compelling use of economic leverage over Taiwan would be costly for China. First, Taiwan's export dependence on China needs to be understood in a broader context. While *Taishang* ship many Taiwanese goods to China, they also sell many Chinese goods abroad. It is estimated that *Taishang* exported 85 percent of what they produced in China in 1992, 70 percent in 1996, and 45 to 50 percent in 1998, and their exports accounted for 14.4 percent of China's total exports in 1994 and 14 to 22 percent in 1996. Moreover, the United States—the security provider for Taiwan—is China's most significant export market and the principal source of China's earnings. As Nicholas Lardy points out, the sharp drop of Taiwan's export market share in labor intensive sectors in the United States and Japan coincided nicely with the sudden rise of China's exports in these sectors and markets, as well as with the influx of Taiwan's investment in China in these sectors. In a sense, the United States continues to be Taiwan's largest trade partner, as it used to be, only now Taiwan's exports are routed through the assembling lines in China. Breaking the trade and investment ties across the Strait would mean an instant reduction of more than 14 percent of China exports and a major disruption of Sino-American trade ties.

In addition, many of China's imports from Taiwan are capital and intermediate goods, crucial

to China's production (versus consumption, as in the case of the import of final consumer goods). Moreover, as Taiwan's investment in China continues to pile up and the division of labor across the Strait escalates, more and more trade is conducted within industrial sectors, as seen from the increasing ratio of intra-industry trade (IIT). One study shows that, for the manufacturing sector as a whole, the IIT index grew from 0.8 in 1980 to 28.8 in 1991. Another study shows that the IIT for the manufacturing sector grew from 16 to 30.4 between 1992 and 1998, most significantly in the following sectors: electrical and electronics, transportation equipment, and optical equipment. Other things being equal, it is more costly to break economic ties if the IIT ratio is high, for it means not only that consumption is disrupted (and substitute markets and supplies must be found), but also that production might be halted as well, affecting a nation's output and employment.

Next, while in an extractive industry, FDI, once made, tends to be at the mercy of the host government, this is not necessarily the case in the manufacturing sector. Firms in labor-intensive sectors, especially those with market share abroad, can be relocated to other lower wage countries. The balance of power does not necessarily shift from foreign firms to host governments once the investment is sunk, if these firms are highly engaged in R&D, carry reputed brand names and other specific assets, and command their own globally diversified production chains and/or marketing channels. These firms are not easily held hostage, as they can either vote with their feet (the case of most Taiwanese small and medium enterprises) or retain bargaining power vis-à-vis host government (the case of many Taiwanese high-tech firms). Many *Taishang* are hostage-resistant. Moreover, once *Taishang* are harassed, other country's investors in China may be alarmed and FDI disrupted as well.

Finally, irrespective of whether they have mobility and asset specificity, *Taishang* are major employers and contributors to government revenue. As Chen-yuan Tung shows, *Taishang* absorbed 2 percent of urban employment in China in 1995, 3.9 percent in 1999, a very significant figure considering that urban unemployment was 4.3 percent in 1995, and 6.2 percent in 1998. *Taishang* are not essential to China's gross capital formation, but their tax revenue is enough to offset 5 percent of the central

government's budget deficit. This revenue-generating function is important to the government in Beijing, considering that China's many indebted state-owned enterprises have been threatening to break the back of state-owned banks. Without government budgetary support, China's banking sector might go bankrupt, which would hurt the public who always put their savings in banks rather than in equity. It is not too far-fetched to contend that *Taishang* are a factor that is crucial to social and political stability in China.

Given the above cost-benefit analysis, it came as no surprise that China's leadership in Beijing had promptly reassured the safety of *Taishang*'s investment and China's need of them during each one of the three recent cross-Strait crises. When a few *Taishang* publicly supported the Democratic Progressive Party (DPP) candidate in the March 2000 Taiwan presidential election, the Beijing regime carefully crafted its warning message, segregating the exceptional few from the rest. Interestingly, these few individuals on the presumed blacklist were not penalized, and since then, they actually have invested more on the mainland. This episode suggests that China probably cannot afford to lose *Taishang* as a collectivity, and was hesitant to lose even those individual *Taishang* not to the liking of leaders in Beijing.

At some high level of economic interaction, both sides have enough stake in the linkage, and the question of which needs the other more becomes irrelevant.

The above analysis also suggests that at some high level of economic interaction, both sides have enough stake in the linkage, and that the question of which needs the other more becomes an irrelevant issue. Both sides would suffer a lot if economic ties were disconnected. To use a high-rise analogy, it does not matter from which floor, the fifteenth or the twentieth, one attempts to escape a towering inferno, the same result can be anticipated. However, it is important to note that cross-Strait economic links are not static. There is no guarantee that China's stake in the cross-strait linkage can

become only higher, not lower. Consider the following hypothetical situation: China's state sector is reformed, its unemployment problem eases, its central government's budget deficit shrinks, its town and village enterprises are transformed into export-oriented small and medium enterprises, and the new entrepreneurs in Shanghai and Beijing replace Taiwanese high-tech firms as second fiddlers to Western high-tech giants. If all these are to happen simultaneously, then *Taishang* on the mainland will become "disposable." The asymmetric economic interdependence across the Strait as we understand it now will then be more likely to be leverage for political blackmail and coercion. To use the high-rise analogy again, China would then be located on the second floor, certainly with a better chance to be rescued, than a Taiwan locked into the fifteenth floor of a towering inferno.

THE "PRO-UNIFICATION" EFFECT

If *Taishang* are not hostages at least in the foreseeable future, are they agents, if only by default, promoting the cause of unification, and advocating pro-unification policies? As of today, there are about 50,000 (26,000 according to Taiwan's official statistics) Taiwanese enterprises and half a million Taiwanese businessmen, including owners, their managers, and service providers, on the mainland. Despite many telephone-based, time-series surveys on Taiwanese residents' views on national identity and their stands on the future relationship between China and Taiwan, it is impossible to find out the attitudes of *Taishang* towards these issues. However, there is no reason to assume that having business interests in China ipso facto makes *Taishang* an active pro-unification force. Many *Taishang* are owners of small and medium enterprises, supposedly sympathetic to the pro-independence DPP. Moreover, even those *Taishang* who feel particularly at home in China realize that they can gain most when there are two governments across the Strait in competition for their loyalty. The maintenance of the status quo ensures the continuation of the bidding war between Beijing and Taipei for the *Taishang*'s loyalty. Furthermore, interviews conducted in Hsinchu and Shanghai reveal that *Taishang*, especially those in the high-tech sector, are essentially cosmopolitan, comfortable working in China, Southeast Asia, the



United States and Taiwan. Some preliminary sociological studies reveal that *Taishang* are increasingly becoming modern nomads, migrating to where business opportunities abound, and dispersing their family members across many continents. For them, citizenship may well be a convenience. Given the choice between Beijing and Taipei, though, *Taishang* probably are more inclined to give their loyalty to the latter.

First, as a recent study shows, during the three periods of tension across the Strait (China's missile tests and war games in the Strait in 1995-96, Lee Teng-hui's proclamation of the "two states theory" in the summer of 1999, and Taiwan's second presidential election), *Taishang* opposed China's intimidation and war games. *Taishang* reacted very strongly and registered their complaints with the Beijing government during the 1995-96 missile crisis. And very few, if any, *Taishang* blamed the Taiwanese government for the following two crises. Indeed, quite a few *Taishang* pointed out to Chinese leaders that the existence of the Republic of China on Taiwan was a reality that no one could deny.

Second, the *Taishang's* affinity with Taiwan's political authority is much stronger than that with China's. *Taishang* have unsurpassed political influence and connection in Taiwan; many have been appointed to the policy advisory group of the president, the board of the Straits Exchange Foundation (SEF), and to the deliberation councils of the economic bureaucracy. Political patrons seek support from *Taishang*. In contrast, *Taishang* at best play third fiddle on the mainland, and never are on an equal footing with leading multinational corporations from other countries, not to mention with members of the "Chinese princeling party" (offspring of Chinese political elite who are now active in business and financial circles). While in Taiwan political patrons come to *Taishang*, in China *Taishang* seek political patrons. Of half a million *Taishang* and their retainers, only one has been elected to a local-level people's congress: Tsang Yu-shou in Ningbo.

Third, *Taishang* retain Taiwan's citizenship, declare income tax in Taiwan, and, in the case of male *Taishang*, render their compulsory military service. Some may have Western passports as well, but probably not Chinese passports, which require one to renounce other citizenships. While lacking a tax agreement, the Taiwanese government seems to be

following the principle of no double taxation, crediting *Taishang* what they have paid to the Chinese government if their salary is dispersed from their enterprises incorporated on the mainland. All this means that *Taishang* have invested heavily in Taiwanese citizenship.

Fourth, the *Taishang* mainland experience is not always a happy one. Collectively, *Taishang* carry weight in the calculations of Chinese leaders concerning cross-Strait relations, but as individuals, they may be unfairly treated at local levels. A significant number of mistreated *Taishang* have established an Association of Victimized *Taishang* to underscore a fundamental reality that protection of their lives and property is weak, given the absence of an investment protection agreement between China and Taiwan. Sixteen cases of personal property loss have exceeded \$12 million each, and none of them has been redressed legally, even though the Chinese Communist Party (CCP) issued a red-lettered decree for proper settlement. Indeed, a lawyer who had represented hundred of cases was denied re-entry to China after he made public the issue. Many *Taishang* have pursued vertical integration and created a group of affiliated companies, but such a legitimate and all too common practice may be viewed with suspicion, and trigger tax and tariff auditing for possible interlocking trade. The CCP has reportedly begun to implant its cells in *Taishang* enterprises.

Even if Taishang eventually choose to settle down in China, they probably will continue to stay in their enclave communities, and maintain their presumed preference for peace and prosperity under the status quo.

In due course, however, some *Taishang* may decide to settle down in China and even retire there (around 6,000 Taiwanese veterans have done so). Costs of living, land prices, and income taxes are low while stock market and business opportunities are tempting in China. Offspring education and medical care are probably two determining factors for *Taishang's* choice of permanent residency. Beginning in the late 1990s, the Beijing regime has been accommodating the request for the establish-

ment of *Taishang* grade schools, using Taiwanese teachers and textbooks. So far, Dongguan in Canton and Kunshan in Jiangsu Province have *Taishang* schools. The Malaysian Chinese solution (educating youngsters in “ethnic” grade schools or international schools in China and subsequently send them to either Taiwan or abroad for higher education) has become a viable option. Medical care is more a concern, especially after the recent SARS (Severe Acute Respiratory Syndrome) epidemic. Taiwanese enterprises have entered contracts with a few designated hospitals for employees’ medical care, but the service is said to be too expensive and the quality questionable. No Taiwanese hospital has been permitted to establish facilities in the mainland, but the Beijing government has recently promised to extend its socialist system of medical care without price discrimination to *Taishang*. *Taishang* have begun to fly in Taiwanese doctors and use an out of the area clause to make claims for Taiwan’s national health coverage. A pattern akin to the Caribbean-Miami solution seems to be emerging: exercise self-care for small illnesses, return to Taiwan for major care, exploit the visiting home doctors, and use local facilities only for most urgent care. Thus, if medical care and the education of offspring are no longer intractable problems for those *Taishang* thinking of settling down in China, then what Taiwan can offer to lure them back to reside in Taiwan are emotional attachment and perhaps peace of mind in a rule of law environment. But even if *Taishang* eventually choose to settle down in China, they probably will continue to stay in their enclave communities, and maintain their presumed preference for peace and prosperity under the status quo. Their opposition to forced unification or risky independence probably will not change easily.

While *Taishang* are not stooges of the Chinese government for the cause of unification, they have been pushing for policies in the direction that Beijing hopes to go, sometimes to the dismay of the Taiwanese government. Effective policy advocacy necessitates collective action, which in turn requires the formation of business associations. *Taishang* are territorially organized into 70 associations, mostly in coastal China, but they are also active in Taiwan’s industrial associations. Autonomous and self-governing, *Taishang* associations often have to work closely with the offices of Taiwan affairs at different

levels of the Chinese government. Back in Taiwan, *Taishang* periodically meet with officials of the Mainland Affairs Council, and top officials typically give speeches at their annual meeting. *Taishang* have voiced their views on at least three policy issues: China’s most favored nation (MFN, later redesignated as permanent normal trade nation or PNTR) status in the United States; the Taiwanese government’s “go slow, no haste” policy; and the three direct links across the Taiwan Strait. Throughout the 1990s, *Taishang* (and American multinational corporations with business interest in China) had supported the renewal of China’s MFN status, and later on, the granting of PNTR to China, long before the Taiwanese government went public in 2000 to “endorse” China’s trade status in the United States. For a while, many members in the U.S. Congress abhorred China’s human rights record and hesitated to ratify China’s MFN/PNTR status. The *Taishang*’s stand put the Taiwanese government in an awkward position. But it was over the “go slow, no haste” policy and the issue of the three direct links that *Taishang* often were at loggerheads with the Taiwan government.

The “go slow, no haste” policy—a policy that restricted Taiwan’s investment in China—started in September 1996. China flaunted this policy and the *Taishang* lamented it. At the end of the 1990s, two prominent businessmen, Yung-ching Wang and Jong-fa Chang, joined the chorus of criticism. As the head of Formosa Plastics, the largest petrochemical firm in Taiwan, Wang was the captain of traditional industry. Chang—head of the Evergreen Corporation, the world largest container shipping company—was the voice of the service sector. The fate of this policy was almost sealed when Morris Chang—the CEO of Taiwan Semiconductor Manufacturing Corporation (the world’s largest integrated circuit foundry) and spokesman for the high-tech sector—also registered his disapproval in 2000. The DPP government—formed after the party dislodged the Kuomintang from power in the March 2000 presidential election—promised to replace “go slow, no haste” policy with an “active opening, effective management” policy in a blue-ribbon national economic conference in 2001, and subsequently expanded the scope of permissive investment in China. The business has recently succeeded in “persuading” the government to lift the



ban on investment in the high-tech sector, including the semiconductor industry, on the mainland.

The most protracted policy discord between *Taishang* and the Taiwanese government revolves around the issue of three direct links across the Strait. In its initial formulation, the three direct links—proposed by China in the early 1980s—were for direct mail exchange, telephone contact, and transportation. In due course, the triplet was reconstituted, now referring to direct communication, trade, and transportation. Liberalization in telecommunications solved the problem of the first direct link. For the other two links, the Taiwanese government established an overseas transshipment center in Kaohsiung and made special arrangements with sea-ports of neighboring countries (for a technical detour of ocean shipping to obtain documents without actually unloading and reloading cargo) in the second half of the 1990s. Direct air links remain an intractable problem, as they are politically and militarily sensitive, involving the issue of immigration and the use of airspace. The SARS epidemic has dampened the *Taishang's* zeal for direct air links and revealed the virtue of keeping a cordon sanitaire across the Strait. However, as the epidemic subsided, the request for this link has resumed. To be fair to *Taishang*, it is important to note that they never have compelled the government to forge direct air links on China's term, which until recently, required Taiwan to accept its "one-China principle," and by logical extension, to define cross-Strait aviation as a special domestic flight. *Taishang* also have been submitting various plans that would not compromise national security, such as permitting airfreight and day flights only, at first. In this light, *Taishang* have not been doing China's bidding, but only promoting their business interests, as any business group would do.

THE "HOLLOWING OUT" EFFECT

The concern about the economic impact on the island of Taiwan's investment abroad, especially in China, is reflected in the debate on the "hollowing out" of Taiwan's industry. The massive departure of Taiwan's enterprises since the late 1980s led to a fear that jobs would be lost, domestic investment would decline, and the manufacturing sector would shrink. Factory closure dominated the news at the turn of

the 1990s. The negative net FDI (outflow exceeds inflow) in the manufacturing sector first appeared in 1987, became significant in 1989, and has remained so ever since 1993 (with the exception of 1995). And the share of the manufacturing sector in general domestic product (GDP) dropped steadily from 39.4 percent in 1986 (the peak year of the postwar era) to 25.3 percent in 2001.

The "hollowing out" warning proved to be a false alarm prior to the late 1990s; outward FDI has contributed to industrial upgrading rather than to an industrial decline in Taiwan. Evidence abounds. First, as Chen-yuan Tung has carefully demonstrated, outward FDI to China brought Taiwan a significantly high level of foreign exchange earnings between 1989 and 1997. Second, most medium and large firms active in outward direct investment have continued to invest and expand their production in Taiwan, according to Ministry of Economic Affairs' surveys of Taiwanese enterprises in 1996 and 1998. Third, while most emigrated small enterprises had either reduced or terminated their production in Taiwan, they did procure intermediate and capital goods from big firms in Taiwan. Their acquisition was reflected in the changing trade pattern between the two sides of the Strait. Fourth, the technology intensity of Taiwan's overall exports continued to grow. Finally, the unemployment rate actually declined after 1986 and remained extremely low through the mid-1990s, while labor productivity for the same period increased drastically in comparison with the preceding ten years. While the share of the manufacturing sector in Taiwan's GDP decreased and the share of the service sector increased, these developments were entirely expected. All matured economies in the West have gone through such structural changes.

Industrial upgrading is often an outcome of "defensive" FDI, where high labor costs, a worsening investment environment, and currency appreciation force small and medium enterprises in traditional sectors to escape abroad in order to safeguard their business stake, thereby indirectly benefiting the home economy. FDI in Southeast Asia by Japanese small and medium enterprises in the 1960s and 1970s belonged to this genre. It promoted Japanese economic expansion abroad and industrial upgrading at home. Taiwan was clearly replicating this experience.

Since the second half of the 1990s, however, Taiwan's FDI has been more of an "expansive type," threatening to create an industrial "hollowing out" effect. The expansive type of FDI is one where oligopolistic competition leads major firms in capital-intensive and high-tech sectors to move abroad to exploit their technological edge when a product is maturing and a patent is ending. In doing so, these leading firms are likely to bring with them all other supporting or affiliated firms in the long industrial chain, featuring a procession of what one may call "the moving pack." If major "industrial clusters" are all drained, and if the home economy is left without a new growth sector, such kinds of FDI may lead to significant investment and employment losses in the home economy. As Cowling and Tomlinson point out, Japan has been overzealously engaged in FDI in the wake of large-scale currency realignment under the 1985 Plaza Accord, helping to send the Japanese economy into a decade-long recession, and to perpetuate the problem of structural unemployment.

A recent study of the Taiwanese economy identifies some early signs of industrial "hollowing out" beginning in the late 1990s, when Taiwan's restive information technology sector started advancing to China. Unemployment rates in Taiwan have been creeping up since the mid-1990s. The high-tech sector by itself does not create a particularly high number of jobs, but has tremendous purchasing power, essential to the expansion of the service sector. Once a high-value added manufacturing sector is gone, the high value-added service sector will soon follow. Gross fixed capital formation as a share of Taiwan's gross national product (GNP) remained steady in the second half of the 1990s, but its overall labor productivity has grown at a slower pace. Moreover, in 2001, Taiwan's unemployment rate jumped for the first time in more than three decades to 4.96 percent, its gross fixed capital formation dropped below 20 percent, and its GDP grew negative 2.2 percent, all record-breaking figures. The economic downturn continued in 2002, with an even higher unemployment ratio of 5.2 percent. Obviously the global recession (caused by the burst of the Dotcom bubble and then the terrorist attacks) and policy uncertainty (caused by the first transfer of power between political parties in Taiwan's history) have contributed to Taiwan's economic contraction. But the massive exit of Taiwan's electronics industry to China that began in 1998 made the specter of

industrial hollowing out in Taiwan even more threatening. While Taiwan's electronics firms continue to perform well in world markets (leading firms have even gained market share), their operation and production facilities are increasingly relocated abroad, especially across the Strait. It was against this setting that leading semi-conductor firms pronounced their intention to set foot in China, sending a shock wave through the core of Taiwan's economy and polity in the past three years. The DPP government hopes to nurture higher level production in the semiconductor industry as well as the growth of new sectors such as the image display sector (especially the production of thin-film-transistor, liquid crystal display or TFT-LCD), the digital content sector and the biotechnology sector. Through a series of programs, the government is attempting to keep high-tech firms rooted in Taiwan by weaving dense, interlocking industrial clusters, thereby raising the opportunity cost of leaving Taiwan.

THE EMERGING FOURTH CONCERN

Dense economic ties with China will remain an inescapable reality to Taiwan. Given the adversarial relationship across the Strait, political, security, and economic risks that this economic linkage with China may entail are understandably major concerns to the government of the Republic of China on Taiwan. It seems that at least in the foreseeable future, China can flex economic muscle to coerce Taiwan politically and militarily only at a great cost that the Beijing regime may not be able to afford. To the Taiwanese government, *Taishang's* investment in China may well be less a political problem than it appears to be. The incipient "hollowing out" effect may be real, though. However, a more potent hazard that cross-Strait economic ties pose to Taiwan is the concentration of trade with and investment in China to such a high degree that recession or currency fluctuation in China may have serious repercussions for Taiwan's economy. How to diversify its external economic ties in order to minimize the transmission of China's potential economic problems (e.g., deflation) to Taiwan seems to be a new concern for policy makers in Taiwan.

Note: Adapted from Tun-jen Cheng, "China-Taiwan Economic Linkages," in Nancy Berkopf Tucker, ed., *U.S.-Taiwan Relationship: Tempting Fate?*



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