



# Investment Across the Taiwan Strait

How Taiwan's Relationship with China  
Affects its Position in the Global Economy

Kerry Brown, Justin Hempson-Jones and Jessica Pennisi

November 2010



CHATHAM HOUSE

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# Executive Summary and Policy Recommendations

In the last decade, while its democracy has grown and developed, Taiwan has experienced mixed economic fortunes. The election of President Ma Ying-jeou in 2008 has brought about a renewed focus on economic development. A major element of this is deeper economic engagement with Mainland China.

Taiwan has made significant investments into the Mainland since the early 1990s, after government restrictions were lifted, and is now one of its most important partners. Even so, Taiwan itself remains a world leader in key areas of technology and innovation.

Since 2000, Mainland investment abroad has started to increase dramatically. So far, Taiwan has been only a small recipient of this. But with the improved relations across the Taiwan Strait, new regulations have encouraged Mainland companies to invest, and there is already an increase year on year. The story of inward investment from Taiwan into China has now been replaced by the story of Mainland investment outwards and into the island.

The Economic Cooperation Framework Agreement (ECFA), signed in 2010, was built on the back of the relaxation of rules on direct air and postal links, and is one of the most potentially significant free trade agreements ever made, simply because it is between two entities which have such a difficult political and diplomatic relationship with each other. It marks a major change, allowing the creation of what is to all intents and purposes a free trade area between Taiwan and the Mainland, despite their political differences. Their respective objectives might be different, but the economic impact for Taiwan is potentially huge – as are the political implications.

Taiwan has committed itself to pragmatic diplomacy under President Ma. One of the main impacts of this has been the recognition that to achieve strong growth, Taiwan has to engage with the Mainland, one of the world's largest emerging markets. In order to do this, Taiwan needs policies that allow it to enjoy the benefits of these deeper links but address the risks of political interference that come from them.

As a successful democracy with good levels of governance, a strong rule of law, and successful internationalized companies, Taiwan has unique leverage with the Mainland. Far from being negative about its relationship with China, it has to see itself as a political model for reforms in the Mainland, and create a strategy where it can influence it in these areas. This is also in line with the agenda of the government in the Mainland, which needs to create a more balanced economic model, deal with social contention, strengthen the rule of law and create a more powerful civil society. Even on the most sensitive issue of political reform, therefore, Taiwan offers things to the Mainland that no one else does. Far from worrying about China's designs on it, it needs to remember its unique potential influence on the Mainland.

## Policy recommendations

- The signing of the ECFA means that Taiwan and China have accepted the wisdom of seeking stability through greater economic integration.
- For Taiwan, policy-makers now have to accept that the greatest chances for growth will arise from engaging with the opportunities in the Chinese market, despite the political risks. Clear sectors and policies need to be set out for Chinese inward investment into Taiwan. Policy-makers need to be knowledgeable about the kinds of companies coming in, about the sectors they are looking at, their potential motives, and the risks they might pose. Frequent reviews need to be made of Chinese ODI, both in Taiwan and comparatively.

- Taiwan needs to be more assertive about the areas where it can influence the Mainland's reform process positively. It needs to be aware of its strengths in terms of creating balanced growth, reform, corporate governance and welfare, and needs to seek links within the Mainland to assist China with its own reform programme so that its system becomes more open, accountable and stable.
- Taiwan needs to diversify its outward investments, supporting businesses with help in markets other than the Mainland where this optimizes the returns for its own economy. It should, in particular, explore more opportunities in other Asian countries such as India and Indonesia. The ECFA should be seen as the first step in increasing economic integration not just in China, but also in other countries through the region, so that Taiwan's voice is heard and its interests promoted.
- Now the commitment to ECFA has been made, everything should be done to ensure that it is successful in helping Taiwan strengthen its economy and improve employment. This will give the island international space, which its hard-fought battles to join multilateral organizations have largely failed to do.
- Taiwan should not underestimate the threat from Chinese intentions, but also the potential for instability in the Mainland, as the country enters a very difficult transition to middle-income status by 2020. China will need to face down many challenges, and Taiwan is best placed to engage positively with it on this so that political instability does not lead to raised tensions, or even the worst-case scenario of military conflict.
- Taiwan should continue to modernize and upgrade its own investment, legal and political environment, so that it remains an internationally respected, modernized territory. Just as the Communist Party of China has tied its reputation to modernity, Taiwan and its political parties, institutions and others should, through research and development and reform, be viewed as modernizing and at the cutting edge of new technical developments.

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# 1 Introduction

The signing of the Economic Cooperation Framework Agreement (ECFA) between Taiwan and the People's Republic of China (PRC) on 29 June 2010 was achieved after a major debate in Taiwan, with over 40,000 people marching at one event in Taipei in opposition to what they saw as the potential threat from the agreement.<sup>1</sup> For President Ma Ying-jeou it was the fulfilment of a large part of his election promise, and it was presented as a major achievement. The agreement is one of the most tangible indicators of greater links between the Mainland and Taiwan, and will have significant implications in the years ahead. This report looks at where Taiwan might be by the year 2020. The key themes addressed are how greater integration with the Mainland market will develop in the coming decade, and the risks and opportunities involved.

Almost inevitably, not just the economic but the political dynamics between the Mainland and Taiwan will play a very large role in what will follow in the years to come. The PRC's economic growth has been one of the most covered stories of the last decade. China has become the world's second largest economy, and the largest exporter and holder of foreign reserves. It is the world's largest holder of foreign debt. It is a markedly different economic and political entity from the one that existed even as recently as 1996, when Taiwan held its first fully open presidential elections. One of the main issues considered in this report is China's increasing importance not just as the destination for inward investment (and here Taiwan has been one of the main players since the 1990s, with over US\$100 billion invested in the Mainland), but also as an outward investor. How Taiwan engages with this new opportunity to receive investment from the PRC while protecting itself from some of the political risks and controversies this might bring is very important. More than in Europe, North America and even Africa and Latin America, where investment by Chinese companies has created mixed feelings, large amounts of Mainland investment into the island will create controversy and debate. The Taiwanese government needs to have a robust strategy to deal with this.

The report discusses another major issue: the processes of globalization and how, through agreements like the ECFA, these can offer more space for Taiwan without creating political problems. Taiwan's need to reinvigorate its economy after a number of years of sluggish growth and maintain its clear economic advantages must be balanced against the equally strong need to retain its separate identity and to pursue its own legitimate interests in an environment where the government in Beijing is increasingly strong and assertive. In the next decade, therefore, any administration in Taiwan will need to steer between the Scylla of Chinese economic might and diplomatic assertiveness, and the Charybdis of its own self-determination and geopolitical needs. Chinese and Taiwanese economic relations have a profoundly political cast, and that is why much of this report addresses the political dynamics within each and the reasons for their importance.

At the moment, in terms of political systems, there is nothing but difference. In the PRC the Chinese Communist Party (CCP) enjoys a monopoly on power. Talk of intra-party democracy and reform is complex, and any suggestion of multi-party politics is taboo. While the experiments in village democracy and deepening legal reform continue, there remain fundamental restrictions on, for instance, courts being able to fully challenge the party state, or civil society being able to function in a way that is fully autonomous. As a recent study of Chinese entrepreneurs has shown, the Mainland's nascent middle class shows little if any interest in fundamental reforms of the system, and operates in a framework in which the key interests in society are still controlled by the CCP.<sup>2</sup>

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1 This is a police estimate. Organizers of the event claimed 100,000 attended.

2 See Bruce J. Dickson and Jie Chen, *Allies of the State: China's Private Entrepreneurs and Democratic Change*, (Harvard University Press, 2010).



Taiwan, on the other hand, has undergone one of the most successful democratic transitions in Asia, developing from a society where martial law was still in place in 1985 to one that by 2010 had held four successful democratic presidential elections, implemented a series of reforms, seen a peaceful transition from one ruling party to another and back again, and created one of the most open, tolerant and stable societies in the whole region. In his presidential address in May 2008 Ma Ying-Jeou talked of the preciousness of this democratic heritage. Preserving this is his declared key objective, and the main means of achieving this is to ensure that Taiwan's economy continues to develop.

In view of these differences, it is not surprising that both sides have opted recently for a 'status quo' approach, avoiding major confrontation, and leaving the larger issue of Taiwan's final status for the future. That issue will matter beyond 2020 and is probably only fully resolvable once the Mainland has reformed its own political system. For the next decade, the key issues will remain the integration of the two economies, and the ways in which both sides attempt to use this to their own economic, political and diplomatic advantage.

### Structure of the report

Chapter 2 provides the background to Taiwan's economic development since 1949. A key feature is how it developed into an extremely successful export-orientated, manufacturing economy in the 1960s and 1970s, which in some ways (though there are important differences) prefigured later developments in the Mainland. High growth created a middle class, a more educated population, and finally a move into a more technology-oriented economy. By 2000, however, Taiwan was starting to experience lower growth and higher unemployment, and the global recession led to a 1.9 per cent fall in growth in 2009. Since then Taiwan's economy has bounced back and is on track now to post much higher growth figures. The chapter also assesses how Taiwan has fared as a democracy since 1996. One can see there a more nuanced story of needing to deliver more complex outcomes, and the economy's need to move up the value chain. And one can also see the looming importance of the Mainland, with a remarkable shift of manufacturing by Taiwanese companies across the Taiwan Strait. The development of these links, particularly in places such as Fujian province in the southeast of the PRC, is a major focus of this section. This is followed by an assessment of where Taiwan stands in 2010: maintaining some of its global competitiveness in areas such as the production of semi-conductors and other key technologies, and attempting to create an international financial centre in Taipei. The latest economic data are presented, along with some analysis of Taiwan's sectoral strengths and weaknesses, and a discussion of Chinese ODI.

Chapter 3 looks in detail at ECFA, and at its background, and impact. These will be the two major themes of the decade ahead, and some understanding of them will be critical for policy-makers and business people who are involved in Taiwan's economy.

Chapter 4 considers where Taiwan will stand in the coming decade in terms of its economic relations with China and in the global economy. Here the question of how it will maintain its strengths and deal with challenges is key. Our conclusion is that with the right policy approach, Taiwan is in a good position to confront these issues, but it needs to be aware of the potential opportunities and threats entailed in deeper involvement in the Mainland economy, in particular how the Mainland might use Taiwan's development experience as a model. Taiwan should not assume that the flow of influence is one way, with the Mainland in the driving seat all the time, but in areas of governance and reform it can find key issues where it is in a position to offer something to the Mainland. Good policy-making is based on good knowledge and assessments, and if Taiwan can develop these, it is more than capable of prospering.

The conclusions in this chapter give rise to a set of policy recommendations, which are listed in the Executive Summary.

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## 2 An Overview of Taiwan's Development Path

### Taiwan's economic development, 1949–96

Over nearly half a century Taiwan set new economic records with an annual average economic growth rate of 8.3 per cent.<sup>3</sup> Many features of its growth prefigured that of other economies in the region, and also have parallels with policies the Mainland has pursued more recently. Wealth creation has been a remarkable feature of what Taiwan has achieved. During this time its per capita income leapt from US\$170 in 1949, similar to that of Democratic Republic of the Congo, to US\$13,500 in 1996, comparable to that of Greece.<sup>4</sup> Taiwan was transformed from major recipient of US economic aid to aid donor and major foreign investor itself. This earned it a place as one of four 'Asian Tigers', along with Singapore, South Korea and Hong Kong. What is now referred to as the Taiwanese economic miracle followed three distinct steps. The first was stabilization of a war-battered economy in the first few years after 1949. During the second, a shift from agriculture to industry triggered sustained high economic growth rates in the 1950s. The third step entailed a period of lower but sustained industrial growth from 1980 onwards, in the face of increased regional economic competition. Omitting the hyperinflation of 1949 and brief fluctuations during the two oil shocks of the 1970s, the process was characterized by moderate inflation and sustained low unemployment. The Taiwanese development model did not drastically increase social inequalities either; in fact, until the 1980s inequalities appeared to have actually decreased as economic growth increased. Throughout the process the nationalist Kuomintang (KMT) government husbanded the economy by setting strategic objectives, offering economic incentives and providing the legal and physical infrastructure within which growth would flourish.

In the last days of the Chinese civil war (1946–49) the KMT brought with it to Taiwan 1.9 million civilians and soldiers, increasing the island's population by a quarter at a stroke. This included a large proportion of China's intellectual and business elite. Installing itself firmly in power, the KMT set about ensuring the economic development of the island. It inherited an agricultural and industrial base created by the Japanese. Japan had imported agricultural products from Taiwan, and in the last years of the Second World War supported its war effort by developing the industrial infrastructure on Taiwan. Metal products, coal, petroleum, steel mills, shipbuilding, machine tools, chemicals, cement and paper industries were all established on the island. However, in 1949 Taiwan remained an overwhelmingly agricultural economy. Using the precious metals and foreign currency reserves brought over from the Mainland, the KMT established a gold-standard reserve currency to back up the newly issued New Taiwan Dollar, through which prices were stabilized and inflation was reduced.

Two further factors were key in providing the basis for sustained economic growth. The first was land reform, which came in the form of two separate government acts. A Rent Reduction Act alleviated the tax burden on peasants, while another redistributed land among small farmers. Landowners were compensated with commodities certificates as well as stock in state-owned businesses. These acts led to dramatic increases in agricultural productivity. They released agricultural labour to work in the emerging urban industries, and created a wealth-owning class with surplus capital to invest. Moreover the profits realized from a more efficient agricultural sector would be reinvested in industrial equipment. The second

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3 Directorate General of Budget, Accounting and Statistics, *Report of National Income Statistics, 1995* (1995) and *Report of National Income Statistics, 2001* (2001).

4 See US Department of State, *Quarterly National Economic Trends, Taiwan Area*, [http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook\\_eng/Y093.pdf](http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook_eng/Y093.pdf) (accessed 12/08/2010).

factor was the KMT government's commitment to education. Initial education reforms focused on providing universal elementary education. Particular emphasis was laid on improving literacy in order to create a workforce educated enough to build an advanced economy. This campaign was highly successful: an illiteracy rate of 40.25 per cent in 1949 had fallen to just 6.8 per cent by 1989.<sup>5</sup>

Once the economy had been stabilized, growth began to rocket, averaging 8 per cent a year throughout the 1950s.<sup>6</sup> It was driven by increases in industrial production as Taiwan began to shift from agriculture to industry. This shift was assisted not only by reinvestment of agricultural capital in industrial ventures, but by large amounts of American aid. Although this aid had been cut in the immediate aftermath of the Chinese civil war, it had quickly resumed in the wake of the Korean War (1951–53), which had left relations between the United States and Mainland China highly antagonistic. Throughout the 1950s and early 1960s American aid totalled US\$4 billion. Of this, US\$1.5 billion was directed into industrial growth while the remainder supported the military. The economic aid was crucial during the first decade of KMT rule, while the military aid allowed the maintenance of large armed forces without strangling economic growth. This was considered necessary given the nature of Taiwan's relations with the Mainland.

The 1950s began with Taiwan's economy still primed for war. Its first four-year plan, begun in 1953, focused on increasing agricultural productivity. At this stage Taiwan experienced a trade deficit with the outside world, especially with the United States, which had become its largest importer. During the second four-year plan, from 1956 to 1960, living standards improved alongside price stability, yet the trade deficit remained. The KMT government used American aid to offset this problem, but also tried to mitigate it through an import-substitution policy that promoted locally created goods, raised tariff barriers and imposed direct restrictions on imports. Controls on foreign exchange were also introduced. These measures together provided the base for industrial development within a fully protected market.

Throughout the 1950s agriculture – in particular sugar, rice, tea and bananas – still provided the bulk of Taiwanese exports. By 1962, however, industrial production accounted for a greater proportion of the economy than agriculture. Once a nascent industrial base had been established, Taiwan could move on to create an export-led development model similar to that pioneered in Japan. This was kick-started in 1959 with a so-called '19 points' programme of economic and financial reform, and followed by statutes for the encouragement of investment in 1960. These reforms liberalized market controls and provided a strategy that aimed to entice capital from foreign corporations. The focus on export-led growth also led to a devaluation of the New Taiwan Dollar and, significantly, the creation of an exports-processing area in Kaohsiung. In 1964 General Instruments pioneered electronic assembly in Taiwan, offering a taste of what was to come. Over the decade Japanese companies in particular moved in to take advantage of favourable labour conditions: the workforce had low salaries but was relatively – and increasingly – well educated, and industrial regulations were lax. Interest rates were allowed to rise, which encouraged domestic savings and further expanded the resources available for new business creation. Taiwan's emergent industries tended to be labour-intensive; its businesses produced manufactured items such as toys and textiles. These businesses were mainly small and medium-sized family enterprises, funded by private savings, but also subsidized by bank credit and government-guaranteed loans. Soon the government began to encourage more technologically advanced industries, including telecommunications, pharmaceuticals and watch-making.

The 1970s saw some rocky times for the Taiwanese economy. Political issues, like Taiwan's loss of status as China's representative at the United Nations in 1971, and the switching of official US diplomatic relations from Taiwan to the PRC in 1979, contributed to a reduction of foreign investment. The oil crisis of 1973 helped precipitate recession, pushing up the price of raw commodities, and subsequently prices for agricultural and industrial products. The second oil shock in 1979, while having a lesser impact, also adversely affected commodity prices. A rise in worldwide protectionism over the decade caused difficulties for an economy that had become largely export-oriented. The KMT government responded

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5 Council for Economic Planning and Development, *Economic Development, Taiwan, Republic of China* (Taipei: CEPD, 1990), p. 9.

6 Tishiyuki Mizoguchi, 'Estimates of the Long-run Economic Growth of Taiwan Based on Revised SNA (1901–2000) Statistics' (Tokyo: Institute of Economic Research, Hitotsubashi University, 2005), <http://hermes-ir.lib.hit-u.ac.jp/rs/bitstream/10086/13688/1/D05-123.pdf> (last accessed 13 August 2010).

by encouraging further industrial modernization. This process placed particular emphasis on high technology, particularly microelectronics, and later personal computers. Taiwanese brands established themselves as suppliers of components to the large high-technology US firms. To promote foreign trade the KMT government lowered tariffs and in 1979 moved the currency from a fixed to a floating exchange rate. Taiwanese companies were encouraged to expand into heavy industry while the government focused on modernizing infrastructure. Beginning in 1974, the government also invested heavily in ten major construction projects. These included Taipei's Chiang Kai Shek airport, a national highway, three new ports, a dike and levee construction, regional drainage, and new large-scale housing projects. Other projects paved the way for an indigenous chemicals industry. The 1970s also saw the development of an independent labour union movement that flourished despite martial law, and that was to have great political importance as it opened up possibilities for social change over the next two decades. Despite the two oil crises, real GDP per capita in the 1970s continued to grow at an average of just under 10 per cent, just as it had during the 1960s.<sup>7</sup> Simultaneously, income inequality had decreased.

By the 1980s Taiwan, having survived the tests of the previous decade, was recognized as a dynamic capitalist economy. The rate of economic growth however dropped to about 7.5 per cent between 1980 and 1995, owing to a tailing-off in industrial production.<sup>8</sup> Instead growth became largely driven by services. Meanwhile unemployment sank further from its average since 1949 of around 3 per cent; indeed at 2 per cent it was so low that Taiwan faced a labour shortage that could only be filled by importing foreign workers.<sup>9</sup> The island had become a mature and diversified economy with a strong presence in international markets, and a large surplus of foreign exchange reserves. This meant that the government could relax its grip, and it began to focus on facilitation of the private sector rather than acting as the driver of economic activity itself. The shift to heavy industry seen in the 1970s changed to a focus on advanced electronics instead. Taiwan began a campaign to entice skilled overseas ethnic Chinese to return to the island since their technological expertise was crucial in the expansion of these industries. Although foreign investment in Taiwan began to slow, the island had also become a major outward investor. Taiwanese companies moved production abroad, to locations in Southeast Asia and in particular China where they took advantage of the same lack of organized labour and the low salaries that had been a feature of Taiwan a few decades earlier. Particularly important were developments in Mainland China, which was by now in the midst of its own economic reforms. Taiwan's opening process reached a peak in 1984 with the abolition of interest rate controls, the slashing of tariffs and the privatization of many government-run enterprises.

The year 1987 in particular stands out as a watershed. The emergency decree that had declared martial law since the establishment of Taiwan as the base of a nationalist government was lifted. Social movements bloomed. Workers, consumers, environmentalists and farmers alike now voiced their demands. Protests erupted. Taiwan's reputation for political stability was damaged and caused some businesses to relocate. At the same time, however, the abandonment of martial law allowed the KMT government to reduce defence expenditures. That same year, civilian contacts between Taiwan and the Mainland were resumed, and Taiwanese residents could now visit relatives in China. The increase in cross-Strait trade began a process of reducing Taiwanese dependence on the US market. Throughout the 1980s the personal savings of Taiwanese citizens continued to increase, the stock market grew rapidly on the back of these personal savings, land prices soared and income inequality increased. In 1990 the bubble economy that had been building up finally burst. The resulting recession was exacerbated by the increased strength of the New Taiwan Dollar, which had appreciated against the US dollar on the back of increased foreign exchange assets. Together these events severely lowered the competitiveness of the island's export-led economy and led to a haemorrhage of labour-intensive small and medium-sized businesses to China and Southeast Asia.

7 Ibid.

8 Ibid.

9 See Taiwan Government Information Office, 'The Story of Taiwan: The Fruits of Economic Development', [www.gio.gov.tw/info/Taiwan-story/economy/edown/3-5.htm](http://www.gio.gov.tw/info/Taiwan-story/economy/edown/3-5.htm) (last accessed 13 August 2010).

The mid-1990s saw a return to economic growth. Taiwan remained a mature economy with a strong advanced-technology sector. Its foreign exchange reserves were among the largest in the world, and it was a major international investor. By 1996 it had drastically increased the educational level of its citizens and built itself a social welfare system that accounted for 11.5 per cent of all government spending.<sup>10</sup> The KMT government remained at this stage the centre of a structure in which it controlled the process: one which consisted of a complex net of relations between business and the state, and between business and the global market. This was about to change, however.

### Taiwan's economic development as a democracy, 1996–2008

During the 1990s Taiwan achieved a remarkable political transition, culminating in the holding of fully free presidential elections in 1996. The road had been paved by the growing tolerance of opposition political forces in the 1980s after the lifting of martial law and the formation in the early 1990s of the Democratic People's Party (DPP), which was able to take part in the 1996 poll. Although Lee Teng-hui of the ruling KMT won, the holding of a competitive election had historic importance. The aggressive response of the Mainland in holding threatening military manoeuvres in the Strait caused the United States to send two aircraft carriers to the region to act as a restraint. In the elections of 2000, Taiwan achieved a transition of power from the KMT to the DPP – the first non-KMT government in the island's modern history – with Chen Shui-bian elected president.

Taiwan's democratization also occurred at the same time as its economy matured. Growth now came from industries on the front line of innovation, such as information technology and biotechnology. Furthermore, several events had a particularly large effect on the island's export-led economy. These included an earthquake in 1999 and global recessions in 2000 and 2008. The key story throughout this era, however, was the continued interdependence of the Taiwanese and Mainland Chinese economies despite the increasing differences between their political systems.

Since the late 1990s economic growth in Taiwan has been relatively modest; in the first decade of this century it has averaged just 4 per cent, down from the 10 per cent average of the 1960s and 1970s. Much of this now comes from knowledge-based industries and services. By 2008 Taiwan was producing 80 per cent of the world's laptop computers and had become the largest producer of liquid crystal display (LCD) screens.<sup>11</sup> Large parts of the economy came to specialize in LCD manufacturing and light emitting diode (LED) technology. Taiwan still occupied niches in the wider manufacturing sector, particularly in mechanical appliances and plastics, but it was now the services sector that provided the bulk of Taiwan's economic growth. In three sub-sectors in particular Taiwan became a regional services centre: banking, insurance and business services.

During the 1990s Taiwan continued down the path of economic liberalization it had taken in the 1980s. Several state-run companies were privatized, including shipbuilders, banks and telecommunications firms. The government remained proactive in providing support for development, not only improving the regulatory framework but continuing to invest in infrastructure, and transport in particular. In 2008 the first rapid transit lines opened in Kaohsiung, Taiwan's second city, while Taipei's transit system is due to double in size by 2013. In the two decades preceding 2008 a network of well-maintained highways, as well as a high-speed rail system serving the major cities of Taiwan's west coast, were built.

The slower rate of growth experienced during the 1990s and beyond was exacerbated by a series of events. The 1997 Asian financial crisis saw capital flight across the region, although Taiwan weathered this relatively well, largely as a result of the restrictions the government had already placed on the outflow of invested foreign capital. The second event was the earthquake that devastated Taiwan in 1999. However, resources were efficiently channelled towards reconstruction, which had largely been achieved by 2000. The historic election of the DPP was overshadowed by the worldwide bursting of the dotcom bubble with the sudden

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10 Council for Economic Planning and Development, *Economic Development*, p. 9.

11 Taiwan Government Information Service, 'A 21st Century Nation – The Republic of Taiwan (Taiwan): A Global Economic Presence', <http://www.gio.gov.tw/taiwan-website/5-gp/a21st/9a7.html> (last accessed 13 August 2010).

collapse in value of global technology companies in late 2000. The terrorist attacks in the United States on 11 September 2001 aggravated the ensuing global downturn. Taiwan fared particularly poorly, given its export-led economy and consequent vulnerability to unfavourable international events. The stock market suffered a huge slump and foreign investment fell. This was notable as it coincided with the first recorded decline in Taiwan's real GDP, which fell by 2.17 per cent in 2001.<sup>12</sup> Even during the recession, however, Taiwan ran a large trade surplus of about US\$19 billion.<sup>13</sup> Inflation, which had remained at a reasonably healthy average of 3.1 per cent throughout the 1990s, slipped to -0.2 per cent in the recession, causing deflation to become a matter of some concern.<sup>14</sup> Unemployment reached a record high of 5.2 per cent at the beginning of 2002.<sup>15</sup> A government-led recovery package, delayed briefly by legislative pettifoggery, was passed by the last quarter of 2001. By 2002 growth had returned and was running at 4.64 per cent for the year.<sup>16</sup>

One of the DPP government's priorities was to attempt to join a number of high-profile economics-focused international organizations including the World Bank and the International Monetary Fund. This presented obvious difficulties, given the requirement that members of most such organizations be recognized sovereign states, yet Taiwan was able to join the World Trade Organization (WTO) in 2002. This involved some legal fudging whereby Taiwan was declared a 'special customs territory' that would join at the same time as Mainland China. However, Taiwan had to join as a 'developed country', which imposed stricter requirements on lowering barriers to foreign competition in its domestic market than were required for a 'developing country'. The economic outlook for Taiwan in 2005 remained uncertain, with its 4.16 per cent growth mediocre relative to its historical levels.<sup>17</sup> This was not helped by a slowdown in the export sector and the increasingly high price of oil. By 2008 the economy came very close to a second recession in the face of a global downturn. Inflation was increasing, wages remained stagnant, and unemployment – while low by Western standards – remained high by Taiwanese historical standards at 4.14 per cent.<sup>18</sup> Social inequality had increased too, the emergent middle class having begun to hollow out. These issues contributed to the DPP's loss of power in 2008; the party was thought by many to have prioritized identity politics and confrontation with China at the expense of the economy.

### Taiwan in 2010: weaknesses and strengths

On the back of strong legislative election wins for the KMT earlier in the year, Ma Ying-Jeou won the 2008 presidential elections on a tide of public anger and disillusionment against the ruling DPP. In a run-off in March 2008, he won 58 per cent of the vote, while Frank Hsieh of the DPP gained 42 per cent. The key themes in the election had been corruption under the DPP, and the economy.<sup>19</sup>

In his inaugural speech on 20 May 2008, Ma promised three specific things. First, he would address the economic performance of Taiwan by upgrading its international competitiveness. Secondly, he would strengthen relations with the United States (they had been under increasing pressure during the Chen era). Thirdly, there would be improvements in the crucial area of cross-Strait relations.

Much of President Ma's election campaign in early 2008 was dominated by promises about improving the economy. Despite the impact of the Asia financial crisis of 1998, Taiwan posted a respectable 5.7 per cent growth rate in 2007, but there was still a feeling in the country that this was not good as the world

12 Compiled from US Department of State, *Quarterly National Economic Trends, Taiwan Area*. [http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook\\_eng/Y0961.pdf](http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook_eng/Y0961.pdf) (last accessed 13 October 2010).

13 Directorate General of Budget, Accounting and Statistics, [http://eng.dgbas.gov.tw/public/data/dgbas03/bs2/yearbook\\_eng/y1191.pdf](http://eng.dgbas.gov.tw/public/data/dgbas03/bs2/yearbook_eng/y1191.pdf) (last accessed 13 October 2010).

14 See International Monetary Fund Statistics, [www.imf.org](http://www.imf.org) (last accessed 13 October 2010).

15 US Department of State, *Quarterly National Economic Trends, Taiwan Area*. [http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook\\_eng/y0281.pdf](http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook_eng/y0281.pdf) (last accessed 13 October 2010).

16 Compiled from US Department of State, *Quarterly National Economic Trends, Taiwan Area*, [http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook\\_eng/Y0961.pdf](http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook_eng/Y0961.pdf) (last accessed 13 October 2010).

17 Ibid.

18 US Department of State, *Quarterly National Economic Trends, Taiwan Area*, [http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook\\_eng/y0281.pdf](http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook_eng/y0281.pdf) (last accessed 13 October 2010).

19 Former President Chen Shui-bian has subsequently been put on trial for graft and massive backhanders; he was sentenced to life imprisonment for embezzlement in 2009, and his appeal is still pending.

was experiencing a boom. In mid-2008, almost as soon as he had been elected, all of Ma's plans were shattered by the global financial crisis, which destroyed confidence and wealth in the financial sector, and led to a paltry 0.7 per cent growth. The situation in 2009 was even worse, with a contraction of 1.9 per cent. Taiwan's export markets were decimated, showing declining figures for 11 consecutive months from September 2008 and only picking up in the fourth quarter of 2009.<sup>20</sup> Unemployment rose to over 6 per cent. In April 2010, the Minister for Economic Affairs, Shih Yen-Shang, forecast a 5 per cent growth rate for 2010, which would be maintained over the next three years. The IMF concurred, saying growth might even exceed 6 per cent. In fact, a 13 per cent growth rate was recorded in the first quarter of 2010, the highest in 30 years, and the second largest increase in Asia after Singapore's. Private investment went up 37 per cent, a 35-year record. Exports grew by 24 per cent (the best performance for 23 years) and Taiwan's ranking in economic competitiveness improved by 15 places to become the 8th in the world, according to World Economic Forum. Taiwan's exports amounted to US\$390 billion in 2009, and it held US\$360 billion of foreign reserves as of mid-2010. Over the last decade, trade has contributed 60–70 per cent to GDP.<sup>21</sup> Taiwan is the world's 18th leading exporter, with total trade value having increased by 120 times since 1971. In 2008, foreign trade came to almost US\$500 billion.<sup>22</sup> According to the World Economic Forum, Taiwan was ranked 12th out of 132 countries in terms of global competitiveness, with only Singapore, Japan and Hong Kong ranking above it in Asia. According to a World Bank report in 2010, it came seventh in Asia in terms of ease of doing business.<sup>23</sup> According to BERI (Business Environment Risk Intelligence), it ranked fifth globally as a low-risk investment environment.<sup>24</sup> Clearly the Taiwanese economy is intrinsically integrated on a global scale in 2010, but this is at odds with Taiwan's irregular political situation.

President Ma, in his election campaign, recognized in early talk about a common Chinese market that Taiwan's economic performance was intimately linked to its relations with the Mainland. In the Chen Shui-bian years, this had been one of the most contentious issues, with periods of great fractiousness between the two sides. Many looked at the telling trade figures, however. Over the last decade, while exports to the United States fell, those to the Mainland rose. While the US economy contracted in 2009, that of Mainland China posted 8 per cent growth. Like the rest of the world, Taiwan looked to the Mainland as a source of development and expansion, particularly because of its newly emerging consumer base. In 1985, Taiwan's largest trading partner, accounting for almost half its exports, was the United States. In 1998, the United States accounted for a quarter of its exports, while China had risen from nowhere to accounting for 23 per cent. In 2009, the Mainland and Hong Kong took 41 per cent of Taiwan's goods combined, with the United States dropping to a mere 11 per cent.<sup>25</sup> Already one of the key investors in so much of Mainland Chinese manufacturing, surely Taiwan could now also capitalize on these increasing trade links?

Ma said in his inaugural address: 'I sincerely hope that the two sides of the Taiwan Strait can seize this historic opportunity to achieve peace and co-prosperity.' During his campaign he had even talked of a Peace Treaty, following on from hints given by PRC President Hu Jintao in his speech at the 17th Party Congress the previous October. Standing by the 1992 Consensus (in which the concept of 'One China' was neither affirmed nor denied by Taiwan), Ma had talked of taking a historic opportunity to put the years of tension and disagreement aside and to move forward. 'Both sides,' Ma said in a speech on 4 August 2008, 'should be committed to not wasting precious resources in a vicious cycle to win over diplomatic allies from the other side.' Using the phrase 'flexible diplomacy,' Ma stated: 'The cornerstone of this [...] is a certain degree of mutual trust across the Strait, which [will] later be extended to the international arena.'<sup>26</sup>

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20 Taiwan Directorate General of Customs.

21 Directorate General of Budget, Accounting and Statistics, Executive Yuan, Taiwan.

22 WTO and Directorate General of Budget, Accounting and Statistics, Executive Yuan.

23 World Bank, 'Doing Business Economy Rankings 2008 to 2009', <http://www.doingbusiness.org/Rankings>.

24 Council for Economic Planning and Development, Taiwan, <http://www.cepd.gov.tw/encontent/m1.aspx?sNo=0013296>.

25 Taiwan Directorate of Customs.

26 Ma Ying-jeao, 'President Ma's Remarks at the Ministry of Foreign Affairs, The Concept and Strategy of Flexible Diplomacy,' speech on 4 August 2008.

Table 1: Taiwan's growth, 2000–10

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*
Growth (%)	5.77	-2.17	4.64	3.50	6.15	4.16	4.80	5.70	0.06	-1.87	8.24
GDP (US\$)	321,230	291,694	297,668	305,624	331,007	355,958	366,357	384,768	391,278	379,400	400,800
GDP per capita (US\$)	14,519	13,093	13,291	13,587	14,663	15,714	16,111	16,855	17,083	16,442	17,660

\*projected

Source: Quarterly National Economic Trends, Taiwan Area, [http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook\\_eng/Y0961.pdf](http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook_eng/Y0961.pdf)

Table 2: The Taiwanese economy – sectors and strengths

	2000 (million NT\$)	2008 (million NT\$)	8-year growth (%)
Agriculture, forestry, fishing and animal husbandry	199,011	208,258	4.6
Mining and quarrying	39,490	51,966	31.6
Manufacturing	2,383,811	2,683,025	12.5
Electricity, gas and water	195,447	68,618	-64.9
Construction	299,070	286,707	-4.1
Trade	1,631,889	2,376,845	45.6
Accommodation and restaurants and bars	208,397	268,788	29.0
Transport, storage and communication	633,979	721,412	13.8
Finance, insurance	1,007,516	1,238,094	22.9
Real estate, rental and leasing	856,928	1,061,179	23.8
Professional, scientific and technical services	220,969	360,975	63.4
Education services	163,951	233,336	42.3
Healthcare and social welfare services	267,210	395,767	48.1
Cultural, sporting and recreational services	147,536	196,668	33.3
Other services	254,012	395,170	55.6
Industries, total	8,509,216	10,546,808	23.9

Source: Quarterly National Economic Trends, Taiwan Area, [http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook\\_eng/Y0961.pdf](http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook_eng/Y0961.pdf)

This was bold talk, and despite initially warm words from the Mainland leaders, the returns for Taiwan were mixed. In November 2008, Chen Yunlin, the head of the Mainland Association for Relations Across the Taiwan Strait (ARATS), and Chiang Pin-kun, the Chairman of the Taiwan Strait Exchange (TRE), the two key official bodies in the PRC and Taiwan respectively dealing with cross-Strait relations, signed an agreement allowing three links – transport, trade and postal. The first direct flight took place on 4 July 2008, and since then scheduled flights have been established



between Taiwan and a number of Mainland cities. There was also provision for as many as 3,000 Mainland tourists a day to visit Taiwan; the number is planned to reach a million by the end of 2010. The momentum behind these practical measures was continued with the fourth round of such talks in December 2009, in which agreements were reached on technical issues in agriculture and fisheries. Both sides have issued official statements welcoming investment from the Mainland into Taiwan (see below). The Mainland has become one of the fastest-growing and larger outward investors in the world, and it would be odd, in view of the fact that it tends to invest in places with a large population of overseas Chinese, for it not to see big benefits for its enterprises in Taiwan where there is a common language and a largely shared culture.

There is one specific deliverable that Ma can boast of in terms of creating more international space for Taiwan: the agreement for it to be allowed to attend the World Health Organization annual meeting as an observer. It did so in May 2009 – the first time since 1971 – with a delegation of 15, despite angry opposition by Ma's political opponents. Opinion polls show that over 90 per cent of Taiwanese wanted this to happen. Beyond this, however, there have been no advances, for instance, on Taiwan being allowed representation at the UN, and its search for diplomatic allies (countries recognizing Taipei over Beijing) remains stagnant. The United States did approve the long-discussed sale of almost US\$6 billion worth of military equipment in early 2010, much to the anger of Beijing, which for the first time threatened specific sanctions against companies in the United States involved in the deal. (So far, however, these threats have not been acted on.) Even so, some analysts noted that the equipment was almost entirely old and largely defensive. Requests for upgraded fighter aircraft were turned down, and the fear remains that the Mainland is in a far stronger position than ever before to inflict diplomatic and economic punishment on those who try to cooperate with Taiwan on its military defence. President Barack Obama's inauguration in the United States in January 2009 led to no new initiatives towards Taiwan. Nonetheless, the stark disagreements of the Chen years between Taiwan and China have gone.

Table 3: Taiwanese imports and exports

	2000 ('000 US\$)	2008 ('000 US\$)	Growth (%)
<b>Total exports</b>	<b>151,949,756</b>	<b>255,628,690</b>	<b>68.2</b>
Asia	79,130,927	169,521,279	114.2
Hong Kong	32,741,718	32,689,899	-0.2
Japan	16,887,176	17,555,991	39.6
Republic of Korea	4,002,304	8,705,814	117.5
Singapore	5,637,065	11,675,814	107.1
Thailand	2,652,616	4,906,009	84.9
Mainland China	4,391,494	66,883,516	1423.0
Middle and Near East	2,548,746	5,714,500	124.2
Europe	23,903,931	29,948,224	25.3
Africa	1,332,643	2,867,348	115.1
United States	35,588,452	30,790,956	-14.5
Central and South America	3,974,854	7,195,332	81.0
Oceania	2,309,084	4,372,518	89.4

The December 2009 elections in 17 of Taiwan's 23 counties offered a good opportunity for the public to give its verdict on the administration. The results were not particularly good for President Ma. The KMT's share of the vote fell to 48 per cent from over 50 per cent in the previous elections, and it lost one of the counties to the DPP. The KMT was victorious in 12 counties compared with the DPP's four. There were several reasons for this decline. The administration's response to Typhoon Morakot in August 2009, in which over 600 people died and thousands were left homeless, was seen as too slow. The then premier was forced to step down to appease public anger and Ma saw a big fall in his ratings. The lifting of a partial ban on the import of US beef later in the year also angered the public because of the friction it caused with the United States and the indecisiveness of the authorities. High unemployment and the economic contraction also all played their part.

Yet, despite the administration's political problems, Taiwan's economic prospects appear to be positive. A report in *The Economist* in May 2010 clarified the industrial strengths and weaknesses of the economy. The island remains a world leader in the manufacture of high-technology equipment, producing 50 per cent of all computer chips, nearly 70 per cent of computer displays, and 90 per cent of all portable computers. Taiwan's Acer is the world's second largest manufacturer of personal computers (see Box 1). These are areas where the country continues to enjoy significant competitive advantages. The high level of US-educated managers and business people also stands to the island's economic advantage, as does the large amount of state investment through the Industrial and Technology Research Institute. This contrasts with Mainland companies, where investment into research and development is relatively low.

Even so, it is clear that one of the main areas for potential growth in the coming decades will be in the Mainland. This is unavoidable. With GDP growth-rate increases in double figures each year in the last decade, China remains one of the world's stronger performing economies. Despite the political issues between the two sides, therefore, Taiwan had to make a choice either to engage with the opportunities across the Strait or to ignore them. With a significant proportion of Taiwanese investors already voting with their wallets, the Ma government has adopted a pragmatic stance. In two areas, Chinese outward investment and the free trade deal, it has showed that Taiwan is open to doing business with the Mainland. The question now is how it will deepen this engagement while mitigating risks, and what might happen as the process continues.

Table 4: Taiwan and China – advantages and disadvantages

Taiwan	China
<i>Advantages</i>	<i>Advantages</i>
<ul style="list-style-type: none"> <li>● Highly educated work force, with great international experience</li> <li>● Strong performance in hi-tech sector and innovation</li> <li>● Good state investment into technology and research</li> <li>● Internationally integrated economy with strong links to the United States</li> <li>● Good standards of governance, and reliable legal system</li> <li>● Intellectual property rights protection</li> <li>● China</li> </ul>	<ul style="list-style-type: none"> <li>● Huge labour market</li> <li>● Plentiful land</li> <li>● Pro-growth government policies</li> <li>● Excellent logistic links</li> <li>● Potentially vast consumer market</li> </ul>
<i>Disadvantages</i>	<i>Disadvantages</i>
<ul style="list-style-type: none"> <li>● Razor-thin profit margins</li> <li>● Moved much capacity to PRC</li> <li>● Continuing political anxiety over its irregular diplomatic status</li> </ul>	<ul style="list-style-type: none"> <li>● Lack of meaningful political reform, despite economic performance.</li> <li>● Poor rule of law, although this has been improving in the last two decades</li> <li>● Vast demographic and sustainability challenges</li> </ul>

### Box 1: Acer – a global Taiwanese company

Today Taiwan produces 50 per cent of all computer chips, nearly 70 per cent of computer displays and more than 90 per cent of all portable computers. It is in this sector that it has maintained its key strategic advantages.<sup>a</sup> This has been built on good levels of state investment through the Industrial Technology Research Institute, and high levels of education; many people in this sector have been educated in the United States or EU.

Acer is perhaps the best example of a company in the high-tech sector, founded and grown in Taiwan, and now having a global reach. Originally formed as Multitech by Stanley Shih, his wife Carolyn Yeh and five other partners, with capital of US\$25,000, in Xizhi, Taipei, purely as a distributor, it became a manufacturer in the 1980s, changing its name to Acer in 1987 and making a successful initial public offering (IPO) the following year.

Acer is a relatively small employer, with 7,000 people currently on its books worldwide, and operations in the United States, Europe and Asia, along with subsidiaries in most other markets. Its turnover increased rapidly in the last decade, rising US\$17.9 billion in 2009. But more significantly, it has also been a proactive acquirer of brands such as the American firm Gateway and Packard Bell, of which it bought 75 per cent in 2008. In October 2009 Acer overtook Dell to become the world's largest PC manufacturer.

There are still challenges for the industry, however. Profit margins in this sector are very narrow. Much capacity and many jobs have moved to the Mainland. In semi-conductors, China is also becoming a competitor in its own right. And in the last few years, funding for research and development has declined. To stay at the top, Taiwan will have to work hard, and Acer is a good example of the areas where it can succeed.

a *The Economist*, 27 May 2010.

### Greater investment links between Taiwan and China

As outlined above, Taiwan has been a major investor in the Mainland, with huge increases in the amounts of capital moving there since the early 1990s. This has been part of the extraordinary story of the PRC's attraction of inward investment after the reforms introduced in 1978. One can identify two clear periods of economic behaviour from 1949 onwards. For the first three decades, the PRC was largely closed to foreign investment. It had no proper legal framework, its companies were 99 per cent state-owned, and foreign capital was regarded as being politically problematic and unwelcome. The first joint-venture law was passed in 1979, allowing non-PRC companies to take a minority stake in ventures with Mainland partners. A number of other reforms were passed in the coming years, meaning that in the 1980s US, European and other Asian countries started to invest increasing amounts in sectors that were opened up in the PRC.

As a facilitating mechanism for this process, Special Economic Zones were established from 1979, granting favourable conditions to investors. There were initially only four, though by the end of the 1984 these were expanded to 14. Shenzhen was one of the earliest, exploiting its favourable location just across the border from Hong Kong, and mostly attracting investment by Hong Kong business people looking for more land and labour for their factories now that these were at a premium in the territory, then under British control. Zhuhai similarly exploited its position opposite Macau, then under Portuguese control. But it was Xiamen, directly facing Taiwan on the southeast coast of Fujian province, that was identified as a key place to attempt to attract Taiwanese investment.

The initial Taiwanese investments were small and cautious, largely because of restrictions on the Taiwanese side. In 1986, they amounted to only US\$20 million. With a new round of liberalization to China's foreign direct investment (FDI) regulations following further negotiations on the General Agreement on Tariffs and Trade (GATT), the precursor to the World Trade Organization, this figure jumped to US\$100 million in 1987, and then US\$420 million the following year. New Taiwanese regulations allowed investment via third-party countries in 1990, which pushed the amount invested up to US\$9.9 billion in 1993, and to US\$40 billion in 1996, almost 5 per cent of Taiwan's GDP at that time.

The PRC had always been searching for specific results from its inward investment strategy. Foreign capital was not the main driver. In the late 1970s and early 1980s the Chinese government knew that it was facing an immense challenge to modernize the economy. Linking itself to a programme of modernity after the political and social catastrophe of the Cultural Revolution (1966–76) was one of the main strategies of the Communist Party for staying in power after so much of its credibility had been lost during the late Maoist years. Human capital had been depleted with the closure of universities in the late 1960s while China's youth were sent off to 'make revolution'. The legacy of this persists even today, with senior managers and politicians largely devoid of international experience because they were educated during a period of great closure and disruption. One of the greatest aims in undertaking foreign partnerships in the 1980s, therefore, was simply to attract foreign know-how, technology and management. Under the mantra of the Four Modernizations, which had been used by Premier Zhou Enlai just before his death in the mid-1970s, the Mainland wanted to reform its economic model, and to create a more solid industrial basis. In doing so it inevitably looked at the successful export-orientated economies of the other Asian Tigers (Taiwan, Singapore, South Korea and Hong Kong) and of Japan, and tried to emulate them.

Initially, politics got in the way. The whole process was disrupted by the turmoil in 1989, when students and others demonstrated against the government in Beijing and over 250 other cities. Yasheng Huang has called the 1980s the period of most liberal economic policy in the Mainland, when banks were willing to lend to entrepreneurs, the state allowed the establishment of semi-private Town and Village Enterprises (TVEs) and a whole generation of entrepreneurs, many of them formerly linked to government, were able to start their own businesses.<sup>27</sup> Corruption, inflation, and a host of administrative problems led to the turbulence in the summer of 1989, which provoked the government crackdown.<sup>28</sup> The era of liberalization seemed to have drawn to a close, with a tightening of policy, many foreign enterprises reviewing their presence in the PRC, and a fierce debate within the political elite in Beijing about what the next steps would be. The evidence is still ambiguous, because although a clampdown did occur, with some business people put in jail and restraints placed on lending, moves continued to reform the investment environment; Shanghai was made a Special Economic Zone in 1990. The break-up of the Soviet Union in 1991 caused yet more soul-searching in Beijing. Some analysts at the time stated that Gorbachev's policy had focused too much on political liberalization instead of first creating the necessary economic infrastructure. Any suggestion that the PRC might emulate what the Soviet Union had done became taboo.<sup>29</sup>

By late 1991, it was clear that paramount leader Deng Xiaoping had grown increasingly frustrated with the inability of the administration to see that economic opening up was still the key to greater prosperity, and that the CCP could only stay in power if this was continued. During his tour to China's Special Economic Zones in the south in early 1992, he asserted the key principles behind the reform process:

*Some people argue that the more foreign investment flows in and the more ventures of the three kinds [Chinese, joint and wholly foreign-owned ventures] are established, the more elements of capitalism will be introduced and the more capitalism will expand in China. These people lack basic knowledge. At the current stage, foreign-funded enterprises in China are allowed to make some money in accordance with existing laws and policies. But the government levies taxes on those enterprises,*

27 See Yasheng Huang, *Capitalism with Chinese Characteristics* (Cambridge University Press, 2008), Chapter 1, and Dickson and Chen, *Allies of the State*.

28 The inside account of this period is contained in the memoirs of then Party Secretary Zhao Ziyang, *Prisoner of State: The Secret Journal of Chinese Premier Zhao Ziyang* (New York: Simon and Schuster, 2009).

29 See Neil Munro, 'Democracy Postponed: Chinese Learning from the Soviet Collapse', *China Aktuell*, Vol. 4, 2008.

*workers get wages from them, and we learn technology and managerial skills. In addition, we can get information from them that will help us open more markets. Therefore, subject to the constraints of China's overall political and economic conditions, foreign-funded enterprises are useful supplements to the socialist economy, and in the final analysis they are good for socialism.*<sup>30</sup>

Not only was it good from now on to get rich, therefore, but it was also acceptable for foreigners to invest, and this is borne out by figures for FDI into China, which show an immense increase from 1993 onwards. According to government statistics, by the end of 2008 there were 659,000 cases of direct foreign investments in the PRC, with a contractual (i.e. promised, rather than realized) stock of US\$1.4 trillion dollars. The total amount of foreign investment actually utilized to the end of 2008 was US\$1.04 trillion. The figures for total foreign direct investment in 2007 and 2008 were US\$74.7 billion and US\$92.3 billion respectively.<sup>31</sup>

Taiwan's contribution to the gross figure is about 10 per cent. It currently has about US\$100 billion invested in the PRC. In 2007 it added US\$1.7 billion to its investments in the Mainland and this increased to US\$1.8 billion in 2008. By far the largest investor was the Hong Kong Special Administrative Region with over US\$27 billion in 2007, and US\$41 billion in 2008. Along with offshore investment vehicles through the Cayman Islands and the British Virgin Islands, however, it is likely that some of this money may have originated in Taiwan. In total 37,488 Taiwanese companies are officially listed as investing in the Mainland. Nanya Plastics is the largest with US\$500 million.<sup>32</sup>

Over 50 per cent of this investment has been in manufacturing, keeping close to the framework agreed in the 1980s that the PRC needed to have a sound export-oriented industrial base to create growth. Many of the companies investing into the Mainland from Taiwan have done so through family links or relationships, with the bulk going to Fujian province, which has the clearest link to Taiwan. Analysis has shown that a great driver of Taiwanese investment has been small and medium-sized companies, which seek competitive advantage and see the low wage costs of the Mainland as a major attraction.

Despite these big increases, politics still got in the way under the DPP between 2000 and 2008. The DPP administration stated that it wanted to see investment flows elsewhere, and started an 'invest in Taiwan' policy, incentivizing Taiwanese companies to reinvest in Taiwan through cheaper land prices, tax breaks, and research and development subsidies. A US\$7 billion low-interest loan fund was set up to encourage companies to stay on the island. Botthand, a telecommunications company, was one of the most high-profile firms to take advantage of these policies and open a plant back home.

From 2004 to 2008, the Taiwan Investment Commission, which is responsible for vetting PRC-bound investment applications from Taiwanese entities, was under instructions from the DPP government to prohibit applications in key high-tech areas. Figures from the Taiwanese Ministry of Economic Affairs showed that 1,090 projects were approved in 2006, for a value of US\$7.64 billion, 22 per cent more in number than in 2005. Regulations for investment in semi-conductors were relaxed, with similar restrictions on chip-testing and packaging lifted in 2007. The political risk associated with such a volume of investment into the Mainland was raised by the Taipei Society, which stated in a report that 'Taiwan's dependence on the Chinese export market has already surpassed Taiwan's dependence on the US export market. This allows China to easily implement policies that interfere with Taiwan's exports and, as such, with Taiwan's industrial development.'<sup>33</sup> According to the Investment Commission under the Taiwan Ministry of Economic Affairs, in the first five months of 2010 there were 187 investments in the Mainland, with a contractual total of US\$4.59 billion, representing a year-on-year increase of 239 per cent, of which 75 per cent was in the provinces of Jiangsu, Fujian, Guangdong and Shandong.<sup>34</sup>

30 Deng Xiaoping, 'Excerpts from Talks Given in Wuchang, Shenzhen, Zhuhai and Shanghai, January 18th to February 21st 1992', available at <http://www.olemiss.edu/courses/pol324/dengxp92.htm>, accessed 17 July 2010.

31 *China Statistical Yearbook 2009*, pp. 745–6.

32 Ministry of Economic Affairs, Taiwan.

33 J. Su, 'Reporters say investment in China may injure Taiwan', *Taipei Times*, 14 July 2004.

34 *People's Daily Online*, 22 June 2010.

It should not be forgotten that Taiwan does have significant investments elsewhere in Asia, in the EU and in the United States. Taiwanese investments in the EU came to €93.61 million in 2008, accounting for only 3 per cent of total outward investments. A report by the Ministry of Economic Affairs stated, 'As Taiwanese companies extend their global reach, the EU will serve as an important destination for Taiwanese investment. Central and Eastern Europe's low labour costs and geographic proximity have already attracted significant manufacturing investment from Taiwanese companies.'<sup>35</sup>

Table 5: Taiwanese investment in China, 1993–2003

	Taiwan FDI (including China)	Taiwan investment in China	Taiwan investment in China as share of total Taiwan FDI (%)	Taiwan investment in China as share of China contracted FDI (%)
1993	4.83	3.17	65.61	8.13
1994	2.58	0.96	37.31	2.23
1995	2.45	1.09	44.61	2.27
1996	3.39	1.23	36.21	2.24
1997	7.23	4.33	59.96	6.73
1998	5.33	2.03	38.17	3.47
1999	4.52	1.25	27.71	2.38
2000	7.68	2.61	33.93	4.39
2001	7.18	2.78	38.80	5.61
2002	10.09	6.72	66.61	12.22
2003	11.67	7.70	65.99	13.71
2004	4.81	3.39	70.42	–

Source: *Cross Straits Economic Statistics Monthly*

## ODI from the PRC and its importance to Taiwan

Outward direct investment (ODI) from the Mainland has been one of the most exciting and rapidly developing new economic phenomena of recent years. Historically, the PRC has not been a major deployer of capital beyond its borders. From 1949 to 1990, it made very few outward investments, almost all of these via vehicles registered in Hong Kong. In the 1960s it established trust and investment corporations, but the amounts registered were minuscule. In the 1980s, needing to source more minerals and energy resources, it started to engage in small investments in Australia and Canada.<sup>36</sup> However, at about the same time as direct investment started to flow into China in significantly increased amounts in the early 1990s, a similar change happened in China's outward investment. The amounts were proportionately much lower, and they tended to be concentrated on energy and mineral assets, but they still increased over the decade to 2001, when China finally entered the WTO. From 2001, there has been a concerted effort by the PRC to invest abroad, diversifying its portfolio and liberalizing its outward investment activity and actors.

<sup>35</sup> 'Taiwan-EU Free Trade Agreement: Creating New Opportunities for the EU and Taiwan', Ministry of Economic Affairs, Taiwan, December 2009.

<sup>36</sup> The background to this history can be found in Kerry Brown, *The Rise of the Dragon: Inward and Outward Investment in China in the Reform Period 1978–2007*, Chapter 4 (Oxford: Chandos Publishing, 2008).

China's overseas investments occur in a specific context, with a structure of regulations and administrative organizations to support, assist and control it. In fact Chinese ODI as it relates to Taiwan, offering some of the most tangible benefits and opportunities, but also presents some of the greatest potential problems.

China has no formal National Investment Strategy as such, but now has enough stock of ODI for it to have built up a profile. Professor Peter Buckley and a team at Leeds University in the UK examined Chinese investments from 1978 to 2006, and identified some recurring patterns. Their overall conclusion was that 'Chinese ODI is associated with high levels of political risk'.<sup>37</sup> Among other determinants they found the following:

1. Chinese ODI has a positive association with host country endowments of natural resources.
2. It has been directed to the acquisition of information and knowledge on how to operate internationally.
3. It has a positive association with the proportion of ethnic Chinese in the host population – a Chinese diaspora, therefore, is seen as offering a base, and some reassurance, for Mainland Chinese investors coming into a particular market.
4. A depreciation of the host country's currency leads to an increase in Chinese ODI.
5. Chinese ODI has a positive association with Chinese exports and imports to the host country.
6. It has a negative association with geographic distance from China.
7. It has a positive association with the degree of openness of the host economy to international investment.

For Taiwan, of course, while the first factor is not relevant, factors 2, 3, 5, 6 and 7 on the list above are all positive. Taiwan is a modern, innovative and knowledge-rich environment, it has powerful ethnic and cultural links with the Mainland, it already has strong export and import links, it is close to the Mainland, and it is a relatively open investment environment. All these factors mean that Taiwan should be a natural destination for Mainland investment.

It is also a relatively risk-free investment environment. Until 2005, the conclusion was that Chinese investors took a different attitude to risk from that of other major investors. They looked at good political links, and preferred to deal with countries where government-to-government relations were good and therefore offered some levels of security even in commercially very difficult environments (as, for example, in some of the main African countries in which China was investing). There is evidence that as China acquires increasing numbers of assets abroad, this attitude is changing, and it is seeking stable, secure and reliable destinations for its capital. Even so, the fact that it has been locked out of many sources of energy where stability exists means that it has had to deal with countries such as Sudan and Iran.

As of the end of 2007, Chinese ODI followed some clear patterns.

- It was predominantly in energy and oil, mining and leasing, with a big increase in finance.
- It was overwhelmingly directed from the centre, and through state-owned enterprises, though some non-state players had started to make a small splash.
- It was a small amount of the global proportion of stocks of ODI, but going up in huge jumps.
- Most of it went into the Asian region, with the bulk of this through Hong Kong. Significantly, the first Chinese investment (a mere US\$2 million) went to Taiwan in 2006.
- Africa saw the largest percentage increases over the period 2003–07, although there was a slowdown towards the end.
- Significant amounts also went into offshore areas.
- Chinese energy companies were key players.

For Taiwan, the leasing opportunities and the chances to work in partnership with Mainland companies were perhaps the strongest element in this new story. While Mainland Chinese have been able to buy property in Taiwan since 2002, there have been tight restrictions on the ways Mainland Chinese can invest on the island, and in what sectors. In May 2009, the Taiwanese Financial Supervisory Commission announced that 100 new sectors were now available for direct investments by Mainland companies from July of the same year. A limit of 10 per cent by institutional investors was set. This was on the back of a trade agreement on economic cooperation signed by Taiwan and Nanjing, Jiangsu province earlier in 2009, and talk by China Mobile of taking a 12 per cent stake in Taiwan's third largest telecom operator, to a value of US\$525 million. According to *The Times*, since 1997 there had been US\$170 million invested by Chinese non-state companies in Taiwan. The change in the rules was a formal recognition that it was now permissible to have Mainland investments in Taiwan.<sup>38</sup> Most of the sectors opened, however, were in low-profit industries; 64 of the 100 new sectors were in manufacturing, 25 in services and 11 in public infrastructure. Restrictions remained in place for LCDs and telecoms.<sup>39</sup>

Table 6: Inward and outward investment flows from Taiwan, 2008–09

		2008	2009	2010			
				December	January	February	Jan–Feb
Approved overseas Chinese and foreign investment	Amount (US\$100m)	82,37	47,98	6,33	3,02	3,47	6,49
	Annual rate of change (%)	-46,38	-41,75	15,23	108,44	-28,40	3,12
Approved outward investment	Amount (US\$100m)	44,66	30,06	4,55	1,57	0,27	1,83
	Annual rate of change (%)	-30,97	-32,71	21,63	74,14	-74,03	-4,87
Approved indirect Mainland China investment	Amount (US\$100m)	98,43	60,58	12,98	5,50	8,22	13,72
	Annual rate of change (%)	-1,28	-38,45	29,16	94,55	227,56	157,07

Source: 'Economy at a Glance', Ministry of Economic Affairs, Taiwan, <http://2k3dmz2.moea.gov.tw/gnweb/English/News/wFrmEnMain.aspx>

Within a year, the Investment Commission under the Ministry of Economic Affairs announced that 52 investments, with a value of US\$77 million, had been approved. Of these, 45 per cent were in computers and electronic and optical products, 37 per cent in communication services and 10 per cent in retail. Many were by small businesses, opening up offices or representative branches in Taiwan.<sup>40</sup> This is still a very small amount relative to the tens of billions of dollars that Taiwan invests in the Mainland or to the Mainland's investment elsewhere. Investment from the Mainland is a huge opportunity for Taiwan but it also carries risks and therefore requires a robust policy framework.

38 Jane Macartney, 'Taiwan opens up to Mainland Chinese investors', *The Times*, 1 May 2009.

39 Chinmei Song and Janet Ong, 'Taiwan Opens 100 Industries to Chinese Investment' (Update 2), Bloomberg, 30 June 2009.

40 'Mainland Investment in Taiwan Set to Rise', *Taiwan Today*, 29 June 2010.



## Box 2: The Taiwan Stock Exchange

Established in 1961, the Taiwanese Stock Exchange Corporation (TSEC) promotes, supervises and regulates 741 companies. The Stock Exchange (TWSE) and the Taiwan Stock Exchange Capitalization Weighted Stock Index (TAIEX) are the two largest bodies in the TSEC.<sup>a</sup>

TWSE was created in 1961 and began trading on 9 February 1962. It is comparable to the United States' Standard & Poor's Index, and is grouped into distinct market value and price average indices. Since its inception the TSEC has become primarily responsible for stocks, bonds, beneficiary certificates, warrants, depositary receipts, and exchange-traded funds (ETF) of Taiwanese companies. While the TWSE is a minor stock exchange compared with Japan's Nikkei Index and the United Kingdom's FTSE, it has shown a steady rate of growth since the early 1980s. In 1983 it had fewer than 120 companies listed; by 2009 there were 741, with 577,290 million shares and US\$655 billion in market capitalization.<sup>b</sup>

TAIEX was created in 1966 and has become the best-known TWSE index. Similar to the Dow Jones, TAIEX has 33 industrial sub-indices ranging from tourism to semi-conductors which cover a majority of the companies involved in TSEC.

In 2009 TSEC cooperated with the FTSE group in establishing the TSEC Taiwan Index Series, which creates a dual index of local Taiwanese and international indices for the benefit of investors at home and abroad. The TSEC Taiwan Index Series is an umbrella term for eight sub-indices that cover:

- *TSEC Taiwan 50 Index*: the 50 largest companies in the TSEC. This index specializes in derivative Taiwanese products.
- *TSEC Taiwan Mid-Cap 100 Index*: follows the TSEC Taiwan 50 index, and contains the next 100 largest companies.
- *TSEC Taiwan Technology Index*: is the benchmark for the technology sector in the Republic of China. It includes the top 150 largest companies.
- *TSEC Taiwan Dividend+Index*: a daily assessment of the top 30 companies in the TSEC Taiwan 50 Index and Mid-Cap 100 Index.
- *TSEC Taiwan Eight Industries Index*: represents the key sectors of the Taiwanese stock market as most information comes from the TSEC Taiwan 50 and 100 Index.
- *TSEC RAFI Taiwan 50 Index*: the top Taiwanese companies with the largest Research Affiliates Fundamental Index.
- *TSEC Taiwan Shariah Index*: top Taiwanese companies that comply with strict Islamic laws concerning money-lending.<sup>c</sup>

Many of these sub-indices point towards expansion in the Taiwanese market. The Taiwan Shariah Index indicates that that TSEC is looking to develop niche markets for money from the Middle Eastern and Islamic countries and is no longer satisfied with representing domestic companies. Today the board of TSEC has four management objectives, its top priority being 'Pushing listings by overseas Taiwanese and foreign enterprises.'<sup>d</sup> A shift in a more international direction indicates the TSEC's desire to compete with Hong Kong, Shanghai, and Tokyo. In May 2010 an American chip-maker, Integrated Memory Logic, raised US\$44 million in its IPO through TWSE.<sup>e</sup> Singaporean firms are also planning their IPOs with TWSE as they feel undervalued in their domestic market and see the TWSE as a potential market that is ripe for medium-sized research and development firms.<sup>f</sup>

Although not directly involved in the Economic Cooperation Framework Agreement (ECFA), the TWSE will be one of the biggest beneficiaries of the free trade agreement with the Mainland. The opening of liberalized trade with reduced tariffs represents a unique opportunity for this once marginal stock exchange to become a regional, if not an international actor. Chairman Chi Schive has announced that a number of state-owned Mainland companies incorporated and listed in Hong Kong Exchange, known as 'red chips';<sup>g</sup> have expressed interest in listing with the Taiwan Depository Receipts.<sup>h</sup> If this were to happen then the PRC's red-chip companies would have access to 23 million new investors and a high-tech stock market with over US\$654 billion in market capitalization by the end of 2011. Financial integration could also play a vital role in lessening tensions across the Strait for the Ma government. By creating the TSEC Taiwan Index Series and increasing the role for TAIEX and TWSE in a global market, the Taiwanese government aims for growth in a high-tech market that would cater to the thousands of university graduates who congregate in Taipei in search of employment every year. While the ECFA could strip away jobs in low-technology centres, manufacturing and agriculture, the TSEC has the potential to replace these jobs with better-paid, more prestigious positions, as befits a growing industrialized economy.

- a 'Service', *Taiwan Stock Exchange*. Taiwan Stock Exchange Corporation, n.d. (last accessed 24 July 2010), <http://www.twse.com.tw/en/about/company/service.php>.
- b 'Listing Statistics (2005–2010)', *Taiwan Stock Exchange Fact Book 2010*, Taiwan Stock Exchange Corporation, 22 July 2010, <http://www.twse.com.tw/en/about/company/factbooks.php>.
- c 'TSEC Taiwan Index Series', *Fact Sheet*, FTSE International Limited and Taiwan Stock Exchange Corporation, 15 January 2007, 25 July 2010, [www.ftse.com/Indices/TSEC\\_Taiwan\\_Index\\_Series/Downloads/TSEC\\_TAIWAN\\_Index\\_Series\\_Factsheet.pdf](http://www.ftse.com/Indices/TSEC_Taiwan_Index_Series/Downloads/TSEC_TAIWAN_Index_Series_Factsheet.pdf).
- d 'Welcoming Message', *Taiwan Stock Exchange*. Taiwan Stock Exchange Corporation, 24 July 2010. <http://www.twse.com.tw/en/about/company/service.php>.
- e Robin Kwong, 'Taiwan's stock exchange chief eyes Chinese companies', *Financial Times*, 20 July 2010, web 24 July 2010, <http://blogs.ft.com/beyond-brics/2010/07/20/taiwans-stock-exchange-chief-eyes-chinese-companies/>.
- f 'Singaporean companies planning to enter TWSE', *Taipei Times*, 13 May 2010, web 26 July 2010, <http://www.taipetimes.com/News/biz/archives/2010/05/13/2003472844>.
- g Glen Linn, 'Red Chips = Green Money?', *Linn's China Gate Stocks*, TypePad Profile, 9 October 2009, web 26 July 2010, [http://chinagate.typepad.com/china\\_gate/2009/10/red-chips-green-money.html](http://chinagate.typepad.com/china_gate/2009/10/red-chips-green-money.html).
- h Note 5 above and Weiyi Lim, 'China Firms May List in Taiwan From 2010, Schive Says (Update 1)', *Bloomberg*, 8 December 2009, web 23 July 2010, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aqbyUT2AJLc>.

### 3 The Economic Cooperation Framework Agreement (ECFA)

Since joining the World Trade Organization in 2001, China has made a major commitment to open its borders to foreign trade. It has been an enthusiastic pursuer of free trade agreements (FTAs); a total of nine were signed by the end of 2009, with six currently under negotiation, and three at the feasibility-study stage (see Table 7). The China–ASEAN FTA was provisionally agreed in Phnom Penh, Cambodia, in 2002. For Taiwan, it is the most significant, because many ASEAN countries are among its key trading partners and also competitors for access to the Chinese market. When the agreement came into effect on 1 January 2010, it gave greater urgency to Taiwan’s own talks with the Mainland on a free trade agreement. President Ma had been accused during his election campaign of talking of a ‘greater China market’. In fact, such a market was created by the FTA with ASEAN. In one step, the world’s third largest single market in terms of GDP (estimated at US\$6 trillion) came into existence, with a consumer base of 1.6 billion people. The China–ASEAN agreement reduced tariffs to zero per cent on 7,881 product categories, accounting for 90 per cent of the imported goods in the region, with tariffs for the remaining goods at only 0.1 per cent. Since 2000, China and other ASEAN members recorded a sixfold surge in economic activity, which rose to US\$193 billion by the end of 2009, with a trade surplus of US\$21 billion for China.<sup>41</sup> China has overtaken the United States to become ASEAN’s third largest trading partner.<sup>42</sup> Despite fears by some opponents in ASEAN countries that the lowering of tariffs would create huge challenges to domestic industries because of the threat from Mainland manufacturers, for many governments the move made economic sense. The Deputy Secretary General of ASEAN, Sundram Pushpanathan, was quoted as saying: ‘In 2010 we are sending a strong message that ASEAN is open for business. [...] In the short term there will be some adjustments that some countries have to make. Some local companies will lose their domestic market share but ultimately consumers will benefit.’<sup>43</sup>

Table 7: China’s free trade agreements, at end of 2009

Implemented	Under negotiation	Under feasibility study
China–ASEAN	China–Australia	China–India
China–Hong Kong (in the Closer Economic Partnership Arrangement)	China–Costa Rica	China–Korea
China–Macao	China–Iceland	China–Switzerland
China–Asia Pacific Trade Agreement	China–Gulf Cooperation Council	
China–Chile	China–Norway	
China–New Zealand	China–Southern Africa Customs Union	
China–Pakistan		
China–Singapore		
China–Peru		

Source: Price Waterhouse Coopers: ‘China’s Free Trade Agreements’, at [http://www.pwccustoms.com/webmedia/doc/633910492656405807\\_fta\\_lower\\_land\\_cost.pdf](http://www.pwccustoms.com/webmedia/doc/633910492656405807_fta_lower_land_cost.pdf)

41 Andrew Walker, ‘China and ASEAN Free Trade Deal Begins’, BBC, 1 January 2010.

42 Michael Moore, ‘China and South East Asia create huge free trade zone’, *Daily Telegraph*, 30 December 2009.

43 Quoted in *ibid.*

The Economic Cooperation Framework Agreement has been Taiwan's response to the China–ASEAN FTA. It may well go down as one of the major achievements of the Ma years. It has great political as well as economic significance, which will be analysed later in this report. Its success or failure will play a key role in Ma's re-election campaign in 2012, and has been an issue on which he has spent much political capital. As one opposition group stated, 'The Ma administration is presenting the ECFA as a solution to Taiwan's economic woes, and says it will prevent Taiwan from being marginalized. The democratic opposition, on the other hand, argues that it moves Taiwan far too close to China, giving the PRC leverage to force its way onto the island, at the expense of democracy there.'<sup>44</sup> Ma himself, just after the signing of the ECFA, said it showed 'a correct decision at a decisive time' and that it would 'break Taiwan's isolation and [...] allow Taiwan to become a springboard for investors into the Mainland China market.'<sup>45</sup> According to analysts D.H. Rosen and Zhi Wang of the Peterson Institute for International Economics, the ECFA 'will be an ambitious accord that fundamentally changes the game between Taiwan and China.'<sup>46</sup>

All of these issues were debated in detail on television between President Ma and the DPP's Chairwoman, Dr Tsai Ing-wen, an expert on international trade agreements, on 25 June 2010. Dr Tsai based her opposition to the ECFA on two key grounds. One was the need to defend labour rights; she said that implementation of the agreement would expose vulnerable parts of the Taiwanese economy to fierce and unfair state-supported competition from the PRC. She used the example of older men with trade skills who were already suffering particularly high levels of unemployment, and who were only likely to be put in an even more difficult position once the agreement was implemented. Secondly, she referred to the need to protect domestic industries. These criticisms were cast in a more political light only a few days later when former President Li Teng-hui marched in Taipei with over 40,000 protestors against the agreement – one of the largest ever marches held on the island against a piece of legislation.

After months of debate within Taiwan and after long, intricate negotiations with the Chinese side, a Basic Agreement was reached on 13 June at the Third Meeting of Experts in Beijing. The ECFA was formally signed in Chongqing on 29 June 2010. The Taiwanese signatories were Chen Yunlin of the Association for Relations Across the Strait on the PRC side, and P.K. Chiang of the Taiwan Strait Exchange Foundation.<sup>47</sup> The agreement deftly avoids mention of the 'two states' issue, referring instead to 'shore-to-shore relations'. Its most immediate impact will be to offer the potential for greater economic ties between the PRC and Taiwan by easing trade blockages, and to gradually integrate the island's economy with the rest of the world by lowering tariffs on and other barriers to Taiwanese goods. The ECFA is divided into five chapters:

- **General provisions:** a basic outline of the goals for ECFA, the range of measures for economic cooperation and trade liberalization;
- **Trade and investment liberalization:** a range and timetable for future negotiations over agreements on trade and goods and services, investments, etc;
- **Economic cooperation:** to include industrial cooperation, customs cooperation, trade facilitation, goods inspection, import licensing and food safety;
- **'Early Harvest':** this list identifies the items and services that will be eligible for early tariff reduction and market access; and
- **Miscellaneous:** includes measures to support food safety, a dispute settlement mechanism, and other administrative details such as the executive body,<sup>48</sup>

44 Taiwan Communiqué, International Edition, June/July 2010, Formosan Association for Public Affairs, Washington DC, pp. 1–2.

45 *Taiwan News*, 7 July 2010.

46 D.H. Rosen and Zhi Wang, 'Deepening China–Taiwan Relations Through the ECFA,' Peterson Institute, June 2010, p. 1.

47 Alan D. Romberg, 'Ma at Midterm: Challenges for Cross Straits Relations,' *China Leadership Monitor*, No. 33, has a full analysis of the political implications for Ma of the ECFA agreement.

48 Economic Cooperation Framework Agreement (ECFA), *Background*.

As it stands, the ECFA is the start of a lengthy process of economic cooperation with the PRC.<sup>49</sup> It could lead to an eventual FTA between Beijing and Taipei that will eventually be recognized by the World Trade Organization on the basis of Article 5 of the General Agreement on Trade in Services, which allows signatory members the right to establish regional trade agreements. But it could take up to 10 years before a formal FTA is hammered out. There is also the possibility that the ECFA may not enter the register of FTAs officially approved by the WTO, and may end up as a domestic law passed by the currently KMT-controlled Legislative Yuan. Both possibilities will require long periods of cooperation, mediation and arbitration between the Chinese and Taiwanese delegations in order to create an FTA that is mutually beneficial.

### Box 3: The impact of the ECFA

The ECFA will open up the following sectors:

- *Taiwan*: Service industry, movies, business services
- *Mainland*: computer services, airline maintenance, medical sector

Taiwanese banks in China will be allowed to conduct business in the Chinese RMB market.

Tariffs on imports from the PRC to Taiwan will be cut in petrochemicals and plastics, cars and car parts, textiles, machine tools and medical equipment.

Tariffs on imports from Taiwan to PRC will be cut in toothbrushes, wristwatches, bicycle tyres, light bulbs and industrial oils.

In either case this lengthy process includes the initial efforts to manage the 'Early Harvest' list, a register of over 800 items from both sides of the Strait that are to be the initial recipients of lowered tariffs and reduced barriers. Taiwan has put forward 539 items with an export value of US\$13.83 billion to be the first entries in the ECFA.<sup>50</sup> The Mainland has put forward 267 products, with an export value of US\$2.86 billion. The ECFA stipulates that over the space of 10 years Taiwan will see the removal of up to 90 per cent of all tariffs and trade barriers for exports from the Mainland and that both sides will expand their total exports. As it stands, cross-Strait trade is almost US\$100 billion a year, with around 40 per cent of Taiwan's goods being exported to China, where they are coupled with Taiwanese investments.<sup>51</sup> The ECFA is also expected to create 260,000 jobs in the next decade, and to lift Taiwan's GDP by 1.7 per cent a year.<sup>52</sup> According to the Peterson Institute for International Economics, Taiwan will increase its GDP by 4.5 per cent by 2020, meaning an extra US\$21 billion will be added to the economy. If Taiwan is able to make similar free trade agreements with, for instance, the EU and United States, then that figure could be 4.9 per cent.<sup>53</sup>

As with all FTAs, complications cannot be avoided because they signal an economy in flux, usually transitioning from a developed to an over-developed economy – from an economy that has grown out of traditional methods of production (manufacturing and agriculture) and must move beyond its own borders to procure the wealth and services it has become accustomed to in its own country, but at a reduced cost, as well as continuing to seek out new transnational opportunities for the development of national products. Based on the experience of other countries, in this period there is often considerable economic disruption, which leads to short-term complications and losses while providing a long-term vision of prosperity, success and innovation.

49 Shih Hsiu-chuan, 'No timetable for ECFA to become FTA', *Taipei Times*, 25 March 2010.

50 He Meng-kui and Bear Lee, "Early Harvest" list includes 539 Taiwan goods: Premier', *Focus Taiwan*, 24 June 2010.

51 Cindy Sui, 'Taiwan at Crossroads in Relationship with China', BBC News, 21 May 2010.

52 Rosen and Wang, 'Deepening China-Taiwan Relations Through the ECFA', p. 2.

53 Ibid.

## Short-term implications of the ECFA

The short-term implications of the ECFA will become evident almost immediately with the Early Harvest list of 539 Taiwanese items that will be considered for unrestricted access to the Chinese market. Currently this does not include those agricultural and manufacturing sectors that are the most vulnerable to competition from cheaper Chinese counterparts, but it does include some of Taiwan's strongest industries, which will directly profit from the unhindered access. This would be an example of both sides giving each other the benefits of economic opening before starting negotiations about trade liberalization. The sectors on the list can become even more competitive when entering the China market, which is the focus of the government's efforts in promoting ECFA.<sup>54</sup> However, there are still numerous possibilities for the ECFA's progress from its early stages (the first 12 months) to the end of transitional period (2015), as many gains made by those on the Early Harvest list will be temporary.

The downside to the Early Harvest list is that it is time-limited, and once it expires the rest of the market on each side of the Strait must open up to the competition from the other side. This could mean exposing key industries, which are in the labour-intensive agricultural and manufacturing sectors, to cheaper products from the Mainland that would undermine native Taiwanese producers. In connecting itself to the PRC's economy Taiwan could lose countless jobs as companies transfer their manufacturing processes to the cost-efficient Mainland. In an effort to offset such losses the government has proposed US\$3 billion in subsidies and aid over the next decade to the most vulnerable sectors.

Taiwan's traditional labour-intensive sectors would not be the only areas to see change as the result of the ECFA; the government would also need to adjust in the short run. KMT politicians have been the target of vocal criticisms from a variety of media outlets and Taiwanese citizens over the ECFA's opaque progress. Opposition political parties led by the DPP and Taiwan Solidarity Union (TSU) claim that the agreement – and the eventual FTA with the PRC – would establish 'closer economic ties [that] will give the government in Beijing leverage to push Taiwan into further political isolation. This would make it increasingly difficult for the people of Taiwan to maintain their freedom, basic human rights and democracy, and determine their own future.'<sup>55</sup> Such statements have mirrored fears of reunification with the Mainland and sent thousands of protestors onto the streets in protest over the lack of transparency in the decision to push through the ECFA without the consent of the public in Taiwan. In the coming months and years before the next elections, DPP and TSU candidates will lambast the KMT for 'giving away freedom and jobs to the PRC'.<sup>56</sup> Combined with exaggerated claims of a gradual Communist takeover of Taiwan, this could harm the KMT government at the polls, starting with the mayoral elections, scheduled for every fourth November, which have traditionally served as a barometer for the following presidential elections. Having angered voters by trying to pass the ECFA through the Legislative Yuan as quickly as possible, the KMT could eventually be replaced by a party promising greater transparency and consensus in negotiating international agreements.

The early years of the ECFA will also include constant negotiations between both parties to secure the best possible terms for their economies. In the PRC this would mean allowing migrant labourers into the Taiwanese agricultural and manufacturing sectors, taking advantage of investment opportunities and possibly exploiting these to pursue reunification strategies. For Taiwan the negotiations would focus on blocking migrant labour from entering the island, carefully mitigating the flight of off-shore Taiwanese manufacturing plants, safeguarding or possibly innovating in the agricultural market, and discussing terms of other FTAs with other regional nations. Taiwan is now likely to embark on a dynamic journey of integration and change, with some clear areas where it has limited powers to control the outcome, but where there are clear benefits.

54 'ECFA economic interest races against time', *United Daily News*, 29 June 2010.

55 *Concerns About the Proposed ECFA Agreement*, New Taiwan, Ilha Formosa, 14 May 2010, [http://www.taiwandc.org/letter\\_wangjinpyng\\_may2010.htm](http://www.taiwandc.org/letter_wangjinpyng_may2010.htm).

56 Vincent Y. Chao and William Lowther, 'Opposition vows "10-year" ECFA fight', *Taipei Times*, 5 June 2010, p. 1.

## Long-term implications of the ECFA

How will the ECFA change Taiwan and the Asian economic zone in the long term? Whatever the differences between the governments in Taiwan and the PRC, they both rely on delivering economic growth in order to maintain their legitimacy in the eyes of their people. Both want the greatest amount of money flowing into their countries, enriching their people and industries as they project their own brand of soft power around the world. The ECFA is worthwhile because the Chinese will have a greater chance of obtaining investment by Taiwanese companies, provided they no longer have to go through Hong Kong to reach the Mainland, and they will also benefit from the improved skill-sets being offered by Taiwanese companies. The better skills and pay provided by Taiwanese companies will lead to a greater competency in workers and managers.

There can be global long-term benefits for both sides too. 'A bilateral agreement is designed to create a friendly environment where Taiwan can more easily convince its major partners of the necessity of involving Taiwan in the bilateral and multilateral economic cooperation in the region,' as one expert has stated.<sup>57</sup> China's signing of the ECFA can be a signal to other countries that having an FTA with Taiwan is tacitly accepted by Beijing and gives the go-ahead to those looking to do business with Taiwan. Once the FTA issue is settled with the PRC, Taiwan hopes to sign similar agreements with South Korea and members of ASEAN, which would open vast markets in areas until now heavily under the shadow of the PRC. Having the ECFA and the experience of negotiating with the biggest player in Asian would avoid the continued marginalization of Taiwan: 'Signing agreements with mainland China, Taiwan's main export market, will help [Taiwan] participate in regional economic integration and mitigate the risk of economic marginalization.'<sup>58</sup> In August 2010, Singapore and Taiwan announced that they were about to start negotiations on their own trade agreement.<sup>59</sup>

Business sectors such as high technology, information and communication technology, green energy solutions, luxury real estate, services and investment would see a boom in jobs as the access to these new markets allows the expansion of Taiwanese companies abroad. The eventual availability and easy accessibility of raw materials from ASEAN countries will offer real value for Taiwanese manufacturers by enabling them to produce cheaper goods for mass consumption. Contentious areas such as agriculture and manufacturing will eventually achieve growth because of the ECFA's trade liberalization. Agriculture, which was a mainstay of the Taiwanese economy in the early period after 1949, is particularly important. There has been a remarkable decline in the numbers of those employed in agriculture, forestry, fishing and animal husbandry. In 1986 there were 1.317 million agriculture workers; by 2007 this number had been reduced by half.<sup>60</sup> One explanation is the success of the education system as children from rural areas attain degrees from prestigious universities and move to the city to find more profitable work. Manufacturers will inevitably continue to move factories to China to take advantage of cheap labour. While this may mean the loss of as many as 1.6 million Taiwanese jobs,<sup>61</sup> the impact is likely to be absorbed because many manufacturing workers are skilled and can be retrained through government programmes for employment on civil projects, domestically or in other specialized industries – which have been projected to expand their total exports to other countries because of the ECFA.<sup>62</sup>

57 Dr Francis Yi-hua Kan, *ECFA and Beyond: Taiwan's Role in the Emerging China-Centred Regionalism*, Prospects & Perspectives No. 1, Cross-Strait Interflow Prospect Foundation, January 2010.

58 Economic Cooperation Framework Agreement (ECFA), *Background*.

59 The Singapore Trade Office in Taipei, and the Taipei Representative Office in Singapore announced this in a joint statement on 5 August: 'Singapore and the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu (Chinese Taipei), both members of the World Trade Organization (WTO), have agreed to explore the feasibility of an economic cooperation agreement between them. Both sides will meet later in the year to discuss the matter. Singapore and Chinese Taipei have always enjoyed close relations. Chinese Taipei appreciates Singapore's role in promoting regional stability including the facilitation of the 1993 Koo-Wang talks.'

60 Directorate General of Budget, Accounting and Statistics Executive Yuan, Republic of China, *Statistical Yearbook of the Republic of China: 2007*, pp. 48–9.

61 Bob Yang, 'ECFA and the Trading of Freedom', *Taipei Times*, 29 June 2010.

62 Junfang Xi, *The Economic Effect of the Establishment of ECFA Between Mainland of China and Taiwan*, Antai College of Economics & Management, Shanghai Jiao Tong University, Shanghai.

## The ECFA in context

### ***The political dimension of the ECFA and Chinese investment***

The whole debate before the signing of the ECFA brought into sharp focus the constellation of political issues that Taiwan has to contend with as it seeks deeper economic integration with the Mainland. Speaking at a protest march in June 2010 in Taipei, former President Lee Teng-hui was reported as saying that ‘The ECFA is a sham of the Chinese communist regime. Under the disguise of benefiting Taiwan, the regime will steal Taiwan’s capital, talent, and technology. It can’t be more obvious that the regime aims at taking over Taiwan.’<sup>63</sup>

The failure to hold a referendum on the issue, and lack of clarity about whether Taiwan would then be able to sign further agreements with the United States, the EU and Japan, only added to the opposition. As commentator Michael Fahey wrote in the *South China Morning Post* on 2 July, President Ma has, in signing the ECFA, reached the limits of his political mandate. If he is perceived to have put Taiwanese sovereignty on the bargaining table, this would be political suicide for him. While the ECFA and Chinese direct investment into Taiwan are economic issues, therefore, they also raise huge political challenges.<sup>64</sup>

Although the precise questions raised by these two issues are slightly different, in the end the main quandary boils down to whether Taiwan can enjoy risk-free benefits from the economic growth of an expanding, increasingly prosperous but politically hostile neighbour. The PRC has not renounced the use of force to resolve the issue of Taiwan’s status, even though it has drawn back from the more bellicose posture adopted under Jiang Zemin a decade ago. Its ultimate objective is still unification. Under the present political system in the Mainland, it is hard to see how this might work. While there is some support for unification in Taiwan, public opinion polls in the last few years have shown this to be declining. The Taiwanese sense of identity is strong. Were Taiwan to be counted as a nation, then, with 24 million people, it would be the world’s 15th largest country. Its position is therefore highly irregular, and its engagement with Mainland China is extremely sensitive. China’s economic links with Taiwan could be seen as driven by purely commercial profit motives – or they could equally easily be seen as having some longer-term, underlying political objectives. This gives the issue of the ECFA and Chinese ODI its added complexity. This is not just about market share, but about acquiring political space.

### ***The political meaning of outward and inward investment***

The issue of companies, private or state-owned, buying assets in another country is always delicate. When American food manufacturer Kraft bought British chocolate company Cadbury in early 2010, there was a huge amount of debate in the British press about seeing such an iconic company go into foreign hands. Potential job losses and restructuring at Cadbury factories in the United Kingdom were one of the most sensitive issues, even though there were signs that similar moves would have happened even if the company had stayed in British hands. This is despite the fact that the United States and Britain like to think they are close allies, with clear political and cultural links. When countries that are not so closely linked, and that have different political and corporate cultures, start to buy each other’s assets, there tends to be a sliding scale of response, from acceptance with reservations to outright opposition.

With its state-directed economy and unique political system, the PRC currently raises the most acute of these reservations. The most famous case was the attempt by the China National Overseas Oil Corporation (CNOOC) in 2004–05 to buy the small US energy company Unocal. After much controversy, CNOOC did not even make an offer in the end. ‘The unprecedented political opposition that followed the announcement of our proposed formation was regrettable and unjustified,’ a company statement said after CNOOC’s withdrawal. ‘This political environment has made it very difficult for us to accurately assess our chances of success, creating a level of uncertainty that presents an unacceptable risk to our

63 Wu Tseh-Shi, ‘ECFA: The beginning of the end of Taiwan democracy’, *Epoch Times*, 27 June 2010.

64 Michael Fahey, ‘Beijing is wrong to think that its trade pact with Taiwan will help its long term political aims,’ *South China Morning Post*, 2 July 2010.



ability to secure this transaction.<sup>65</sup> One Californian member of Congress summed up the mood in the United States when he said that a successful bid by CNOOC would have had ‘disastrous consequences for our economy and national security’<sup>66</sup> All this was on the back of Dubai Ports’ attempts to buy P&O Ferries and some of their assets in the United States, and the failed telecommunications investment bid by Huawei for 3com in 2005.

Mainland policy-makers were adamant that investment from a Chinese state- or non-state-owned entity was not a threat. The General Manager of the Chinese Investment Corporation, Gao Xiqing, said in 2007 that the China Investment Corporation, established in September of that year, would be run according to ‘ethical standards for investment’. Chairman Lou Jiwei has also said, ‘We will adopt a prudent accounting system, adhere to commercial lines and improve the transparent [*sic*] on the condition that company interests will not be jeopardised.’<sup>67</sup> However, he continued, this needed to be a ‘gradual process. If we are transparent on everything, the wolves will eat us up.’ British journalist John Kampffer commented after the purchase of a 3 per cent stake by the China Development Bank in Barclays in the United Kingdom:

*Ever since the events of 9/11 the [British] government has seen radical Islamism [...] as the greatest threat facing the country [...] And yet a new threat is emerging which neither Britain nor other western states have prepared for – the spread of Chinese and Russian power and influence. The theatre of battle is the City of London. [...] The question is not which countries are acquiring wealth and power but which value systems. [China represents] rapid development, unencumbered by lectures about human rights and democracy.*<sup>68</sup>

In 2002, the Taiwanese government even viewed outward investment as an area in which to tread carefully. According to Alain Guilloux, Taiwan’s diplomatic isolation after its departure from the United Nations in 1971 meant that, by the late 1980s, ‘the state started mobilizing non-state actors towards external policy goals.’<sup>69</sup> This meant Taiwanese companies were encouraged to invest and trade with countries that might be friendly to Taiwan’s goals of creating more international space for itself and seeking legitimacy through commercial recognition by other countries, even if it proved unable to upgrade this to a political level. A ‘Go South’ policy was implemented, with the government providing assistance to allow more enterprises to invest in Southeast Asia. The policy was viewed as a deliberate attempt to strengthen Taiwan’s role *vis-à-vis* the region’s states. In the end, however, the vast bulk of outward investment from the island still moved to the Mainland.

*Like Korean, Hong Kong, or Singaporean companies, Taiwanese companies are attracted by the potential of the mainland market and low production costs, while China sees Taiwanese investment as a way to help promote unification. In particular, Taiwanese business associations enjoy a special status on the mainland. Taiwanese entrepreneurs on the mainland have generally opposed policies that increased cross-Strait tension.*<sup>70</sup>

The claim made by some of the ECFA’s critics that China sees Taiwanese investment as a way to promote unification should give policy-makers in Taipei pause for thought. On the question of whether there is a potential political price to be paid by recipients of Chinese investment abroad, so far the signs are very mixed. There were indications that the Mainland was willing to give generous aid and development packages to Africa if countries were willing to either maintain their diplomatic links with the PRC, or,

65 Quoted in D. Teather, ‘Washington opposition forces Chinese to withdraw oil offer,’ *The Guardian*, 3 August 2005.

66 Ibid. See also Brown, *The Rise of the Dragon*, pp.167–8, for analysis of the Unocal case.

67 Quoted in Michael F. Martin, ‘CRS Report to Congress: China’s Sovereign Wealth Fund,’ 22 January 2008, p. 10.

68 John Kampffer, ‘The West’s great new threat is at home in the City,’ *The Guardian*, 26 July 2007.

69 Alain Guilloux, *Taiwan, Humanitarianism and Global Governance* (London: Routledge, 2009), p. 48.

70 Ibid., p. 49.

at least in one case, switch them from Taipei to Beijing.<sup>71</sup> On the whole, the more tangible threat was from PRC espionage and hacking via some of its investments, something that Taiwan could see. The PRC's activity in this area became clear when Google made the first moves to withdraw at least some of its services from its Mainland-hosted site in December 2009. It had noticed over 20 aggressive hacking attacks that year, some of them trying to penetrate to g-mail accounts to access information on human rights activists. But even before that, in the liberal investment environment of the United Kingdom, claims had been made that telecommunications companies such as Huawei, which had substantial contracts with British Telecom, were problematic. According to one report, in early 2009, the British intelligence agency warned UK companies about the threat from aggressive cyber attacks from Chinese sources, and expressed fears about the involvement of Huawei in UK telecoms equipment: 'Working through Huawei, China was already equipped to make "covert modifications" or to "compromise equipment in ways that are very hard to detect" and that might later "remotely disrupt or even permanently disable the network".'<sup>72</sup> A year later, India also blocked Chinese mobile and telephone operating companies from contracts in these sectors of the economy for security reasons. Many viewed this as pure trade protectionism, however. The reassurance from the Chinese side is that it is willing to abide by whatever rules there might be in the countries in which it invests, and that others need to be more relaxed about what Chinese enterprises are doing and their motives.

Does Chinese overseas investment really have a political dimension that those receiving it need to be especially careful about? At the root of this question is the issue of China's intentions and motives. It has maintained a state structure where one political party has a monopoly of power. The Communist Party elite have shown in their actions that they can be ruthless in preserving their interests, and that these interests are not necessarily the same as those of China itself, however cleverly they may have articulated such a notion. In many ways, the CCP operates like a state within a state, with parallel structures of authority in government and party, where the party almost always holds ultimate power. The CCP has been very pragmatic in its exercise of power in the last decades, stating on many occasions that the key objective is to deliver GDP growth and to continue raising the living standards of the people. However, it has also been utterly ruthless in crushing any organized political opposition. And with regard to Taiwan, it has very clear, long-running and long-term objectives. It would be strange if China did not want to use its economic power now to make progress towards its ultimate objective of reunification. While at the moment the Chinese leadership under Hu Jintao is content with the status quo, and has been keen to work with President Ma in areas of mutual benefit and agreement, one has to remember the longer-term objectives. As the State Council paper issued in the PRC in 1993 asserted, 'the different social systems across the Strait [...] should not constitute any barrier to peaceful unification.' And the debate about the ECFA, in fact, highlights these objectives vividly.

### ***The ECFA: political risks and benefits***

There is a range of perspectives about the future political, rather than economic, impact of the ECFA on Taiwan. According to the Peterson Institute report cited earlier, 'China is frank in stating that it supports an ECFA undertaking because it believes this will maximize the prospect for eventual political integration across the Taiwan Strait.'<sup>73</sup> For Michael Fahey, however, 'Beijing's strategy is to wait for the magical economic elixir it has given Taiwan to take effect [...]. This betrays a fundamental lack of understanding about the arc of Taiwanese history over the past three decades.' Saying that 'Taiwan's educated and ambitious people aspire to much more,' he cites the problems of Foxconn (see Box 4). The signing of the ECFA is only a gesture; Taiwan's fundamental economic problems remain 'income stagnation and unemployment,' and to address this, just having 'yet more markets for low-margin contract manufacturing' which in many ways is all that the ECFA offers, is not going to be enough.<sup>74</sup>

<sup>71</sup> Graham Bowley, 'Cash helped China win Costa Rica's recognition', *The New York Times*, 12 September 2008.

<sup>72</sup> Michael Smith, 'Spy chief fears cyber attack', *The Sunday Times*, 29 March 2009.

<sup>73</sup> Rosen and Wang, 'Deepening China-Taiwan Relations Through the ECFA', p. 2.

<sup>74</sup> Fahey, 'Beijing is wrong to think that its trade pact with Taiwan will help its long term political aims'.

#### Box 4: Foxconn – when things go wrong with Taiwan investment in the Mainland

Australian academic Anita Chan was one of the first to write about the challenges of Taiwanese investment in the Mainland, and being able to meet international labour standards and corporate social responsibility requirements. In the 1990s, the surge of manufacturing-based investment from Taiwan into Chinese provinces such as Fujian and Guangdong meant that factories were being set up almost weekly. Not surprisingly, it was hard to keep abreast of what was happening. Many joint-venture factories found themselves exposed for poor labour practices, using child labour and other exploitative practices.<sup>a</sup>

With the passing of several pieces of legislation, things have improved in the last decade. A new Contract Law in early 2008 gave Chinese labourers improved rights to sick pay and holidays. Even so, even the most experienced Taiwanese companies can find the Mainland a tough place to operate, as one story in mid-2010 showed.

Foxconn, under its parent company Hon Hai Precision Industries, is one of the most successful exporters from the Mainland. Established in Tucheng, Taiwan, in 1974, it is still headed by its original founder Terry Gou. But the small plastics manufacturer is now the world's largest manufacturer of electronics and computer components. It counts Apple and Dell among its customers, and produces most of the world's iPods, iPads and Wiis. According to Foxconn's website, the company had revenues of US\$61.8 billion in 2009, with 800,000 employees, the vast majority of them in Mainland China.

Its flagship factory, opened in Shenzhen in 1988, became the focus of media attention in 2010. With over 450,000 people working on its premises, Foxconn Shenzhen struck many who visited it as being like a city within a city. It had its own shops, gyms, dormitories, facilities and power generator. The facility was in operation 24 hours a day, seven days a week. It also proved popular with workers, receiving over 8,000 applications to work there every week.

In May 2010, reporters started to notice, however, that had been several suicides at the plant. Initial speculation linked this to the compensation the company had paid out to the families of people that had killed themselves there before. Over a short period, 10 people died by their own hands, many of them leaping off the roof of one of the high buildings on the factory site. Terry Gou visited the factory, expressing his concern, and saying that he 'was losing sleep' over the phenomenon. A further suicide happened in a Foxconn-owned factory in Hebei. Labour activists accused the company of running an overly strict regime, operating long shifts and underpaying people. Gou pointed to the facilities in the factory, and raised the wages by 100 per cent (a move followed by a number of other companies in China at the same time, including Kentucky Fried Chicken.) Even Steve Jobs, the CEO of Apple, one of Foxconn's main clients, was forced to defend the company.

Despite this, Foxconn remains one of the largest Taiwanese companies exporting from China to the global market place. It has operations in the United Kingdom, the United States, Hungary, India and other markets. Foxconn's case proves that, in the highly volatile Mainland market, even the largest and most experienced investors have to be careful.

a See Anita Chan, *China's Workers Under Assault: Exploitation and Abuse in a Globalizing Economy* (Armonk, NY: M. E. Sharpe, 2001).

Speaking on 7 July, just after the signing of the agreement, David B. Shear, Deputy Assistant Secretary of State in the Bureau of East Asian and Pacific Affairs at the US State Department, said that the 'ECFA should be [able] to make Taiwan a more attractive place to trade and invest by lowering non-trade tariffs terms in Taiwan and in facilitating efforts by America and other foreign firms'.<sup>75</sup> Despite the fact that Taiwan is, inevitably, an inexperienced negotiator in such matters, the deal on the surface looked favourable for it. And the game plan of using it to pave the way for perhaps even more significant deals with the United States, the EU and others was still clear. Shear referred to the 270 direct flights that now existed across the Strait, and the one million tourists from the Mainland due to visit Taiwan in 2010, stating that 'cross-Strait relations are healthier than they have been at any time in the last several decades'. He said that closer economic integration would only further reduce tensions, serving to deliver the aims mentioned above.

One of the main priorities for Taiwan in the last decades has been to secure greater international space for itself. It remains diplomatically isolated, with only 23 countries formally recognizing it. While it is a member of the WTO, the Asia-Pacific Economic Cooperation and the Asian Development Bank, and managed to secure observer status at the World Health Organization (WHO) in 2009, after a long campaign, it continues to remain hampered in its operations at the international level. Under the WTO, for instance, it cannot unilaterally negotiate free trade agreements with other parties. And it was only granted its WHO observer status with the PRC's agreement. Writing in *The South China Morning Post* on 7 July, distinguished lawyer Jerome Chen and academic Yu-jie Chen stated that perhaps President Ma's greatest accomplishment in signing the deal was to avoid all talk in it of Beijing's 'One China' principle. But as another commentator from the Australia National University stated, 'The major objection to the treaty is the fundamental issue of whether further economic integration with China will make China more vulnerable to Mainland coercion in the future.'<sup>76</sup> While the ECFA does not mention the One China principle, it remains an odd agreement simply because it is between two parties one of which does not recognize the other. Despite vocal opposition demands, Ma rejected the need for a referendum on it, claiming it was about economic issues and did not impinge on sovereignty.<sup>77</sup> That issue remains the great elephant in the room. Will the ECFA help Ma's government domestically to deal with the need for investment in new technology and service industries in Taiwan itself? Will it encourage local and international investors to invest in the island? Will it help the skilled workers who have been cut out of jobs because of the enormous shift of manufacturing to the Mainland? These are the big practical questions to which Ma has to find answers through the ECFA, and quite quickly. He is due to stand for re-election in early 2012 and he needs the agreement to show returns well before then.

The immediate returns for Ma have been mixed. In one poll, carried out in July by the Research, Development and Evaluation Commission, his popularity had risen from a low of 24 per cent to over 46 per cent. The fact that the organization carrying out the poll had government links, however, raised doubts about the robustness of its findings.<sup>78</sup> The Global Views Research Survey Centre, in another poll in July, found a more modest rise to just over 32 per cent in Ma's approval ratings.<sup>79</sup> He remains in dangerous political territory, therefore, and needs to show tangible results for his policy very soon.

75 <http://www.carnegieendowment.org/events/?fa=eventDetail&id=2955>.

76 Stuart Harris, Australia National University, 8 July 2010. <http://www.eastasiaforum.org/2010/07/09/taiwan-and-its-new-economic-agreement-with-china/>.

77 In reality only one country has ever had a referendum and that was due to the fact that the (Costa Rica) government had just collapsed and needed to have some legitimacy in order to sign an FTA with the United States.

78 See Jens Kastner, 'Taiwan's President Ma Ying-jeou rebounds', *Asia Sentinel*, 15 July 2010.

79 Denis Engbarth, 'Most citizens still disgruntled with Ma's performance', *Taiwan News*, 21 July 2010.

### Box 5: The two, or three, visions for cross-Strait relations

The issues of inward and outward investment and trade flows across the Taiwan Strait, and that of the ECFA, are all politically framed by a number of statements and proposals delivered over the past decade and a half by elite leaders on either side. For Taiwan, the overarching framework for agreement on relations across the Strait between the two sides is best articulated by the informal '1992 Consensus' reached following meetings between officials from the PRC and the Taiwanese government. The two sides agreed that there was only one China, 'with each side reserving the right to express its viewpoint concerning [the nature of that one China]'. In other words, the negotiators found a formula to sidestep the thorny issue of sovereignty. For all its flaws and ambiguities – and the contention by many DPP supporters in Taiwan that it was an *ex post facto* invention of the Taiwan negotiating team – the Consensus at least afforded a basis for future discussions by parking the most difficult issue.

On the part of the PRC there have been two major policy statements about the approach to resolving cross-Strait issues. One was made by the then President of the PRC, Jiang Zemin, in January 1995. This has been called the 'Eight-Point Proposal' and calls for:

1. Adhering to the principle that one China is the basis and prerequisite for peaceful reunification. China's sovereignty and territorial integrity must never be allowed to suffer division.
2. Allowing for the development of nongovernmental economic and cultural ties between Taiwan and other countries.
3. Holding negotiations with Taiwan authorities on the peaceful reunification of the motherland.
4. Aiming to achieve the peaceful reunification of China since Chinese should not fight Chinese, but willing to use force to resolve the issue if necessary against the foreign forces who intervene.
5. Developing economic exchange and cooperation between the two sides separated by the Taiwan Strait.
6. Promoting and maintaining cultural contact.
7. Respecting the rights of Taiwanese.
8. Welcoming and encouraging leaders of Taiwan to visit the Mainland and Mainland officials to visit Taiwan.<sup>a</sup>

These combine a series of what can be called 'hard' and 'soft' measures to bring the two sides together. Cultural ties and the so-called 'three links' (postal, air and shipping) belong to the latter. Developing political links is also important. However, the key provisions in the official Chinese position are the refusal to relinquish the right to use force, and the insistence that Taiwan's future status must be addressed as a domestic issue, not an internationalized one.

That the PRC has not renounced force in the issue of Taiwan remains a major block to pursuing deeper proposals for political dialogue. Paramount leader Deng Xiaoping's vision in the 1980s was that the 'one country, two systems' formula could be used to resolve the three issues involving sovereignty that had been 'left over from history': Hong Kong, Macao and Taiwan. However, this was in the end brought to resolve the issue of Hong Kong's status after its reversion to PRC sovereignty from the British in 1997. From the outset, Taiwan's leaders adamantly rejected the notion that a formula applied to two foreign colonies could have relevance to an entity that was sovereign and not under any foreign power. Perhaps tacitly acknowledging the point, Deng and his team dangled significantly more generous offers to Taiwan including the ability, post-unification, to maintain its own military, police force, political system, flag and other privileges befitting its special status. Once Taiwan had become a fully functioning democracy by 1996, it became much harder to envisage even this more expansive model having appeal in Taiwan, let alone ever working. The Hong Kong Special Administrative Region, to this day, remains only a partial democracy, with a proportion of its

Legislative Council elected, and the rest appointed. Arguments continue over the introduction of universal suffrage for the position of Chief Executive, something that was promised for 2012 but has now slipped to 2018, and that may be further postponed.

President Hu Jintao has also made a 'Proposition on Taiwan', supplementing the issues put forward by Jiang Zemin and offering what seemed to be even more generous terms. These included (1) reaching a common understanding on the principle of One China, (2) ending hostility and reaching peaceful agreements under the One China principle, (3) starting discussions between the two sides about political relations as a preliminary to unification, (4) stepping up contacts on military issues 'at an appropriate time', (5) developing transport and communication links across the Strait, and (6) promoting cultural exchanges.

With the return to power of the KMT in the presidential elections of 2008, President Ma Ying-jeou presented his own position on the status of cross-Strait relations in his National Day Address in October 2009. He identified the principal elements of his policy as:

- Acceptance of the 1992 Consensus;
- Support for links through visits to Taiwan by Mainland tourists, direct air, sea, and postal links, food safety inspections, and cross-Strait legal assistance;
- An attempt to extend these into the economic realm with a free trade agreement;
- Defence of Taiwanese national sovereignty and interests, in particular protection of its democratic system;
- Development of friendly relations with both Taiwan and China and the promotion of 'flexible diplomacy'; and
- A national defence strategy of 'effective deterrence and resolute defence' in developing a professional military base to protect the security of Taiwan.<sup>b</sup>

The conflict over the sovereignty of Taiwan remains highly contentious, as these three different visions show. Some of the feelings aroused were clearly illustrated soon after President Ma's election, when a senior Chinese official from the State Council's Taiwan Affairs Office, Zhang Mingqing, was thrown to the ground while visiting the southern Taiwan city of Tainan, a stronghold of DPP supporters and pro-independence sentiment, on 21 October 2008.<sup>c</sup> When the newly appointed head of the Mainland Chinese Association for Relations Across the Taiwan Strait and former State Council director of the Taiwan Affairs Office, Chen Yunlin, visited Taiwan in November (the first such visit by someone in his position) he was also greeted by street demonstrations in Taipei and Hsinchu, indicating the continuing anger that the issue of Mainland affairs arouses in Taiwan.<sup>d</sup>

The US position was reiterated by State Department Deputy Assistant Secretary David B. Shear on 7 July 2010: the United States did not support Taiwan's independence, wished to see cross-Strait issues resolved peacefully and in the interests of both sides, welcomed dialogue and opposed unilateral attempts by either side to change the status quo. He also made clear that the United States was 'fully committed to the Taiwan Relations Act,' passed in 1979, which commits the US executive to consult with Congress on any issues involving threats to Taiwan's security. This has supplied a security blanket to the island ever since. The United States has put its money where its mouth is in supporting Taiwan: in 2009, the island was its ninth largest trading partner, with bilateral trade amounting to US\$46 billion. The United States also has US\$21 billion of FDI in Taiwan.<sup>e</sup>

a Full summary text at <http://eng.wcetv.com/1/2008/05/27/43@49.htm>, accessed 26 March 2010.

b President Ma Ying-Jeou's National Day Address, 10 October 2009, at <http://www.mac.gov.tw/ct.asp?xitem=66641&ctNode=5909&mp=3>.

c 'Taiwanese Attack Chinese Envoy', at <http://news.bbc.co.uk/1/hi/world/asia-pacific/7681711.stm>.

d See 'Top Chinese Envoy in Talks in Taiwan', at <http://news.bbc.co.uk/1/hi/7705468.stm>.

e <http://www.carnegieendowment.org/events/?fa=eventDetail&id=2955>.

### ***The Mainland's military voice***

What cannot be left out of the equation is the military threat posed by the PRC. While economically there might be one narrative, therefore, there is a completely different one in terms of how the PRC is deploying its forces and what that says about its intentions. The ECFA might be the soft-power side of the Chinese strategy, with the hundreds of powerful missiles ranged along the Fujian coast and aimed at Taiwan telling a different story.

A report by Taiwan's Ministry of National Defence issued at about the same time as the signing of the ECFA spells this out in some detail. The report is quoted as stating that 'China's military preparedness for an attack on Taiwan has never been relaxed and [...] if the People's Liberation Army (PLA) launched a missile attack on Taiwan, it would destroy more than 90 per cent of the nation's political, economic, military and civil infrastructure'.<sup>80</sup> The report also predicts the number of Chinese missiles aimed at Taiwan could reach 2,000 by the end of 2010. A number of new aggressive technologies have been adopted by China in order to focus on Taiwan's potential vulnerabilities, and the strength of its navy has also been enhanced.

It is no secret that China's People's Liberation Army (PLA) has made Taiwan its key focus since the 1990s. Taiwan remains the PRC's key strategic issue, far outweighing ongoing disputes about borders with India, or issues over disputed territories such as the Spratly Islands. The PRC's military interests abroad are increasing, largely to protect its assets. But its core military capacity is concentrated on Taiwan. And in the past, when the PLA has been able to hijack policy, it has significantly turned up the heat – as it did in 1996 during the first fully open presidential elections in Taiwan when it undertook aggressive military exercises close to Taiwan's territory. The PLA remains answerable to the Communist Party, and under its political control. Under Hu Jintao, a policy of greater patience has been exercised. But year on year, China's openly declared military expenditure has increased by double-digit amounts, and is now US\$80 billion. According to most analysts, this is most likely to be a huge understatement.<sup>81</sup> China's actual military expenditure is almost certainly larger by a factor of two to three. In the last decade, since being forced to divest itself of commercial interests in 1998, the PLA has significantly increased its professional capacity and upgraded its equipment, and much of what it does is a direct threat to Taiwan.

This has to be factored into any policy-making around links between Taiwan and the PRC. While enhanced trade and economic links are positive for Taiwan, and the risk from them can probably be dealt with, it would be naïve for it to ignore the issue of China's ultimate ambitions. Although Hu Jintao and the current leadership of the CCP are content with the status quo, we have to look at a future scenario in which the PRC becomes increasingly dominant, economically, diplomatically and militarily. In that case, it will almost inevitably become assertive about what it feels are its legitimate demands in the region.

The Taiwanese economy will be a major factor here. As long as it is strong and performs well, an attack on Taiwan would, in the words of one Taiwanese analyst, be like killing the goose that lays the golden eggs. It would not serve China's interests to launch an attack that would be militarily, politically and strategically risky, and that would be likely to destroy much of what makes Taiwan viable as a major, successful economy. Only a truly desperate, dysfunctional political situation would lead the PRC to do this. Taiwan's economic prosperity is therefore critical to its future stable existence and to its security.

In that sense, President Ma's decision, despite the criticisms expressed it has generated, was pragmatic and sensible. Ironically, in order for Taiwan to secure its future economic stability and security, it has to engage with the Chinese market. But it has to do so with a high awareness of the risks and problems. The alternative, which would be to keep the Chinese market at arm's length, will

80 Hsu Hsao-hsuan, 'PRC's preparations to attack Taiwan accelerate', *Taipei Times*, 19 July 2010.

81 There remains great variance and controversy over the true amount of Chinese spending on its military.

deliver less and less. Taiwan has accepted with the ECFA that it sits in a privileged strategic position across from one of the world's fastest-growing, most dynamic markets. It now has to use the ECFA to exploit that advantage but control the continuing risks and threats that the Mainland poses to it in terms of its international space and continuing autonomy.



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## 4 Taiwan 2020

Where is Taiwan likely to stand in the next decade? What will its economic and security situation be like? Where will the biggest threats and opportunities come from? And what sort of policies does Taiwan need to stand it in good stead in the coming decade?

None of these questions can be answered without factoring in the role of the PRC. The relationship between the PRC and Taiwan stands centre stage, and whether Taiwan likes it or not, what happens in the PRC, and what the PRC does abroad, has an intimate impact on its own future. This report has argued how, in outward investment and trade, Taiwan and China are inextricably linked to each other. The same is true of international diplomacy and the military. This concluding chapter looks at some scenarios for the next decade, and makes policy recommendations for Taiwan, in its relations with China and the international community, to ensure the optimal outcome, which is for both countries to be prosperous and peaceful, perhaps living with their differences unresolved, but at least with a relative degree of harmony.

Globalization has brought mixed results for Taiwan. On the one hand, it has created more international space and more legitimacy. Taiwan's economy stands to benefit from greater integration into the global system, if this is handled correctly. The ways to do this, now that the ECFA has been signed, are increasingly uncontroversial. Integration in the global economy at least gives Taiwan a voice, because of its size and economic weight. On the other hand, however, it means that the full force of a newly empowered, more assertive and more prominent China is brought more and more deeply into Taiwan's own internal affairs. Thus global economic integration is a mixed blessing. The Mainland government has a clear strategy of using economic integration and other links to achieve its ultimate objective of a political outcome along the 'one country, two systems' pattern for unification. Opinion polls in Taiwan show that, while most support the status quo, the appetite for unification is growing weaker over the years, whereas the sense of being Taiwanese and yet being denied the status of a fully sovereign country is growing stronger.

The tensions within the processes of globalization present particularly sharp, almost existential problems for Taiwanese policy-makers. On the one hand, globalization is positive, but on the other it is regarded with suspicion. It is no wonder that on this issue there has been such sharp disagreement among political parties on the island, coalescing especially around the issue of the ECFA.

### Scenarios

There are a number of possible scenarios for the coming decade. Three are described below, Scenario 1 being the least likely or desirable, and Scenario 3 the most realistic and desirable. All show that policy-makers in Taiwan have to factor in a wide range of risk in their planning.

#### ***Scenario 1: Worst Case***

The Mainland's patience runs out, the PLA returns to its strident position of over a decade ago, and political consensus in Taiwan hardens to demands for a legitimate independent voice. Military conflict ensues, bringing in the possibility of international and in particular US involvement.

This is unlikely because everyone would end up losing. For the Mainland, it would mean a tremendously difficult military attack by an army that has never been involved in combat operations of this size. There would be a real possibility of direct conflict between the PRC and the

United States, with wholly uncontrollable outcomes. The economic impact of such a scenario would also be devastating: Taiwan's capacity would potentially be largely destroyed, and there would be a knock-on effect on the PRC, which would be seen as an aggressor, with possible sanctions and other forms of economic isolation.

While unlikely, such a scenario cannot be discounted. Policy-makers on both sides of the Strait, and international partners, need to work to avoid this outcome at all costs.

### ***Scenario 2: Mildly Pessimistic***

The status quo is maintained, but internal reforms in China change the dynamics in unexpected ways – for instance, through greater political reform, so that the PRC comes closer to the Taiwanese model.

While China's economic performance has been very strong in the last three decades, the problems of corruption, governance, the legal system and political reform have all been well covered. Many of these have even been admitted by elite leaders in China. There are two possible ways in which this scenario might play out. The first is that internal issues are forced upon China much more quickly, and in a way that makes policy-makers in Taiwan rethink the principles around greater integration. China might, for instance, make moves towards partial democratization and a substantial programme of legal and political reform. The second is that internal issues, despite the strong performance of the Chinese economy, create instability and uncertainty in the PRC, leading to outcomes that are difficult to predict and manage. In that case, integration would be a source of greater potential instability for Taiwan.

It is unlikely that the Communist Party will voluntarily undertake deep political reforms in the coming decade. This timescale is too short. It may well be, however, that it is forced to move more quickly to address some of the problems caused by its demographic, environmental and social issues. In that case, the PRC might be prepared to accept more flexible terms for a settlement with Taiwan. It might grant Taiwan more international space, and be willing to talk of a looser sovereign settlement. This might be attractive for Taiwan in resolving its isolation and enhancing security. For this scenario, the key point is to expect the unexpected. The PRC is undergoing huge changes, socially, economically and politically. The impact of these on its internal stability and international behaviour should not be overlooked. Elites may be forced to look at wholly new ideas as they focus on the key priorities – maintaining stability within China, ensuring continuing economic growth and maintaining the Communist Party in power.

### ***Scenario 3: Status Quo/Mildly Optimistic***

The status quo is simply maintained. Tensions remain over Taiwan's international space, but these are managed. No major policy changes are likely on either side, as they look further into the 21st century for something that might be capable of reconciling their options and strategies. Taiwan is able to work with economic integration while maintaining its separate identity, although the anxiety over its highly irregular status continues, leading it to seek affirmation through international bodies, and to carve out at least some space for itself that does not lead to an unmanageable conflict with the Mainland.

At the moment, under what is called the fourth-generation leadership of President Hu Jintao and Premier Wen Jiabao in the Mainland, and the KMT led by Ma in Taiwan, continuing the status quo appears to be the most desired and most likely outcome. And yet on both sides events might disrupt this. A severe economic downturn for both, worse than that experienced (at least in 2009) by Taiwan, might lead to destabilizing social and political outcomes. A change of government in Taiwan, in 2012 or 2016, could reconfigure policy towards the Mainland, perhaps in a more confrontational shape. Leadership changes after the 18th Party Congress in Beijing in late 2012 will see a new raft of empowered Chinese leaders whose outlook on Taiwan might be more assertive. There may even be international events, from the implosion of North Korea to US actions against China, that could have knock-on effects on Taiwan's security and economic prosperity.

### Turning the tables: how Taiwan can take advantage of the most likely outcomes

As of late 2010, all projections show that China's economy will continue to expand, bringing with it ever greater Chinese influence and assertiveness. This is backed up by China's diplomatic behaviour in the last decade. As its economy has grown, it has continued to integrate into the global governance system, and to pursue its goals of a peaceful, stable international environment while it develops and expands. The only two things that might change this would be a wholly unforeseen disruptive event (international conflict, economic collapse, environmental or health catastrophe) or an abrupt change in the views of elite leaders in China from 2012. Both of these are very unlikely at the moment.

#### Box 6: Taiwan and the 'green economy'

One area in which Taiwan can attempt to be an exemplar is on the 'green' agenda. Many of the challenges the Mainland faces in its immense process of industrialization are the same as those faced by Taiwan – on a smaller scale – during its own industrialization period. Taiwan passed a Water Pollution Control Act as early as 1974. It established the Taiwan Environmental Protection Administration in order to promote international conventions and protocols in 1987. This does not mean the island does not still have major environmental challenges, as the tragic impact of Typhoon Morakot in August 2009 showed. In the space of two days, 250 cm of rain fell, the worst case recorded in half a century. The International Energy Agency, in its *World Energy Statistics* for 2009, ranked it as the world's 22nd largest emitter of greenhouse gases, and the 18th per capita. Like the Mainland, Taiwan remains dependent on fossil fuels. It is unlikely that this dependency will be easy to shift in the short term.

The Taiwanese government is very aware of the huge importance of creating a sustainable green-energy model for its economy. It has made commitments to reduce its carbon imprint in line with the Kyoto Protocol and the Copenhagen Global Climate Change Summit in late 2009. It has stated its keenness to encourage Taiwanese companies to make Clean Development Mechanism investments and to reduce greenhouse gas emissions. Using the Renewable Energy Development Act, it has also drafted a Greenhouse Gas Reduction Bill and an Energy Tax Bill. It has requested that all major development projects undergo an environmental impact assessment, and either reduce emissions or devise offsets. It has initiated a national emissions registry platform and a voluntary reduction programme for industries. It has attained a 40 per cent recycling rate, and has expanded forest coverage. Also in 2009 it reduced total electricity consumption by four billion kilowatt-hours.<sup>a</sup> According to Stephen Shu-hung Shen, the Minister for Environmental Protection, speaking on 10 December 2009, Taiwan's total carbon emissions decreased for the first time in 2008, falling by 4.4 per cent to 257 million tonnes, with the per capita rate dropping by 4.8 per cent to 11.2 tonnes. Shen continued, 'In 2008, the Taiwan government announced the voluntary carbon dioxide reduction targets for the period 2016 and 2020 returning to 2008 levels, and by 2050 returning to 50 per cent of 2000 levels.' He went on, 'In the future, Taiwan's international cooperation will focus on continuously introducing advanced environmental management and technologies to improve local environmental quality, sharing Taiwan's experience to assist other nations to solve environmental problems.'<sup>b</sup> One of these would of course be China. And the need there for high-quality cooperation and ideas about how to confront its huge environmental and sustainability challenges is growing ever greater.

a Press release from the Environmental Protection Administration, Taiwan 2009

b 'Taiwan's Proposals and Visions on International Cooperation of Climate Change Mitigation'.

If Taiwan has to accept a world in which the economic power and the influence of the PRC continue to grow, what must it do to engage with this process and fulfil its own key goals? There is no way in which it can stop China on this path. So how can it enjoy at least some benefits from what China is doing? There are in fact two things Taiwan can do. One of them it is doing already, and the other it might do more assertively in the coming decade.

Taiwan is already concentrating on its own economy, and sees this as one of the key ways in which it can develop greater strength and stability, despite the threat that China might offer. Paradoxically, Taiwan has to accept that only greater economic integration with China will deliver it the best opportunity to achieve this. No other market offers the sort of growth potential or the possible returns. Taiwanese businesses evidently made this decision years ago when they started to deploy more and more capital into China. With the ECFA, politicians have joined them. The inescapable fact is that China offers Taiwan the greatest economic benefits and returns, even as it presents huge political risks. Not taking these opportunities means that economic growth for the island becomes tougher and tougher. The future of the Ma government rests on how the ECFA increases prosperity on the island. The simple fact is that Taiwan's poor economic performance in the last ten years has been in no small part due to lack of engagement with the Mainland economy.

Critics say that the Mainland might be able to 'buy' Taiwanese sovereignty in the end, and 'annex by economic actions'. That threat exists, certainly, but this can only happen if Taiwanese policy-makers are passive. In fact, there is a new strand in which Taiwan could use its influence through integration in a way that serves its own mid- to long-term goals, reduces tension across the Strait, improves security and maintains its own identity.

Taiwan's true strength is that it has undertaken a revolutionary, successful and stable process of political reform. Since the 1980s, it has gone from martial law under one party to fully open presidential elections in 1996, with peaceful transitions of government from ruling party to opposition party in 2000 and in 2008. Civil society and the media on the island are vibrant. Despite some ongoing problems, the record of Taiwanese companies and entities in terms of transparency and openness is way above that of the Mainland. While China has been able to generate huge increases in GDP growth, the stark fact is that it is in the midst of a hugely complex, contentious and disruptive process where many issues about social structure, welfare, healthcare, pensions and political organization remain largely unaddressed and unresolved. Economically, China is ahead of Taiwan by virtue of its sheer size. But politically, it is far behind.

Greater economic integration may carry the risk that China will try to exert more influence in Taiwan, but it also means that Taiwan has an unparalleled opportunity to influence what happens in the Mainland. It can do this openly, transparently and wholly in the interests of both sides. Taiwan stands best placed of all outside entities to help with fundamental reforms in the Mainland. With a dynamic policy in this area, it could see economic benefits, but also political returns, come far sooner than expected.

## China and 'the Taiwan model'

Political elites in the Mainland, officials, academics and observers have argued that while there is a high awareness that the Chinese must undergo a profound reform of their systems of governance and modernize the ways in which decisions are made, the courts run, civil society functions and people participate in the political system, China must find its own way. The argument is that the PRC is *sui generis*, unique to itself, and therefore, while it has looked at other potential models from Singapore and Japan to Europe and even to the United States, in the end it will have to come up with something suitable for China's own circumstances. Elite leaders are not shy about talking about reform and democracy in the PRC. Hu Jintao used the word 'democracy' more than any other in his speech at the 17th party congress in 2007. Wen Jiabao also frequently uses it. Some promises have been made that China will indeed democratize in the next few decades, with talk of 30 to 60 years. While there is plenty of argument about the detail, there is little dispute that the current system needs to change and become more modern. The question is always how.

Mention of Taiwan in discussions about these issues in China is not popular. Yet in fact Taiwan serves as the closest and most culturally relevant model for the PRC. The process in the 1980s of originally tolerating unions and groups outside the KMT (the *dangwai* or 'outside the party' groups), which then grew into independent political forces, offers a system and a process that are perfectly possible in the Mainland. Taiwan's creation of a viable rule of law, its ability to maintain stability while it undertook political reform, and its developmental model are all relevant to the Mainland. Finally, the history of Taiwan lays to rest the tired claim that the Chinese are somehow not ready for democracy. What Taiwan has done politically opens up a range of possibilities that the Mainland should look at closely, as it now starts to truly engage with fundamental political reform.

Indeed greater economic integration and links offer Taiwan the opportunity to be more proactive in two areas that are largely risk-free, while conveying the underlying message that Taiwan is what China should aspire to be politically, whatever the economic story might be. The first opportunity is for Taiwan to work as much as possible with partners in China to promote the rule of law. Taiwanese companies, academics and others can legitimately do this because of their huge investments there. A firm and reliable legal structure is important for investor confidence, for security and therefore for the stability of the government itself. Taiwan's experience of legal reform needs to be promoted in China. The second opportunity is in the governance and internationalization of corporations. Taiwanese companies are able to operate at a level internationally that Chinese companies, so far, have failed to do. Greater corporate links will mean that company governance can be promoted between Taiwanese and Mainland companies. Fundamental issues such as the rights of shareholders, the need for transparency and the governance of assets can all be discussed.

From the issues around equitable growth to the green agenda, Taiwan should explore ways in which it can enjoy a deeper dialogue with China. Their common cultural background means it can discuss these in more direct, productive ways than others can. And it may well be that this dialogue lays the basis for talk about more fundamental reforms in the PRC, from the role of its civil society (something that is strong in Taiwan) to the final great issue – the democratization of the political system in the PRC. Taiwan's influence here could be crucially important not just for itself or for the Mainland, but for the world. China's reforms in the coming years will be hugely significant to its own future sustainable viability. In having a voice here, Taiwan will not just be a passive onlooker, but at the heart of discussions on change within the Mainland. That, after all, is what integration means – a two-way relationship. And in creating modes of integration, unexpectedly Taiwan could find that, legitimately and wholly without contention, it is able to speak back to China in ways that are more influential and carry greater impact than anyone else.



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