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Chinese Economic Coercion Against Taiwan

A Tricky Weapon to Use

Murray Scot Tanner

Prepared for the Office of the Secretary of Defense

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Preface

This monograph analyzes the political impact of the rapidly growing economic relationship between the People's Republic of China (PRC) and Taiwan and evaluates the prospects for Beijing to exploit that expanding economic relationship to employ economic coercion against Taiwan. It also identifies China's goals for applying economic pressure against Taiwan. To establish a framework for evaluating China's relative success or failure in using economic coercion against Taiwan, this work draws upon the conclusions of the large and empirically rich body of studies of economic diplomacy that have focused on economic coercion and trade sanctions.

In examining Taiwan's response to the rising cross-strait economic relationship, the study analyzes Taipei's two decade-long effort to strike a difficult balance between two goals:

- limiting excessive dependence on mainland China that could be exploited for political pressure
- taking advantage of China's explosive economic development to improve Taiwan's eroding economic competitive position.

A large portion of this monograph is devoted to evaluating the cross-strait economic relationship and Taiwan's potential economic vulnerability to Chinese efforts to cut off or disrupt key aspects of that relationship. But this document also extensively analyzes the challenges that China has faced in its efforts to convert this raw, potential economic influence into effective political leverage.

This work closes with an overall evaluation of the cross-strait relationship and Taiwan's vulnerability to a variety of scenarios for economic pressure—some of which Beijing has actually attempted in recent years, and some of which are as yet only hypothetical or threatened. It also briefly discusses the potential impact of cross-strait economic diplomacy on U.S. policy interests in the Taiwan Strait. As such, this monograph should be of interest to policymakers, analysts, and others interested in U.S. policy toward Asia.

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Contents

Preface	iii
Figures	ix
Tables	xi
Summary	xiii
Acknowledgments	xvii
Abbreviations	xix

CHAPTER ONE

Introduction	1
Potential for Economic Coercion	1
Purpose of This Study	5
Organization of This Monograph	8

CHAPTER TWO

Economic Coercion: Factors Affecting Success and Failure	11
Defining Economic Coercion/Economic Pressure	11
Mainland Chinese Economic Pressure: Serving Many Political Goals	13
Forcing Policy Change	13
Destabilizing, Subverting, or Creating Domestic Pressure on the Target Regime	14
International Signaling	15
Domestic Political Symbolism	15
Punishment and Eroding Military Power	16
Likely Scenarios for Chinese Economic Coercion Against Taiwan	16
Export Sanctions	17
Import Sanctions	17
Financial and Investment Sanctions	17
Selective Harassment or Intimidation of Taiwan Businesspeople	17
Economic Disruption, Damage, and Sabotage	18
Deliberate Slowing or Withholding of Business	19
Efforts to Hasten the “Marginalization” or “Hollowing Out” of Taiwan’s Economy	19
Factors Affecting Success and Failure of Economic Coercion Against Taiwan	19

Economic Factors That Help Determine Success or Failure	20
Levels of Economic Pain and Disruption	20
Political Factors That Help Determine Success or Failure	22
China and Taiwan's Bitter Historical Relationship	23
Beijing's Specific Demands	23
Efforts to Subvert or Change Taiwan's Government	25
Likely Issues in a Beijing-Taipei Economic Confrontation	27
The Target State's Political Capacity to Resist Coercion	28
Beijing's Quest for "Conduits of Influence" Within Taiwan Politics	29
Domestic Politics in the Initiating State	30
International Support for the Initiating and Target Countries	31

CHAPTER THREE

Taiwan's Struggle to Manage Expanding Cross-Strait Economic Ties	33
Key Conclusions: Taipei's Powerful Dilemmas in Controlling Cross-Strait Trade and Investment	33
Taiwan's Major Policies Designed to Limit Mainland Influence	36
Beijing's Initial Entreaties to Taiwan	36
Taiwan's Response: From Full Embargo to Rapid Opening	38
Shifting Investment Patterns and Rising Concerns About Dependence	42
Taipei's Rising Concerns About Growing High-Tech Investment	43
Encouraging Diversification: President Lee's "Go South" Policy	45
Tightening Administrative Oversight and Controls: "No Haste, Be Patient"	47
Cross-Strait Economic Ties Under Chen Shui-bian	50
From "No Haste, Be Patient" to "Active Opening, Effective Management"	50
The "Mini-Three Links"	54
Continuing Support for Diversification	54
Restricting Flows of Mainlanders to Taiwan	55
Financial Markets	56
Using Technological Limitations and Recent Semiconductor Business	57
Ongoing Battles over the Full Three Links	60
Business and Opposition Party Reactions	62
Holiday Direct Flights	66
Conclusion: Overall Evaluations of Taiwan's Government Policy	68

CHAPTER FOUR

Economic Factors: Evaluating Taiwan's Vulnerability	73
Main Findings	74
The Rapid Expansion of Cross-Strait Trade and Investment	76
Cross-Strait Trade	76
Cross-Strait Investment: Enormous, but Just How Enormous?	77

Gauging the Importance of Cross-Strait Economic Relations to Taiwan's Economy	82
The Strategic Significance of Current Cross-Strait Economic Ties	87
The Rising Importance of Mainland-Based Production: The Information Technology Sector	88
Strategic Resources: Vulnerability to Cutoff	90
Vulnerability to Deliberate Economic Disruption: Stock Markets	91
Disruption of Taiwan's Information Networks	96
Coda: China's Economic Dependence on Taiwan	97
Conclusion: Putting Taiwan's Economic Vulnerability in Perspective	99

CHAPTER FIVE

Political Factors: Converting Economic Influence into Political Leverage	103
Political Factors Influencing the Success or Failure of Economic Pressure	103
Domestic Politics and Their Influence on Economic Coercion	104
Major Findings: Obstacles to Beijing's Political Leverage	104
Turning Economic Influence into Political Leverage: Beijing's Strategies	105
Seeking Conduits of Influence in Taiwan	106
Public Opinion: Economic Closeness, but Political Drift	107
Neutralizing Potential Leverage: The Shifting Center of Taiwan's Elite Politics	109
The "Taishang": Business as the Key Conduit for Beijing's Influence?	111
Beijing's Questionable Assumptions About the Taishang	112
Beijing's Efforts to Leverage the Taishang	113
The 1990s: Private Reassurance	113
The 2000 Taiwan Presidential Election: Turning Up the Heat	114
Failed Regime Change: The Taishang in the 2004 Elections	118
The "Taiwan Spy" Case: "Killing the Chicken . . ."	118
Chen's Reelection and Beijing's Frustration	120
DPP Counterattack: Neutralizing Taishang Influence	120
Fleeing Pressure from Two Sides: Learning to "Fly Below the Radar"	123
Assessing the Taishang's Opposition to Chen	124
Beijing Rethinks Economic Leverage, Spring 2004	126
Back on the Attack: The Hsu Wenlong Case, May 2004	127
Beijing's Counterproductive Strategy Toward the Taishang	132
The Impact of Economic Pressure on Mainland Chinese Politics	132

CHAPTER SIX

China's Economic Leverage: A Powerful Weapon, but Tricky to Use	135
Taiwan's Rising "Asymmetric Interdependence" with Mainland China	135
Taiwan's Struggle Between Growth and Excessive Dependence	136
Taiwan's Vulnerability to Specific Coercion Scenarios	137
Mainland Economic Vulnerabilities	140

Beijing's Challenges: Converting Economic Influence into Political Leverage.....	141
Potential Risks for U.S. Interests: Beijing's Frustrations and Taipei's Fears.....	142
Bibliography	145

Figures

4.1.	Cross-Strait Trade 1990–2005	77
4.2.	Taiwan's Total Exports as a Percentage of GNP, 1991–2005.....	83
4.3.	Cross-Strait Trade as a Percentage of Taiwan's Total Trade	84
4.4.	Cross-Strait Imports as a Percentage of Taiwan's Total Imports.....	85
4.5.	Cross-Strait Exports as a Percentage of Taiwan's Total Exports	86

Tables

4.1.	Taiwan-Approved Foreign Direct Investment in China and Selected ASEAN Countries, 1986–1994.....	78
4.2.	Percentage of Selected Taiwan IT Products Produced in Mainland China, 2004	89

Summary

This monograph analyzes the rapidly expanding economic relationship between mainland China and Taiwan and the prospects and challenges Beijing faces as it tries to exploit this economic relationship to gain political leverage over Taipei.

Since the early 1980s, the economic relationship between Taiwan and mainland China has exploded, driven by far-reaching economic and political reforms on both sides as well as powerful natural complementarities in the two economies. As a result, the two economies are now in a deep, wide-ranging relationship of “asymmetric interdependence” in which each side relies upon the other for important contributions to its economy, and each would suffer great economic pain and dislocation in the event of a major disruption in that relationship. But as Taipei’s leaders have long feared, Taiwan depends on the mainland market for a far higher percentage and a far broader range of its economic activities than the mainland depends on Taiwan.

From virtually no contact a quarter-century ago, by late 2001, China had replaced the United States as Taiwan’s number-one market for its exports. Cross-strait two-way trade has risen from an estimated \$950 million (U.S.) in 1986 to more than \$46.3 billion by the end of 2003, the latter figure being equal to 17.1 percent of Taiwan’s total trade. China is also the number-one venue for Taiwan’s foreign investment and the number-one production base for many of its most profitable exports—especially its information technology (IT) exports. Cross-strait economic ties now occupy terrific weight within both economies, particularly Taiwan’s. Exports to the mainland equaled more than one-tenth of Taiwan’s entire gross national product (GNP) by the end of 2003. Taiwan’s foreign direct investment (FDI) in the mainland accounts for more than half of all Taiwan FDI—or perhaps much more than half.

The expanding cross-strait relationship raises serious security questions, particularly for Taiwan. Many analysts have expressed concern that China will exploit the economic relationship with Taiwan in ways that could undermine the United States’ long-standing opposition to either side unilaterally or coercively altering the status quo across the Taiwan Strait and its insistence that any resolution to cross-strait conflict be acceptable to the people of Taiwan. Beijing has, in fact, either committed or publicly contemplated many forms of economic pressure against Taiwan at various times within the past two decades. Beijing has openly proclaimed that its key goals for

expanding economic relations with Taiwan include encouraging “peaceful reunification” and “using business to pressure politicians.” Over the years, Chinese leaders and analysts have often argued that cultivating economic ties with Taiwan might contribute to reunification in many ways, from the magnetic to the highly coercive.

Economic experts warn that if China were able to close down key parts of the cross-strait economic relationship, Taiwan would be vulnerable to a major recession and other severe forms of economic dislocation. The hundreds of thousands of Taiwan businesspeople now working on the mainland are also vulnerable to pressure and harassment from mainland authorities. In addition, China has demonstrated that it can disrupt key sectors of Taiwan’s economy, including its stock markets and information networks.

Since 1979, successive Taipei governments have struggled to strike a balance between growth and security in their cross-strait economic policies. Both government and business leaders strongly desire to draw on mainland China’s rapid growth as a vehicle to rescue Taiwan’s increasingly challenged international competitive position. At the same time, both the Lee Teng-hui and Chen Shui-bian administrations have sought to limit Taiwan’s economic dependency on Beijing. Politically, advocates of liberalizing cross-strait trade and investment relations—in particular, Taiwan’s influential mainland-invested business community (the “Taishang”)—have won the lion’s share of these battles. Presidents Lee and Chen, however, have periodically shown real willingness to resist such pressure and can point to some significant successes in limiting Taiwan’s dependence—most notably in slowing the pace of high-tech investment on the mainland and maintaining a significant technological “gap” or “lag” between what Taiwan firms produce on the island and what they produce across the strait. Taipei’s efforts to get Taishang to move their investments to less-threatening Asian venues have been far less successful.

Most experts on economic diplomacy agree, however, that the level of economic deprivation an “initiating” country (e.g., mainland China) can inflict rarely, by itself, determines the effectiveness of economic coercion. Several political factors—in particular the domestic political situation within the initiating and “target” countries—usually have a greater impact on the initiator’s ability to convert economic influence into political leverage. For Beijing to initiate economic pressure, a key challenge is identifying and effectively exploiting “conduits of influence” within the target’s (e.g., Taiwan’s) political system—that is, politically influential classes or groups in Taiwan with a stake in promoting the policies that Beijing also supports. These conduits of influence are a key factor in converting economic influence into effective political leverage.

Somewhat surprisingly, given the high level of Taiwan’s economic dependence on the mainland, these economic ties have not automatically translated into effective political leverage for China. Indeed, in recent years, Beijing has often been frustrated in its efforts to exploit this economic leverage, at least in the near term. From China’s perspective, the cross-strait economic relationship is potentially a very powerful

political weapon, but it is a weapon that Beijing is finding increasingly tricky to use. For example,

- Beijing's frustration was dramatically illustrated in the 2004 Taiwan presidential election. The elections proved that widespread forecasts that Taiwan's business leaders and Taiwan voters—both worried about the poor state of Taiwan's economy and anxious for expanded cross-strait economic relations—would combine to defeat President Chen Shui-bian were mistaken or at least badly exaggerated.
- A major reason why Beijing is having trouble exploiting its economic leverage is that most Taiwan businesspeople have become highly adept at “flying below the radar” politically—keeping their true political inclinations and activities hidden from political leaders in both Taiwan and mainland China, thereby frustrating Beijing's efforts to pressure them into forming a ready-made “lobby” for Beijing's interests. While mainland-invested Taiwan businesspeople have been, for the most part, successful in encouraging their government to loosen economic restrictions on cross-strait ties, the business community has been unwilling or unable to use its political influence to pressure Taipei into making significant political concessions to Beijing.
- Taiwan's voters have also frustrated Beijing's forecasters. Although the voters have largely supported candidates who favored improved cross-strait economic ties, it has not prevented the continuous slide in support for reunification with China on terms that Beijing prefers.
- Nor have Taiwan's political leaders sat back passively as Beijing attempted to exploit its burgeoning economic might. President Chen has frequently shown himself to be fairly adept at politically disarming or counterattacking many advocates of a more rapid opening up of cross-strait relations.
- Finally, China must reflect upon the potential blowback that large-scale efforts at economic coercion against Taiwan might have upon its own economy and society. Although Taiwan is, overall, more economically dependent upon mainland China than China is on Taiwan, there are key regions and sectors of China's economy that are enormously dependent upon Taiwan investment, and these would likely suffer very badly in the event of a serious cutoff of trade and investment.

But Beijing's difficulty in translating economic leverage into political leverage is not necessarily good news for either Taiwan or for U.S. interests in the region. There is significant evidence that in the wake of the 2004 Taiwan presidential election, China's growing frustration over its problems in employing economic levers of power temporarily undermined the position of those policy advisors who were most optimistic about the long-term efficacy of economic power and cross-strait economic integration—and perhaps correspondingly strengthened the hands of those Chinese analysts who advocate using more nakedly coercive measures against Taiwan. These tensions

have eased in the past year as Beijing adopted a more restrained, seductive strategy toward Taiwan, and Chen Shui-bian has encountered numerous political setbacks at home. But Chinese analysts overwhelmingly attribute Chen's problems to factors other than the power of the growing cross-strait economic relationship.

Taipei's fears about cross-strait economic relations may also increase threats to stability in the region. Many in Taipei do not share this report's conclusion that Beijing is having difficulty transforming its economic influence into political leverage. Fearing that Beijing's rapid economic growth will eventually grant it overwhelming political leverage, many of Taiwan's more strongly pro-independence leaders believe that the time to push for constitutional reforms or other measures to formalize a more independent relationship is "now or never."

This study indicates that, for Beijing, there is an irony in its efforts to exploit its economic leverage to bring Taiwan closer to a reunification deal. Cross-strait economic links appear to have the greatest impact on Taiwan's politics when Beijing is least aggressive in trying to exploit them, as it has been since early 2005. When Beijing uses high-profile, high-pressure economic tactics, they have tended to backfire, creating powerful opposition in Taiwan and undermining the political effectiveness of those with a stake in closer cross-strait economic and political ties. Taiwan business and political leaders seem more inclined to reflect positively on the importance of future cross-strait economic relations when Beijing keeps a low profile and refrains from overt pressure tactics. But when Beijing's leaders have become frustrated with Taipei's "envelope-pushing," they all too often see the Taishang as a convenient target for their momentary wrath. The Beijing leadership—by attacking one of the few groups left in Taiwan with a reasonably positive impression of it—has, in the words of an old Chinese saying, "lifted a rock only to drop it on its own foot." China has at its disposal a potentially powerful weapon to keep Taiwan from drifting away. But there is serious doubt whether Beijing's leaders have the political self-restraint to use this weapon effectively over the long run. Whenever Beijing has grown irritated with Taipei, Taiwan businesspeople operating in China have made exceedingly tempting targets.

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Abbreviations

ASEAN	Association of Southeast Asian Nations
ASL	Anti-Secession Law
CEO	chief executive officer
CNOOC	China National Offshore Oil Corporation
COCOM	Coordinating Committee for Multilateral Export Controls
CPC	China Petroleum Corporation
DOE	U.S. Department of Energy
DPP	Democratic Progressive Party
EDAC	Economic Development Advisory Conference
FDI	foreign direct investment
GMD	Guomindang
GNP	gross national product
IPO	initial public offering
IT	information technology
LCD	liquid crystal display
MAC	Mainland Affairs Council
MIC	Market Intelligence Center
MIC/III	Market Intelligence Center's Institute for Information Industry
MND	Ministry of National Defense
MoEA	Ministry of Economic Affairs

MOFTEC	Ministry of Foreign Trade and Economic Cooperation
NDU	Taiwan National Defense University
NSB	National Security Bureau
NTD	New Taiwan Dollar
PC	personal computer
PLA	People's Liberation Army
PFP	People's First Party
PRC	People's Republic of China
SARS	severe acute respiratory syndrome
SEF	Straits Exchange Foundation
TAA	Taipei Airlines Association
TFT	thin-film transistor
TSMC	Taiwan Semiconductor Manufacturing Corporation
TSU	Taiwan Solidarity Union
UMC	United Microelectronics Corporation
WTO	World Trade Organization

Introduction

Potential for Economic Coercion

Economic relations between Taiwan and the People's Republic of China (PRC) were virtually nonexistent from 1949—when China's Guomindang (GMD, the Nationalist Party) government fled the mainland to Taiwan—until 1979, when the Communist Party embarked upon its historic policy shift toward market-oriented economic reform and opening to the outside world. Throughout this period, Taiwan, motivated by security concerns, maintained a rigid policy of no economic or political contact with the mainland. During much of this same period, the PRC leadership under Mao Zedong was committed to one of the world's strictest regimes of economic isolation and autarky. There were limited, largely underground, indirect trade ties through Hong Kong (then a British colony) and a few informal trade exchanges between fishermen in several small Taiwan-controlled islands close to the PRC coast. But beyond these very modest contacts, both governments feared that extensive economic ties might grant their adversaries dangerous levels of political leverage, and, thus, they maintained firm policies of mutual isolation.

Since the early 1980s, however, the cross-strait economic relationship has exploded, driven by far-reaching economic and political reforms on both sides, as well as powerful natural complementarities in the two economies. The volume of cross-strait economic activity has expanded at a terrific pace. From virtually no contact a quarter-century ago, by late 2001 China had replaced the United States as Taiwan's largest export market. China has also become Taiwan's number-one target for its overseas foreign direct investment (FDI)¹ for at least several years. Cross-strait two-way trade has risen from an estimated \$950 million² in 1986 to \$37.4 billion by the end of 2002, the latter figure being equal to 15.4 percent of Taiwan's total trade. With Beijing's apparent blessing, Taiwan has maintained a considerable trade surplus

¹ *Foreign direct investment* refers to investment by foreign companies in companies, facilities, and equipment. It does not include portfolio investments made in stocks or equities.

² Throughout this study, references to *dollars* or use of the dollar sign (\$) refer to U.S. dollars, unless Taiwan's currency, the New Taiwan Dollar (NTD), is explicitly noted.

with China over the past two decades, and China is the principal source of Taiwan's overall trade surplus.

The raw volume of trade and growth rate in trade and investment, though impressive, hardly begin to capture the increasing strategic importance of the relationship. Cross-strait economic ties now occupy a very large "weight" within both economies, particularly Taiwan's. Trade and investment with China now constitute a large and growing percentage of Taiwan's total FDI and foreign trade and are also very large in relation to its gross national product (GNP). In qualitative terms, Taiwan and China's economies are now deeply intertwined in many of their most important, cutting-edge economic sectors—in particular their information technology (IT) sectors. The blossoming interdependence of the mainland Chinese, Taiwan, and Hong Kong economies has accelerated the rise of "Greater China" as one of the most vibrant economic regions in the world.

The expanding cross-strait relationship raises serious security questions, particularly for Taiwan. Many analysts have expressed growing concern that China might be able to exploit these expanding economic ties as powerful levers of influence to pressure Taiwan politically. These fears are well captured in the words of Taiwan political scientist Tung Chen-yuan:

Taiwan's government feels ill at ease having such a close economic relationship with its powerful political rival, in part because it fears the flood of Taiwan investment and trade will make it economically dependent on China, thus undermining its de facto political independence. In fact, these fears have been triggered and reinforced by the fact that Beijing explicitly considers cross-Straits economic relations an important source of political leverage against Taiwan.³

A number of analysts have argued that China could exploit its economic relationship in ways that could undermine the United States' long-standing opposition to either side unilaterally or coercively altering the status quo across the Taiwan strait and its insistence that any resolution to cross-strait conflict be acceptable to the people of Taiwan. Among the chief concerns is the prospect that the PRC could exploit the burgeoning economic relationship to bring economic and political pressure on Taiwan in a variety of ways:

- Compel Taiwan to engage in negotiations over reunification or other key issues on a disadvantageous footing.

³ Chen-yuan Tung, "China's Economic Leverage and Taiwan's Security Concerns with Respect to Cross-Straits Economic Relations," paper presented at the Taiwan Studies Workshop, Fairbank Center, Harvard University, Cambridge, Mass., May 2003a. See also Chen-yuan Tung, "Cross-Straits Economic Relations: China's Leverage and Taiwan's Vulnerability," *Issues and Studies*, Vol. 39, No. 3, September 2003b, pp. 137–175.

- Undermine political support in Taiwan for developing and funding adequate self-defense capabilities.
- Pressure politically influential individuals in Taiwan—either economic or political elites—into constituting an essentially unwilling domestic lobby for Beijing’s interests.
- Intimidate large portions of the broader Taiwan electorate or key social interest groups into supporting concessions to Beijing.
- Deter Taiwan from undertaking, or compel it to withdraw, important and otherwise popular domestic policies or political system reforms that do not unilaterally change the cross-strait status quo, but which Beijing nonetheless opposes as threatening.
- Compel Taiwan’s political or economic leaders to take economic decisions that would undermine Taiwan’s long-term economic vibrancy or international support by transferring key activities and resources (including personnel) to the mainland, or by “marginalizing,” or “hollowing out,” key economic sectors.
- Inflict significant and deliberate damage on key Taiwan economic activities (e.g., causing major downturns in stock and bond markets, interfering with key information networks) or harass Taiwan businesspeople.

These scenarios for mainland economic coercion are hardly hypothetical. Beijing has committed or publicly contemplated every one of these scenarios for economic pressure against Taiwan at some time within the past decade. Indeed, since its first economic outreach to Taiwan in 1979, Chinese leaders and policy analysts have publicly argued that their main goals for expanding economic relations with Taiwan—in addition to accelerating China’s own economic growth—include encouraging “peaceful reunification.” As several scholars have stressed, Beijing has for years openly proclaimed its strategy of “using the people to pressure the officials” (*yi min bi guan*) and “using businesspeople to pressure politicians” (*yi shang wei zheng*).⁴

But China’s leaders and policy advisors are far from unified in their estimates of the utility of economic levers in dealing with Taiwan, and their assessments have varied over time, depending on how they see the overall state of the relationship. In their statements and publications over the years, Chinese leaders and analysts have often argued that cultivating economic ties with Taiwan might contribute to reunification in many ways. Economic interdependence, they have argued, can support a full range of strategies for influencing Taiwan—from the magnetic to the coercive. At the most coercive level, mainland Chinese analysts have overtly threatened

⁴ Chinese analysts have actually used several different versions of these Chinese expressions, each with their own particular emphasis on how the economic can serve the political. Also, because of the wide meanings of Chinese characters, these expressions can have multiple meanings. *Yi shang wei zheng*, for example, can also mean “using commerce to serve politics.” For a discussion of these strategies, see Chen-yuan Tung, 2003a, pp. 137–139, and Chen-yuan Tung, 2003b.

that China could embargo imports from Taiwan or cut off mainland exports of key commodities in order to cause “economic chaos” and break Taiwan’s political will.⁵ On a less explicitly coercive level, some mainland analysts have argued that Taiwan’s economic growth is now so dependent upon the China market that any effort by Taiwan to “obstruct . . . the normal development of cross-Straits economic and trade ties actually means hindering Taiwan’s economic growth.”⁶ At the least coercive level, some Chinese leaders have argued that expanding economic links will help create a large community of shared interests between the two sides. President Hu Jintao voiced this argument in a meeting with Taiwan delegates to the March 2003 Meeting of China’s legislature, the National People’s Congress.⁷ More privately, some mainland experts freely concede that to the extent that economic interdependence with Taiwan helps ease the mainland’s transformation into a society that is more prosperous, stable, powerful, internationally respected, and politically better-governed, it will ease Taiwan’s reluctance about reunification and make the mainland a far more attractive partner for the wealthier and democratic Taiwan. Indeed, some mainland advocates of political reform and democratization have turned the argument around and explicitly made the point that the need to entice Taiwan into reunification is a powerful reason for encouraging more-rapid economic and political change.⁸ Over the years, many senior Beijing officials have argued that China must cultivate relationships with economic and corporate leaders in Taiwan, as well as average citizens whose livelihoods depend upon economic ties with China, in order to forge a lobby that sees not only its economic but also its political future linked to China, and would pressure Taiwan’s political leaders to improve relations with the mainland.

Analysts outside of China are also deeply divided in their assessments of how much political leverage China is gaining over Taiwan as a result of its growing economic relationship. Some argue that China has had great difficulty deploying this relationship as a political weapon. Others contend that Taiwan’s economic dependence upon the mainland is so great that Taiwan officials are already censoring their own

⁵ An example of such blatantly coercive talk, discussed further in Chapter Five, was a May 2004 article on an official Web site by Taiwan analyst Wang Jianmin of the Chinese Academy of Social Sciences Taiwan Research Institute. Wang’s threats are discussed in Wang Jianmin, “Dui Tai jingji zhicai? Guo Tai Ban Fouren!” (“Economic Sanctions Toward Taiwan? The State Taiwan Affairs Office Denies It!”), *Lien-ho Pao* (Taipei), June 4, 2004, p. A2.

⁶ See the article by Professor Deng Lijuan of the Xiamen University Taiwan Research Center: “Mainland Becomes a Major Force Driving Forward Taiwan’s Economy,” *People’s Daily* (Beijing), March 2, 2004.

⁷ Hu Jintao, Speech to Taiwan Delegates of the National People’s Congress, Xinhua Domestic Service (China), March 11, 2003. For an analysis of the speech, see Murray Scot Tanner, “Hu Jintao as China’s Emerging National Security Leader,” in Andrew Scobell and Larry Wortzel, eds., *Civil-Military Change in China: Elites, Institutes, and Ideas After the 16th Party Congress*, Carlisle, Pa.: U.S. Army War College, Strategic Studies Institute, September 2004b, pp. 49–76.

⁸ These arguments have been made privately to the author and other Western analysts by Chinese analysts on several occasions since the mid-1990s.

deeply held political beliefs, with or without overt acts of pressure from Beijing. For example, Tung Chen-yuan, a specialist on cross-strait economic and political relations at Taiwan's National Chengchi University, argues that "despite Taipei's fears . . . Beijing has showed itself to be reluctant and generally ineffective in exploiting its economic leverage through trade sanctions, even during the 1995–1996 and 1999–2000 Taiwan Strait tensions."⁹ Tung notes that even during the 1995–1996 missile crisis, Beijing actually went out of its way to reassure Taiwan investors that their holdings would be safe.¹⁰ It is not clear whether these reassurances reflected a nationwide policy promoted by Beijing, or whether these reassurances were initiated by local mainland governments that were fearful of the impact that a cutoff of business with Taiwan might have on their local economies.

John Tkacik, an American China specialist, has argued that despite President Chen Shui-bian's long-standing support of Taiwan independence, he backed off from promoting independence after his election in 2000 because of mainland economic pressure:

Taiwan, it seems, is too dependent on China to be independent. . . . President Chen, most of his financial backers, and a majority of his own political party are all too aware of the central fact of Taiwan's economic predicament; its entire export manufacturing sector relies on mainland Chinese labour and factories for growth. . . . Into the 21st Century, Taiwan's drift toward political "independence" will have halted, and Taiwan's increasing symbiosis with mainland China will bind the island ever more tightly to the mainland.¹¹

Purpose of This Study

This study was intended to do the following:

- Identify China's goals for applying economic pressure on Taiwan, analyze its range of available methods or scenarios for applying pressure, and examine its overall evaluation of the utility of economic pressure for achieving political goals. Traditional studies of economic coercion usually limit their analysis to large-scale and blunt forms of coercion, such as full-blown trade sanctions, investment seizures, and cutoffs of aid. This study addresses those scenarios, but also examines

⁹ Chen-yuan Tung, 2003a.

¹⁰ Chen-yuan Tung, 2003a.

¹¹ John Tkacik, "Taiwan Dependence: The Strategic Dimension of Cross-Strait Trade and Investment," in Andrew Scobell, ed., *The Costs of Conflict: The Impact on China of a Future War*, Carlisle, Pa.: U.S. Army War College, Strategic Studies Institute, October 2001, pp. 35–62.

some more sophisticated and realistic sets of options for economic pressure based on Beijing's past practice and Taiwan's current concerns.

- Identify the key factors that determine how vulnerable a “target state” such as Taiwan is to economic coercion attempts by an “initiating state” such as China. Experts on economic diplomacy have done extensive empirical research on historical efforts by initiating states to use economic coercion and have identified several factors that make “successful” economic coercion more or less likely. Specialists on China-Taiwan relations have also analyzed many of these factors at length. This study draws on both of these bodies of research to identify the factors that would most likely enhance or undermine China's success in using economic coercion against Taiwan.
- Analyze the rapidly growing cross-strait economic relationship and its political implications for economic coercion against Taiwan. Drawing on the “success factors” identified in the section above, the study evaluates Taiwan's relative economic and political vulnerability to economic pressure from mainland China.

In recent years, a consensus has emerged among most experts on economic diplomacy that “objective” economic vulnerability does not, by itself, determine how likely a target country is to make political concessions in the face of economic pressure. A series of political factors also play a pivotal role in determining a target country's vulnerability. Likewise, many experts on cross-strait relations have recently noted that China-Taiwan economic and political relations seem to be showing “opposite trends”—with economic ties growing closer by the day even while political relations between Beijing and Taipei are cooling.

Because of these complex issues, this monograph's evaluation of Taiwan's vulnerability to economic coercion focuses on the more purely economic aspects of the relationship between Taiwan and the mainland, in an effort to evaluate mainland China's ability to inflict economic pain and dislocation on Taiwan's economy, and it focuses on the political factors that are determining China's success or failure in converting its economic influence into real political leverage over Taipei and that will help decide whether or not Taiwan is likely to make major political concessions in the face of mainland economic pressure.

Measures of Taiwan's economic dependence and vulnerability to mainland China (e.g., China's capacity to inflict economic pain and deprivation) include such factors as the following:

- the levels of economic interaction between China and Taiwan and changes in these levels over time
- the relative importance or “weight” of the cross-strait relationship in Taiwan's total foreign trade, FDI, and overall economic activity (e.g., total GNP)

- the degree of importance or substitutability of these cross-strait economic activities in Taiwan's overall economy; that is, Taiwan's ability to forgo these economic benefits in the event of any prospective economic dispute with the mainland
- the relative effectiveness of policy measures taken by Taiwan officials in their efforts to minimize China's economic leverage.

In analyzing Taiwan's vulnerability to economic coercion, this study also goes beyond the factors traditionally examined by experts on economic diplomacy (imports/exports, investment and asset seizures, foreign aid) by examining a broader, more contemporary array of economic levers (including influence over information flows and IT sources, and influence on stock and bond markets).

China's capacity to convert its economic influence over Taiwan into successful political leverage will depend in large part on Beijing's ability to manipulate key "conduits of influence" in the Taiwan political system. These conduits include (but are not necessarily limited to) the following:

- mass political support: the likelihood that the Taipei government can persuade the people of Taiwan to rally behind their government in the event of economic coercion and demonstrate their willingness to endure economic pain and dislocation inflicted by the mainland
- the Beijing government's ability to manipulate its available economic "carrots and sticks"—in particular, using these economic weapons effectively to leverage specific, powerful political constituencies within Taiwan and encourage them to pressure Taipei to make concessions to Beijing; one of the key factors here is the ability of Beijing's prospective Taiwan "target groups"—most notably Taiwan's mainland-invested business sector—to avert or resist economic pressure from Beijing
- the Taipei government's capacity to resist pressure from any such "target groups" in Taiwan society that might be subject to pressure from Beijing; among the key factors in Taipei's ability to resist such pressure will be its capacity to politically neutralize or isolate these target groups, or to buy them off
- the likelihood that international actors would be willing or able to come to Taiwan's economic assistance in the event of such pressure.

Because there is a strong consensus among experts on economic coercion that economic pressure by itself generally tends not to be very effective, or only tends to be effective under certain unusual conditions, this monograph pays particular attention to whether or not Taiwan suffers from a "special vulnerability" to China that might help the Chinese to be more successful than most other countries that have tried to use economic concessions.

This study briefly explores the implications for Taiwan and for U.S. interests if China feels that it must exert greater pressure against Taiwan but has come to believe that economic means will not be sufficient to accomplish its key goals.

Organization of This Monograph

This chapter introduced the reasons for rising concern that Taiwan's growing economic relationship with the mainland might confer dangerous political leverage on Beijing's leaders and lays out the outline of this study.

Chapter Two clarifies some key concepts in this study—including how the terms *economic coercion* or *economic pressure* are defined. It also identifies several of the most widely discussed scenarios for mainland economic coercion against Taiwan. But the largest portion of Chapter Two focuses on several key findings about the effectiveness of economic coercion drawn from the extensive political science literature on economic diplomacy. Drawing on empirical studies of economic sanctions and coercion in recent history, experts have identified several factors that help to determine whether countries that employ economic coercion (“initiating” countries) are likely to succeed in pressuring their objects (“target” countries).

Chapter Three analyzes the rise of the China-Taiwan economic relationship since both countries began their mutual opening in 1979. This chapter focuses in particular on the political struggle by Taiwan's governments since 1979 to devise policies that could control and manage Taiwan's economic relationship with the PRC and minimize mainland China's capacity to economically dominate or inflict economic pain on Taiwan. These efforts by the Taiwan government to limit excessive dependence on the mainland have constantly run up against powerful economic and political forces pushing for a more rapid liberalization of cross-strait economic relations.

Chapter Four analyzes the economic dimension of China's influence over Taiwan. It examines the magnitude and importance of Taiwan's economic relationship with the mainland and attempts to assess how much economic leverage the PRC derives from this relationship. This chapter draws on the findings of experts on economic diplomacy (discussed in Chapter Two) to identify those economic factors that are apt to have the greatest impact on the PRC's political leverage on Taiwan.

Chapter Five analyzes the political dimension of China's economic relationship with Taiwan. It examines several political factors that help to determine how much actual political leverage Beijing has been able to derive out of its burgeoning economic relationship with Taiwan. A key focus in this chapter is on the political role of Taiwan businesspeople and corporations that have investments in the mainland—a group that many analysts have argued would be the principal lever that Beijing would use to exert economic pressure on the Taiwan government.

Chapter Six summarizes the conclusions of the study, especially those in Chapters Three, Four, and Five, to analyze Taiwan's susceptibility to economic pressure as a result of its growing economic relationship with mainland China. It also draws on these conclusions to analyze the prospects for several of the most likely scenarios for PRC economic pressure against Taiwan. The chapter closes with a brief analysis of the implications that trends in cross-strait economic relations may have on U.S. interests in the region.

Economic Coercion: Factors Affecting Success and Failure

Defining Economic Coercion/Economic Pressure

This study examines Chinese efforts at “economic pressure” or “economic coercion.”¹ Economic pressure, coercion, or sanctions are usually initiated by large, internationally activist countries acting singly or at the head of a coalition of countries, and their targets are usually much smaller countries.² Countries that initiate sanctions or pressure usually do so as a surrogate or replacement for other policy measures, because they believe those alternative measures are either insufficiently harsh (as with diplomatic protests), or inappropriate to their policy goals, or potentially too dangerous (as with covert action or military attacks). Economic pressure often serves as a convenient and politically popular middle path, “adding teeth to international diplomacy—even if the bark is worse than the bite.”³ In all of these respects, Chinese economic pressure against Taiwan fits the standard pattern.

In this document, the terms *economic pressure* and *economic coercion* refer to efforts at coercive or threatening economic behavior by an initiating government (in this case, mainland China) directed against a target government (Taiwan).

¹ In this monograph, the terms *economic pressure* and *economic coercion* are used interchangeably. The mainstream political science literature on economic diplomacy employs the term *economic sanctions*, a policy action that usually denotes more formal, discrete, overt acts of pressure, such as the initiation of an explicit cutoff of exports or imports to a target country. Examples of studies taking such an approach are Gary Clyde Hufbauer, Jeffrey J. Schott, and Kimberly Ann Elliott, *Economic Sanctions Reconsidered: History and Current Policy*, Washington, D.C.: Institute for International Economics, 1985; and James M. Lindsay, “Trade Sanctions as Policy Instruments: A Re-examination,” *International Studies Quarterly*, Vol. 30, No. 2, June 1986, pp. 153–173. Although such formal economic “sanctions” are possible scenarios for mainland Chinese pressure against Taiwan, Beijing has also historically employed many much-more-subtle acts of pressure. Hence, this study uses the broader terms *pressure* and *coercion*, and considers formal “sanctions” to be forms of such pressure.

² This section draws heavily on several sources: Hufbauer, Schott, and Elliott, 1985; Lindsay, 1986; Jean-Marc F. Blanchard and Norrin M. Ripsman, “Asking the Right Question: When Do Economic Sanctions Work Best?” *Security Studies*, Vol. 9, Nos. 1 and 2, Autumn 1999–Winter 2000, pp. 219–253; Daniel W. Drezner, “The Hidden Hand of Economic Coercion,” *International Organization*, Vol. 57, Summer 2003, pp. 643–659; and David Baldwin, *Economic Statecraft*, Princeton, N.J.: Princeton University Press, 1985.

³ Hufbauer, Schott, and Elliott, 1985, p. 10.

Economic pressure includes the deliberate disruption, or threat of disruption, of “customary” trade, financial, or other economic relations.⁴ It includes deliberate efforts by the initiating government to use its economic relations to commit economic disruption or destruction against the targeted economy or efforts to harass businesspeople and economic officials of the targeted territory. This definition excludes cases where positive economic incentives alone are used to achieve foreign policy goals but does include efforts to use economic incentives in close connection with economic sanctions (e.g., carrot-and-stick diplomacy).⁵

The initiating government’s goal in disrupting (or threatening to disrupt) normal economic relations is to achieve one or more of the following objectives:

1. to deter the targeted government from undertaking some behavior the initiating state finds objectionable, or induce the targeted state to cease its behavior, or compel it to undertake some action it would not otherwise have taken
2. to generate popular pressure on the targeted government to cause it to change its policies
3. to provoke an uprising or coup against the targeted government that leads to the emergence of a new government that will act in accordance with the initiating state’s wishes
4. to send messages to third parties—either domestic or international—about the resolve of the initiating country in dealing with the target.

This monograph does not examine what might be called economic warfare or the economic aspects of warfare. Economic warfare refers to actions in which military operations (including violent covert action) are used in tandem with economic sanctions, or where sanctions serve as an immediate prelude to military action.

Most notably, this study does not incorporate an analysis of the capacity of the initiating state—mainland China—to undertake a full-blown military blockade of the targeted government’s—Taiwan’s—economic relations with the rest of the world. Such an assessment would require an essentially military analysis of China’s capabilities—rather than a political-economic analysis—that goes beyond the scope of this study. The RAND Corporation and other analysts have undertaken studies of China’s capacity to carry

⁴ The use of the term *customary* rather than *contractual* economic relations draws on previous general studies of economic sanctions, but is especially important in the case of China and Taiwan. Because economic relations across the strait have been, and to a considerable extent still are, legally restricted by both sides, a great deal of this economic relationship has developed unofficially or even secretly. Consequently, this study avoids such distinctions as legal or contractual economic exchanges and activities and focuses instead on customary economic relations—that is, levels of economic exchange and activity that would probably have occurred in the absence of sanctions.

⁵ This definition merges wording used in Hufbauer, Schott, and Elliott, 1985, p. 2; and Blanchard and Ripsman, 1999–2000, p. 219.

out such military activities against Taiwan.⁶ This study does, however, include assessments of whether or not other less-aggressive forms of economic pressure are likely to succeed without resorting to such forms of economic warfare—for example, whether or not an effort to cut off Taiwan’s trade with China would be likely to succeed without a companion effort to disrupt Taiwan’s trade with potential third-party suppliers.

Mainland Chinese Economic Pressure: Serving Many Political Goals

China, like other major powers, has typically used economic pressure and coercion to serve several policy objectives at the same time (some of which may be in contradiction to each other). Often, an initiating country’s stated goals will change during the course of an episode of economic pressure, depending in part on whether or not the country’s leaders think they are enjoying success with their demands.

Forcing Policy Change

The most obvious and straightforward use of economic pressure is to compel the target country to comply with the initiating country’s demands. These demands usually include the following:

- deterring the targeted government from undertaking or repeating a policy or action that the initiating government finds objectionable (including various forms of “self-censorship”)
- forcing the targeted government to withdraw a policy that the initiating power finds objectionable
- compelling the targeted government to comply with the initiator’s policy preferences.

The logic behind these goals is straightforward. A government, such as that in mainland China, hopes that by initiating economic pressure it can convince the target leadership (Taipei) that the economic and political pain it will suffer for undertaking some policy action will far outweigh any benefits the target leadership could derive from that policy, and that the initiator is willing to reapply or heighten this pain in the future if the action is continued or repeated.⁷ Among the most common historical examples have been efforts to compel one country to withdraw its troops from another country (and deter it from attacking other neighbors), improve its human rights record,

⁶ See, for example, David A. Shlapak, David T. Orletsky, and Barry A. Wilson, *Dire Strait? Military Aspects of the China-Taiwan Confrontation and Options for U.S. Policy*, Santa Monica, Calif.: RAND Corporation, MR-1217-SRF, 2000.

⁷ Lindsay, 1986, p. 155.

comply with international weapons-nonproliferation regimes, or alter offensive economic policies and regulations.⁸

But, like most other initiating countries, China has also historically employed economic coercion to serve many other political goals that are less direct and straightforward than simply acceding to Beijing's demands. Indeed, several of Beijing's goals are not even directed at the Taipei officials. These additional goals include

- undermining domestic political support for Taiwan's government
- cultivating support among the mass electorate or various political or economic elites within Taiwan
- simple punishment or disruption of Taiwan's economy
- undermining the economic base for Taiwan's military potential
- sending an international signal to Taiwan's potential supporters
- sending a domestic signal to buttress support for the Beijing government.

Destabilizing, Subverting, or Creating Domestic Pressure on the Target Regime

Among the most common indirect goals of economic pressure—pivotal in the case of mainland China and Taiwan—is to try to subvert or destabilize the target government. In extreme cases, this involves trying to remove the target government's leaders from power while leaving the political system intact, or even subverting the entire political regime. Initiators often use sanctions in the hope that by causing great levels of economic damage, they can encourage one group within the target leadership (e.g., the military) to overthrow the current leadership, or foment political unrest or instability within the target country.

As sanctions expert James Lindsay points out, *the use of sanctions to try to subvert the government assumes that there is a close, strong, and positive relationship between the denial of economic resources and the prospects for political instability or political disintegration within the target country.*⁹ Of course, if the initiator's real goal were only to force policy change, sanctions could also succeed, so long as the target country *feared* that sanctions were likely to destabilize its regime, whether or not that was objectively true.

Over the past decade, one of mainland China's most persistent goals in using economic pressure against Taiwan's new democratic regime has been to accomplish a form of regime change in Taipei. Beijing has at times hoped that it could use the prospect of economic pain to induce Taiwan voters—or at least a politically influential portion of the electorate, such as the business class—to vote out pro-Taiwan independence political leaders, presumably out of a belief that the incumbent government had undertaken

⁸ See, for example, Hufbauer, Schott, and Elliott, 1985.

⁹ Lindsay, 1986, p. 155.

unwise policies that brought on the economic pressure. Beijing may also hope that voters would defect from the Taipei government if they interpreted the sanctions as a credible display of resolve by Beijing and feared that even worse coercive actions might follow if they do not remove their current government.

For China, a central element in this strategy has been to cultivate the rise of politically powerful groups in Taiwan—especially businesspeople who have invested in the mainland (known as the “Taishang”)—who believe that their personal economic interests lie in cooperating closely with China. Beijing’s strategy has also included harassing or punishing Taiwan businesspeople that do not support closer political links to China. In this study’s assessment of the PRC’s economic leverage against Taiwan, a key question concerns whether or not these assumptions about how Taiwan interest groups and voters are responding to mainland economic pressure are valid. Chapter Five focuses primarily on the challenges and obstacles that Beijing has encountered in its efforts to generate political pressure to change the Taiwan government, particular since the election of Chen Shui-bian in 2000.

International Signaling

Almost certainly, one of Beijing’s most important goals for undertaking economic coercion would be international signaling—to demonstrate its resolve to third-party countries, discouraging them from providing public, diplomatic, economic, or military aid to Taiwan. From Beijing’s perspective, a crucial objective would likely be to deny Taiwan a victory in its efforts to establish its formal independence by deterring other countries from officially recognizing Taiwan or admitting its government to international organizations with status equal to a sovereign country. Beijing may well hope that if Taiwan “throws a party and nobody comes” that it may soon rescind its policies and seek a negotiated deal—under conditions that would be dramatically more advantageous to Beijing.

Domestic Political Symbolism

In the case of Taiwan, domestic political symbolism would be one of China’s most powerful motivations for applying pressure—economic or otherwise. Initiating governments commonly try to use sanctions to increase their domestic support, stanch a decline in that support, or thwart domestic criticism of their foreign policy by showing that it is capable of acting decisively. Domestic political concerns are extremely important in shaping China’s Taiwan policy, and economic coercion would almost certainly have a wide variety of domestic political goals in addition to those geared toward Taiwan and other countries. For the new leadership of President Hu Jintao and Premier Wen Jiabao, employing economic coercion could be used to head off suspicions among fellow leaders that they were too soft or inexperienced in their dealings with Taiwan. It could also be intended to reassure the People’s Liberation Army (PLA) leadership that the new Party chiefs are tough enough to handle this crisis. Some Chinese

analysts, speaking privately, insist that one of the most powerful domestic motivations for applying pressure on Taiwan is Beijing's desire to avert antigovernment mass unrest by nationalistic Chinese citizens, and, secondarily, to deter other regions or groups within China from taking encouragement from Taiwan's independence efforts and perhaps attempting their own secession (e.g., China's Muslim western regions, Tibet, and perhaps even Mongolia and the Manchu and Korean regions of the Northeast).

Punishment and Eroding Military Power

Finally, another common goal of economic pressure is *simply to inflict punishment* on the target country for its disputed actions, regardless of whether the initiating country really expects that it can force the target country to change its policy. Some analysts argue that simple punishment is rarely one of the original goals for a regime initiating coercion. But punishment often emerges as an end in itself later in the process, particularly if economic pressure is failing to change the target country's policies and the initiator *simply wants to send the message that the target cannot undertake its actions without cost*. Relatedly, many initiating countries undertake economic coercion in part to *undermine or impair the target country's economic base for developing its military power*.¹⁰ China has long pursued a wide array of policies designed to deny Taiwan access to advanced weapons technology for its military.

Since China's package of goals for using economic coercion will help determine how it defines success or failure, it will have a powerful impact on how any coercion scenario plays out. Most obviously, a definition of success would include whether or not Taiwan withdrew the offending policies. But because economic coercion can serve numerous policy goals, failure in this narrow definition of success might not mean complete failure—and might not cause the initiating country to feel it must either resort to harsher coercive measures or declare defeat. How China defines success (e.g., changing Taiwan's policy, isolating it internationally, salvaging popular support at home, or crushing Taiwan's democratic regime altogether) would help determine whether economic pressure was a prelude to stronger military actions. Chinese sanctions might not have to succeed in forcing Taiwan to back down in order to be a political success at home.

Likely Scenarios for Chinese Economic Coercion Against Taiwan

Over the past two decades, the interpenetration of China and Taiwan's economies has become so wide-ranging (see Chapter Four) that it offers each side many options for exerting economic pressure on the other. Few analyses of cross-strait economic

¹⁰ A well-known historical case of this was the West's COCOM (Coordinating Committee for Multilateral Export Controls) sanctions against the former Soviet Union.

relations, however, explicitly spell out the full range of scenarios or forms that economic coercion might take. Likewise, most international relations studies of economic coercion focus exclusively on just two or three major forms of sanctions—specifically, import and export sanctions, investment and asset seizures, and foreign aid cutoffs. But this list includes items that are not relevant to the China-Taiwan case (e.g., foreign aid), and it fails to capture many of the economic levers and sanctions that most greatly concern analysts and political leaders who are worried about PRC economic coercion against Taiwan. The list does not, for example, address pressures on target-state investors, or attacks aimed at disrupting critical economic markets and information infrastructure, or the use of diplomatic or economic pressure against third-party countries designed to hurt the target country.

There are many possible scenarios for the mainland to try to exert economic pressure against Taiwan, and Beijing may try to employ several of these scenarios at the same time:

Export Sanctions

In this scenario, China restricts or cuts off all or most exports, or exports of strategically important goods, to Taiwan, in an effort to starve the island's economy.

Import Sanctions

In this scenario, China would restrict or cut off all or most imports, or imports of strategically important goods, from Taiwan, in an effort to hurt production, sales, and employment on the island and undercut the taxes the government receives from these industries. A subtler version of this might include selective use of international legal sanctions, including World Trade Organization (WTO) antidumping cases against Taiwan and Taiwan businesses, or efforts to restrict imports from countries that support Taiwan. Some senior mainland Chinese analysts have argued that because of the large and growing share of Taiwan's total exports that are directed toward the PRC, import sanctions would be an especially effective method of punishing Taiwan.

Financial and Investment Sanctions

In this scenario, China might freeze or seize the assets of all or a very large percentage of the Taiwan companies and investors in China in an effort to inflict pain on these companies, their investors, and their employees. This scenario refers to widespread pressure against a very large percentage of Taiwan investors and should be distinguished from the more focused harassment or intimidation of selected Taiwan businesspeople and investors addressed earlier.

Selective Harassment or Intimidation of Taiwan Businesspeople

Perhaps China's most prominent and widely used form of economic pressure in the past five years has been selective threats and harassment against mainland-invested

Taiwan businesspeople (discussed extensively in Chapter Five). The most common forms of coercion involve putting pressure on businesspeople carrying on trade or investment on the mainland, whose reliance upon customers and assets there make them especially vulnerable. Repeatedly in recent years, the PRC has harassed Taiwan businesspeople residing on or invested in the mainland, particularly public supporters of President Chen Shui-bian and his Democratic Progressive Party (DPP). At its most heavy-handed, Beijing has publicly trumpeted the arrest of Taiwan businesspeople on allegations that they engaged in spying for Taiwan. Examples of more sophisticated and less coercive strategies would include PRC efforts to cultivate and lobby Taiwan businesspeople residing on the mainland to donate money to Chen Shui-bian's opponents or facilitate their return to Taiwan to vote against him in the March 2004 presidential election.

China's capacity to exploit this scenario has been expanded in recent years by the enormous influx of FDI into China from many countries other than Taiwan. China can afford the luxury of being more politically selective about how it handles investors.¹¹ In the wake of both of Chen Shui-bian's successful election bids (2000 and 2004), Beijing criticized prominent businesspeople who had supported Chen or his cross-strait policies.¹² Shortly thereafter, the mainland holdings of at least two of these corporations (ACER and Chi Mei) began to suffer reversals including selective investigations that were widely—and probably correctly—attributed to deliberate efforts at intimidation (see Chapter Five).¹³

Economic Disruption, Damage, and Sabotage

The extensive interpenetration of China and Taiwan's economies and their large and highly marketized flows of money, information, and commodities also open up these economies to many other forms of economic damage, disruption, or sabotage. China, for example, has frequently attempted to overtly (and probably covertly) induce economic instability or worry in the Taiwan economy. On several occasions, Beijing has noted its capacity to induce large fall-offs in Taiwan's stock and bond markets. Mainland-based sources have also repeatedly attempted to disrupt key aspects of Taiwan's economic infrastructure, including IT systems, communications, and transportation. The extensive integration of key parts of Taiwan's economy with the mainland

¹¹ According to a respected Western financial journalist interviewed for this study, China may decide to pressure Taiwan investors because it may want to drive its case home to Taiwan that it does not need to put up with Chen Shui-bian's activities or those who support them. In the words of the journalist, "Beijing can afford to say to some Taiwanese investors, Sorry, you're no longer friendly—good-bye!"

¹² These included chief executive officers (CEOs) Stan Shih of ACER, Nita Ing of Taiwan High Speed Rail, Chang Yungfa of Evergreen, and Hsu Wenlung (also spelled Shi Wen-lung) of Chi Mei.

¹³ Goh Sui Noi, "Taiwan's Economy: Will China Swallow It Up?" *Straits Times* (Singapore), July 1, 2001, p. 41.

has raised concerns about its susceptibility to severe disruption or isolation strategies from the mainland.

Deliberate Slowing or Withholding of Business

A far subtler sign of disapproval has been the withholding or delay or boycotting of the “normal” development of business. This method establishes a quiet but publicly deniable linkage between private cross-strait business relations and Beijing’s overall assessment of Taipei’s political activities. In the spring of 2004, for example, Beijing signaled its anger over Chen Shui-bian’s reelection and the pro-DPP activities of some Taiwan businesspeople by deliberately slowing the growth of business ties in the IT sector. In June 2004, China for the first time in many experts’ memory decided not to send a delegation to the Computex 2004 IT fair in Taipei—the world’s second-largest international computer show.

Efforts to Hasten the “Marginalization” or “Hollowing Out” of Taiwan’s Economy

The hollowing out or marginalization of Taiwan’s economy is not so much a direct strategy of coercion as it is a long-term process by which the mainland tries to get Taiwan businesspeople to transfer more and more of the most valuable, productive, and innovative aspects of the Taiwan economy to the mainland, or the mainland tries to develop Chinese business sectors that can successfully compete with and supplant some of Taiwan’s top businesses. The danger of this long-term process has been analyzed by several Taiwan economists. Examples would include the fear of many in Taiwan that the Shanghai/Pudong port will supplant Taiwan’s port city of Kaohsiung as a major deep-water shipping facility, or that Taiwan semiconductor manufacturers would eventually transfer their most productive, cutting-edge facilities to the mainland. Economically, this process would undermine Taiwan’s long-term economic importance and independence and erode the resources on which Taiwan relies to support its society, government, and military. Diplomatically, hollowing out undermines the economic ties and resources that help buttress international diplomatic support for Taiwan even among those countries with which it has no official relations.¹⁴

Factors Affecting Success and Failure of Economic Coercion Against Taiwan

Analysts of economic coercion have, for the most part, come to a remarkably strong consensus on its efficacy that should hearten supporters of Taiwan. As stated simply

¹⁴ Two excellent analyses of the hollowing out or marginalization trend have been made by economist Tain-jy Chen (see Tain-jy Chen, “Will Taiwan Be Marginalized by China?” *Asian Economic Papers*, Vol. 2, No. 2, Spring/Summer 2003, pp. 78–97; and Tain-jy Chen, “Living Under the Roof of WTO: Cross-Strait Economic Relations Since WTO,” unpublished conference paper, 2004).

by Hufbauer, Schott, and Elliott, “Sanctions often do not succeed in changing the behavior of foreign countries.”¹⁵ The data from their study and others demonstrate a rather low overall success rate of economic coercion in forcing major policy changes, regime change, or other key goals.

Against this overall trend, however, experts on economic diplomacy have spotlighted several factors—both economic and political—that increase or decrease the effectiveness of economic coercion.¹⁶

Economic Factors That Help Determine Success or Failure

Levels of Economic Pain and Disruption

Chapter Four assesses the interconnection between Taiwan and mainland China’s economy, and the mainland’s capacity to inflict economic pain and dislocation on Taiwan. While studies have stressed that the level of economic pain that initiating countries can inflict rarely, by itself, determines whether coercion is effective, it is clearly one of many important factors. Historically, many attempts to use economic sanctions have failed to force the target to comply because these tools have rarely inflicted sufficient economic pain on the targets.¹⁷ Factors that help determine the initiating country’s capacity to inflict economic pain or dislocation include the following:

The portion of the target country’s external economic activity that the initiating country can control or influence. One measure of this factor is the percentage of the target country’s total foreign trade and FDI that can be controlled by the initiating country.

The importance of this external portion of the target country’s economy in the target’s overall economy. One measure of the importance of the target country’s external economic activities is the percentage of the target country’s total economy that

¹⁵ Hufbauer, Schott, and Elliott, 1985, p. 10.

¹⁶ Some experts argue that economic pressure is more effective than it might first appear to be. They contend that in most cases in which sanctions have been successful, they succeeded long before they were actually put in place—with countries that feared sanctions often capitulating, cutting a deal, or quietly restraining their offensive policies long before the sanctions actually had to be enacted. These analysts argue that the data on the success of sanctions—most notably the widely used data of a study by Hufbauer, Schott, and Elliott (Gary Clyde Hufbauer, Jeffrey J. Schott, and Kimberly Ann Elliott, eds., *Economic Sanctions Reconsidered, Supplemental Case Histories*, 2nd ed., Washington, D.C.: Institute for International Economics, 1990)—only looks at cases in which sanctions were actually put in place, and, thus, they systematically understate the *effectiveness of the threat of sanctions* in forcing target states to change their behavior. On the other hand, most of the cases that defenders of sanctions pointed to as examples of success involved disputes over relatively “low-stakes” issues—e.g., disagreements over economic regulations and market access. The revisionists have not yet proven that sanctions have yielded significant success in cases in which vital national security or sovereignty goals have been at stake—the very sort of issues that would likely be at stake in a prospective dispute between China and Taiwan (see Drezner, 2003).

¹⁷ Hufbauer, Schott, and Elliott, 1985.

is tied up in external trade and investment, and how much of this external economy can be controlled or influenced by the initiating country.

The strategic importance and “substitutability” of the products or economic activities sanctioned. Embargos and asset seizures sometimes fail because the embargoed goods or assets are not sufficiently important to the target country to make it worthwhile to the target to comply with the initiator’s demands. Many other efforts at coercion fail because the target country is able to weather the initial blow and soon make adjustments that undermine the long-term effectiveness of the sanctions by finding substitute products, sources, or markets for the sanctioned goods and activities. In the words of Hufbauer, Schott, and Elliott, economic coercion often loses its effectiveness because sanctions “create their own antidote.”¹⁸ A key issue is the “substitutability” of the goods or activities under threat or sanction. Economic sanctions create powerful incentives for the target country to find domestic substitutes for imported goods that have been cut off, or new markets to which to sell their embargoed exports. And the longer the target country can endure the initial blow of economic coercion, the greater the chance it has of finding substitute goods, activities, or markets.

As Chapter Four demonstrates, China’s capacity to inflict economic pain on Taiwan’s economy in the short term is considerable. But an important policy challenge is how well and how quickly Taiwan might respond with economic adjustments that undermine the effectiveness of Beijing’s pressure. To examine this point, this study focuses on the strategic importance and substitutability of the goods that China can control or influence—in particular, Taiwan’s important high-tech manufacturing sector, Taiwan’s information networks, and such indispensable goods as food or fuel.

The initiating country’s capacity to monitor and enforce economic coercion. Among the most powerful reasons economic sanctions fail is the failure of monitoring, enforcement, and cooperation—either through lax domestic enforcement in the initiating country or the undermining of sanctions by third countries allied with the target. Enforcement failure is especially common in cases when the target country (e.g., Taiwan) is wealthy enough that it can offer significant “free rider” or “defector benefits” to businesspeople and officials in the initiating country or third countries in return for helping the target undermine the economic sanctions. A relatively wealthy target country such as Taiwan might easily succeed in corrupting key enforcers within the initiator country.

Chinese economic pressure against Taiwan could be undermined at home, particularly if various Chinese regional, sectoral, or business interests are badly hurt by sanctions against Taiwan and come to feel that they are unfairly bearing the whole burden of the sanctions for the rest of the country. In addition to the direct loss of income from the sanctions, Chinese firms may also resent the damage that the sudden cutoff

¹⁸ Hufbauer, Schott, and Elliott, 1985, p. 10.

of trade causes to their international reputations as reliable suppliers.¹⁹ These injured groups may lobby Beijing to relent, or they may disobey Beijing's orders or engage in smuggling to maintain their economic activities with Taiwan.

Another factor that often exacerbates third-country support for the target country is efforts by the initiating country to enforce the sanctions extraterritorially on third countries—an action mainland China seems quite likely to take if it is serious about placing sanctions on Taiwan. Such pressures on third countries frequently inspire powerful third-country resistance by business and other actors against the initiator.

Problems of monitoring and enforcement have made certain types of sanctions far more difficult to use effectively. In the recent past, experts on economic diplomacy argued that sanctions on imports from the target country, for example, tend to be far less common and far less successful than financial export sanctions. Target countries can often find alternative markets in which they can sell their goods—especially if the goods have a high value and relatively few alternative suppliers. Import sanctions are also especially difficult to police, particularly if it is difficult to establish the true country of origin, as in the case of “bulk goods,” such as petroleum, textiles, or grain.

But in recent years, the rise of offshore banking, electronic transfers, and third-country investment havens has also made financial sanctions extremely difficult to police. As noted in Chapter Four, this is powerfully evidenced by the apparent inability of either Taiwan or mainland Chinese authorities to say with any precision what percentage of the billions of dollars in FDI entering China from British Caribbean countries actually initiated in Taiwan or the mainland.

Political Factors That Help Determine Success or Failure

Experts on economic diplomacy have identified a set of political factors that, historically, have often had a greater impact on the effectiveness of economic coercion than the level of economic pain and dislocation that the initiating country can inflict.²⁰ Several of these political factors increase the likelihood that economic coercion will succeed, because they magnify the political costs that the target state must suffer if it refuses to comply. Others undermine the effectiveness of economic coercion because they decrease the political and diplomatic costs the target state must suffer, or because they magnify the costs that the initiating state must pay if it attempts to use economic coercion.²¹ These factors include

¹⁹ The United States confronted such domestic business opposition to sanctions in the case of the grain embargo on the Soviet Union in 1980 (Hufbauer, Schott, and Elliott, 1985, pp. 655–670).

²⁰ Blanchard and Ripsman, 1999–2000.

²¹ Blanchard and Ripsman, 1999–2000.

- the historical relationship among the initiating and target countries
- the nature of the goals or demands sought by the initiating country, and the political capacity of target countries to comply with these goals and demands
- international support for either the initiating country or the target country
- the domestic balance of power and levels of political unity within both the target country and the sanctioning country.

China and Taiwan's Bitter Historical Relationship

China and Taiwan's powerful historic animosity generally decreases the likelihood that Taiwan would be willing to make major concessions in the case of an economic confrontation. Studies of economic diplomacy demonstrate that the historic relationship between the initiating country and the target country—whether it is basically friendly or hostile—has a profound impact on whether or not they see their dispute as “zero-sum” and are willing to reach a compromise. Countries with historically strong relationships tend to place great value on preserving those relations through economic compromise and are far less likely to fear that those concessions will endanger their long-term security interests. Historically bitter adversaries such as China and Taiwan, however, will be far more fearful that concessions to their opponent will erode their long-term security, undermine their reputation for defending their interests against their adversary, and allow their opponent to derive greater “relative gains” from a compromise solution. A simple hypothetical example illustrates this point very well—Taipei is far less likely to fear the long-term strategic consequences of giving in to economic pressure from the United States or South Korea than it is to fear making significant concessions in response to pressure from China.

Beijing's Specific Demands

The exact nature of Beijing's demands against Taipei would likely have a major impact on Taipei's likely response and therefore on Beijing's prospects for success. When countries such as Taiwan are targeted with economic coercion, they must weigh the economic pain they suffer against the importance of the concessions that the initiating country is demanding of them. The nature of the initiating country's demands has a great impact on whether solutions or compromises that are acceptable to both sides can be found, or the targeted country must dig in its heels to defend its national security. Initiating countries have historically tended to enjoy far greater success in compelling their target countries to comply with certain types of demands—for example, demanding that they make modest adjustments in objectionable economic policies—than with other, more serious demands—for example, demanding that the target country withdraw from an invasion of a third country, or demanding that the target country make major concessions on issues linked to national sovereignty.

Experts on economic diplomacy highlight the importance of whether or not the initiating country's demands on its target are seen by both sides as "divisible" or "indivisible"—that is, whether both sides believe that the very nature of the demands makes a win-win compromise solution inherently possible, or if one side or the other sees the confrontation as intrinsically zero-sum and fears that any major concession it makes to its opponent could place its future interests at significant risk. The target country's government is also likely to fear that if it makes concessions on high-stakes issues, its domestic opponents will be able to attack it politically for selling out vital national interests. For its part, if Beijing's demands and goals are cast in relatively general terms, Beijing may find it easier to publicly "claim victory and go home" rather than escalating to more confrontational tactics.

According to major studies of economic coercion,

- Economic sanctions are more likely to succeed when the initiating country demands that the target undertake more modest policy changes. These demands, though "modest," need not be "trivial." Examples of success include U.S. and Canadian efforts to prevent South Korea from obtaining a nuclear plant. Such sanctions, however, commonly take several years to succeed when they succeed at all.²²
- Economic coercion, historically, has rarely been effective in compelling target governments to undertake major changes in policy, nor has it often been effective in deterring target countries from undertaking major policies that the initiating country considers offensive.
- Economic coercion has also rarely been effective in trying to subvert the target government, and when it has succeeded, it has usually been accompanied by military or covert action.²³

A major effort at economic coercion against Taiwan would almost certainly concern issues of extreme emotionalism and high political stakes involving independence, sovereignty, and national identity—for example, in response to Taiwanese revisions to its constitution that Beijing believes effectively define Taiwan as independent of China. It is highly questionable, therefore, whether lessons learned from the use of economic coercion in battles over trade, economic policies, or other relatively low-stakes issues would have great relevance in assessing this relationship.

²² Hufbauer, Schott, and Elliott, 1985, pp. 41–42.

²³ One study concluded that in seven of 12 major cases of economic sanctions, the target government did not modify its previous behavior in response to sanctions, and in four other cases (a total of 11 of 12), the target government did eventually modify its disputed behavior, but not because of the economic sanctions (Lindsay, 1986).

In recent decades, there have been relatively few cases of initiating countries trying to use economic coercion to compel a target country to make concessions on issues of comparable importance to those at stake in the mainland China–Taiwan case.

One major study found just 17 cases concerning such “major changes in target country policies” between 1914 and 1983. At stake in these disputes have been issues such as surrendering occupied territory or colonies (e.g., Namibia, Angola and Mozambique, Cyprus, Gibraltar); surrendering independence (e.g., Biafra, Hyderabad); sacrificing support for a major ally (e.g., U.S. support for Israel); or making fundamental changes in their regime (e.g., forcing South Africa to reform Apartheid in the 1970s or forcing Poland to end martial law in the early 1980s).²⁴

To be sure, these are important issues, but even many of these cases hardly rise to the seriousness of the stakes involved in a prospective mainland China–Taiwan dispute. And as might be anticipated, the success record of economic coercion in such high-stakes disputes is not impressive. In only three of these cases did analysts judge economic coercion to be reasonably successful in compelling a major policy change, notwithstanding the fact that in many of these cases economic sanctions remained in effect for decades and were often accompanied by significant covert action, military pressure, or a major domestic insurgency.²⁵

Two of the three cases of success, however, may be relevant to China and Taiwan’s disputes over independence and sovereignty issues. Hufbauer, Schott, and Elliott’s data indicate that in modern times there have been very few examples of initiating countries successfully using economic sanctions to compel a country to withdraw a declaration of independence. In the few cases where this has worked, economic pressure was effective only with a virtually complete blockade of the target state or control over its currency operation, and still had to be accompanied by powerful companion military measures.²⁶

Efforts to Subvert or Change Taiwan’s Government

Beijing’s most fundamental, enduring tactical goal in employing economic pressure has been encouraging a subtle form of regime change in Taiwan. Beijing has tried to exploit the rapidly deepening cross-strait relationship to undermine the domestic political power of those Taiwan officials whom it regards as pro-independence, and

²⁴ Hufbauer, Schott, and Elliott, 1985, pp. 46–47, Table 3.5, pp. 54–55.

²⁵ Hufbauer, Schott, and Elliott, 1985, pp. 46–47, Table 3.5, pp. 54–55.

²⁶ Among the few examples of this hard-won success are Nigeria’s extermination of the Biafran independence movement in 1966–1969 and India’s incorporation of Hyderabad in 1948. In both of these cases, however, Hufbauer, Schott, and Elliott judged military action to be the more decisive factor in the Indian and Nigerian victories. See Hufbauer, Schott, and Elliott, 1990, pp. 84–87, 298–304.

to build support (or at least acceptance) for reunification among Taiwan's citizenry and elite. During the 2004 Taiwan presidential campaign, Beijing undertook a high-profile effort to mobilize opposition to President Chen Shui-bian, particularly among Taiwan's mainland-invested businesspeople, the "Taishang."

The historical record of attempts to use economic coercion to subvert, overthrow, or drive out governments, however, is even worse than that of attempts to compel these governments to comply with major policy demands.

- According to one study of six major cases of attempted subversion by sanctions, all six failed to overthrow the target. There is only a handful of cases in which governments that became the target of economic sanctions subsequently collapsed, and in none of these cases were the sanctions a significant contributing cause in that collapse.
- Another larger study looked at 19 cases of attempted destabilization and found that in 10 of these cases the sanctioning country enjoyed some noteworthy success in destabilizing the target country—though, in most cases, it did not actually succeed in removing or overthrowing the government. But even this somewhat higher success rate comes with a number of powerful caveats. In virtually every case of successful destabilization, the economic coercion was accompanied by covert action, quasi-military operations, or a preexisting insurgency. All of the nations that succumbed to pressure, moreover, were already suffering from levels of economic distress and/or political instability far higher than those in Taiwan today.²⁷
- Based on an examination of the case evidence, it is extremely rare for a democratic regime as well consolidated as Taiwan in 2006 to be overthrown, or the incumbent party driven from power, entirely or primarily as a result of economic coercion.²⁸

Economic coercion has occasionally contributed to the collapse of a target government, particularly when the sanctions were part of a broader effort to step up economic and moral pressure on the regime, or in cases where the sanctions made threats of subsequent military intervention more credible. Forceful economic sanctions by China may well heighten Taipei's perception of Beijing's credibility with regard to using military or other harsh sanctions later. But studies of the available record indicate

²⁷ Hufbauer, Schott, and Elliott, 1985, pp. 43–44, Table 3.2, pp. 50–53.

²⁸ In the post-WWII era, one of the few clear examples of a consolidated democratic government being driven from power in this way was the Soviet Union's successful use of economic and diplomatic coercion against Finland in the so-called Nightfrost Crisis of 1958, when Moscow forced the Finnish government of Prime Minister Karl August Fagerholm to resign for a variety of allegedly anti-Soviet political attitudes. This, indeed, may be the only clear case of such success against a consolidated democracy. See Hufbauer, Schott, and Elliott, 1985, pp. 298–301.

that economic coercion rarely succeeds by itself in forcing a target government from power.

Indeed, attempts to subvert a target government with economic sanctions probably backfire more often than they succeed, allowing many target governments—authoritarian as well as democratic—to turn foreign pressure to their advantage and strengthen their popular support. For authoritarian governments, foreign coercion often provides a ready-made pretext to crack down violently on their domestic critics. Democratic target governments can also counterattack their opponents who favor making concessions to the initiating state, labeling them as “appeasers” or “fifth columnists.” As Chapter Five demonstrates, Taipei’s current DPP coalition government has employed this tactic on several occasions with significant effect.

Thus, initiating countries that assume they can use economic pressure to encourage division within the target government’s coalition or to spur electoral opposition or even popular unrest or coups d’état are not only often wrong, they frequently have it backward. Outside economic coercion frequently tightens unity within the target country and strengthens support for that leadership. Many reasons have been offered for this seeming paradox. Attacks from the outside are often seen as attacks on the country as a whole, not just a fraction of the country. Very few citizens within the target country identify with the attacker or its goals, and even fewer wish to be labeled as supporters of the attacker. Also, targeted state governments often believe even more strongly that their original policy goals were correct and see no alternative as better.

Likely Issues in a Beijing-Taipei Economic Confrontation

Many of the issues that are most likely to be at stake in the event of mainland Chinese economic pressure against Taiwan are portrayed by both the Beijing leadership and the Chen Shui-bian government as powerfully symbolic, and many leaders on both sides regard them in “zero-sum” or “indivisible” terms. This is especially true of issues related to Chinese and Taiwanese sovereignty, including

- any prospective formal declaration of Taiwan’s independence
- international recognition for Taiwan, including diplomatic recognition by third countries or Taiwan’s membership or even formal observer status in many international organizations, such as the World Health Organization
- several issues related to constitutional reform in Taiwan, including the question of which group of people (the citizens of Taiwan, or all of China) are the basis of sovereign authority for the constitutional government, how the Taipei government defines its national territory, the formal name of the country and state, and even the continued existence of the “provincial” level of government on Taiwan

- the issue of whether or not Taipei's acceptance of the "one China" principle or the "1992 consensus" should be a precondition for further cross-strait negotiations
- the legal identity—formal governmental or informal and private—of any negotiating delegations dispatched by the two sides.

To be sure, third parties could imagine hypothetical win-win solutions to many of these issues that appear to meet the demands of both sides. But at present Beijing and Taipei usually cast their public positions in more zero-sum terms and express fears that even minor concessions could lead down a slippery slope to unacceptable consequences. Thus, the manner in which both sides now portray their demands tends to undermine the likelihood that Beijing's use of economic levers alone would be effective.

Some Chinese and foreign experts interviewed for this project have argued, on the other hand, that China's economic levers have been more effective when used toward less highly charged, symbolic goals. In particular, China has been most effective in using its economic leverage to create pressure on more limited, strictly economic issues. In Chapter Five, it is argued, for example, that pressure from China has not caused Taiwan's business community to lobby effectively for reunification under Beijing's terms. But as Chapter Three demonstrates, Beijing has been far more effective in creating incentives for businesspeople to press Taipei to further open up cross-strait economic ties. China has also been relatively effective in creating incentives for these businesspeople to move larger portions—and more important portions—of their businesses to the mainland. These activities further heighten Taiwan's economic interdependence with the mainland and may increase Beijing's future economic leverage vis-à-vis Taiwan.

The Target State's Political Capacity to Resist Coercion

The political capacity and will of the target state to resist are among the most decisive factors in determining the effectiveness of foreign economic pressure. Indeed, they may be the single most decisive factors in the equation. The target state's capacity to resist is, in turn, shaped by the domestic balance of political power and the level of political unity within the target. To effectively resist foreign economic pressure, target governments such as Taiwan must be able to mobilize popular and elite support for their decision not to make major policy concessions in the face of coercion, and they will very likely have to demand short- or even long-term sacrifice from their populations and their key constituency groups. Target states that are plagued with deep internal divisions—ongoing insurgencies or guerilla warfare, the existence of well-organized fifth columns, deep internal ethnic, religious, regional, or partisan tensions—usually find it far harder to mobilize effective "rally round the flag" appeals or strategies of shared sacrifice and conservation.²⁹

²⁹ Blanchard and Ripsman, 1999–2000.

Conversely, a crucial tactic for any initiating state is to mobilize support for its demands among key domestic opposition groups within the target country, and thereby make it harder for the target state to resist. Strong opposition groups within the target may insist that their government comply with the initiating government's demands as a cost of supporting some of the leadership's other policies. The opposition may also try to mobilize disaffected groups in society to press the target government to make concessions, or the opposition may be able to bribe or steal away key elements of government coalition. At the most extreme, the opposition may attempt to overthrow the government to force compliance. In nearly all modern cases in which sanctions have been used effectively to undermine or overthrow a target government, the target country was already suffering from deep—even violent—internal political divisions or insurgency before the economic sanctions were put in place.³⁰

But as Chapter Five illustrates, target country governments such as Taiwan need not sit passively in the face of economic pressure. Target governments can employ a number of political strategies to win over, isolate, or undermine domestic groups that support making concessions to the initiating state. Among the more effective is scapegoating—portraying these domestic supporters of concessions as weak, disloyal, or self-interested, or even the bought-off “fifth column” of the country that initiated economic pressure. Effective scapegoating strategies can involve persuading the majority of citizens that the government's opponents are advocating concessions that will benefit themselves but will sell out the interests of the great majority. If used effectively, the target government can portray itself as bravely defying not only foreign enemies but domestic traitors as well. Governments in some target states have occasionally found clever ways to shift or redirect the costs of economic sanctions off the backs of most of their citizens and onto the backs of their key opponents—perhaps by seizure or taxation of the opponents' assets to pay the costs of resisting foreign sanctions.

Target governments may be able to find ways of compensating their most important domestic supporters for any losses they may suffer as a result of the government's decision to resist economic pressure. In many cases, for example, the target governments have tried to protect the military and internal security forces from the pain of sanctions as a hedge against a coup attempt. If, however, the government is unable to insulate its key supporters from the pain of sanctions, these supporters may gradually begin to defect to the opposition.³¹

Beijing's Quest for “Conduits of Influence” Within Taiwan Politics

Chapter Five assesses how Taiwan's domestic politics have affected China's efforts to turn its economic influence into political leverage. Mainland China's most enduring strategies for exploiting economic pressure against Taiwan involve trying to mobi-

³⁰ Blanchard and Ripsman, 1999–2000.

³¹ Blanchard and Ripsman, 1999–2000.

lize support or acquiescence from pivotal political classes or groups within Taiwan. Chapter Five focuses on the mainland's obstacles in trying to develop "conduits of influence" in Taiwan's democratizing political system. The term *conduits of influence* in this study refers to political classes or groups in the target country that have a stake in promoting policies that also serve the initiating country's interests. Beijing has focused on three conduits of influence—trying to reshape mass political opinion, change the center of gravity in Taiwan's elite politics, and transform Taiwan's business community into an irresistible political lobby for Beijing's interests. Specifically, Beijing seeks to influence Taiwan by doing the following:

- using closer economic ties to reshape Taiwan's mass public opinion and encourage the long-term development of closer social and ethnic ties across the strait
- exploiting economic ties to reshape the balance of power among Taiwan's political elites, which involves trying to strengthen the domestic political position of Taiwan's political leaders who support closer political ties with Beijing, or who feel they have no choice but to rein in their anti-mainland policies for fear that they will not win reelection if they cannot deliver economic growth to the people of Taiwan
- employing economic leverage to pressure or encourage powerful and self-interested Taiwan businesspeople into lobbying for mainland political interests within Taiwan's political system.

Chapter Five demonstrates that domestic groups and classes within the target country also need not sit back and allow the initiating country to exploit them as its conduits of influence. Some key interest groups may take measures to insulate themselves from such political and economic pressure. In recent years, many members of Taiwan's mainland-invested business community have employed a passive—but powerful—strategy of lowering their political profile to reduce Beijing's potential influence over them.

Domestic Politics in the Initiating State

The domestic political balance of power and unity within the initiating country likewise can have a powerful impact on the effectiveness of sanctions. Serious economic sanctions against Taiwan would also cause considerable pain for the mainland—pain that would not be born equally by all Chinese. As Chapter Four demonstrates, Taiwan's economy is growing increasingly dependent upon China for its growth and to maintain the international competitiveness of Taiwan industry. But Chapter Four also underscores that cross-strait economic relations are not a case of one-way dependence. The relationship is better described as "asymmetric interdependence," with both sides depending upon each other, although Taiwan's dependence upon the mainland is greater. Thus, even though mainland China may be highly motivated to use eco-

conomic pressure against Taiwan given the issues at stake, Beijing would nevertheless have to consider carefully the economic and political costs it would suffer from such sanctions.

International Support for the Initiating and Target Countries

The ability of both the initiating and the target states to marshal international support can have a significant impact on the effectiveness of economic coercion. Economic sanctions tend to “bite” harder when they are compounded by diplomatic isolation and political pressure. Initiating countries can heighten the effectiveness of economic pressure by withdrawing diplomatic recognition from their target, excluding it from international organizations, or mobilizing a disciplined coalition of allied states to pressure the target. All of these actions reinforce the costs that sanctions place upon the target state government, demonstrate the resolve of the initiating state, and highlight the risks of further escalation.³²

Conversely, the target state’s level of dependence upon its key allies, and those allies’ willingness to support the target, help to determine whether the economic pressure will be politically effective. If powerful allies provide timely, appropriate economic aid to the target, the leverage of the economic sanctions will be greatly softened, undermined, or even broken (the Berlin Airlift is, of course, the archetypal case). If the target can mobilize third-party supporters to put their own pressure on the sanctioning state or defend the target state in international organizations, the political and economic costs of sanctions will also be lowered. If, however, third-party states prove unwilling to provide assistance, the economic sanctions will bite more. And from the target’s perspective, perhaps the worst prospect of all would be if longtime allies suddenly withdrew their support and joined in the pressure with the sanctioning state. When South Africa ceased assisting the Rhodesian white minority government in resisting international sanctions during the 1970s, it was in many ways a death knell for that government.³³

³² Blanchard and Ripsman, 1999–2000.

³³ Blanchard and Ripsman, 1999–2000.

Taiwan's Struggle to Manage Expanding Cross-Strait Economic Ties

Throughout the presidential administrations of Chiang Ching-kuo (1975–1987), Lee Teng-hui (1987–2000), and Chen Shui-bian (2000 to the present), Taiwan's government has increasingly feared that excessive economic dependence upon mainland China would give Beijing the leverage it desired to force Taiwan to the bargaining table on terms unfavorable to Taipei. One of Taipei's most enduring goals in its mainland China policy has been to minimize the potential economic pain and disruption that China could inflict upon Taiwan through economic coercion. But the goal of minimizing mainland economic pressure has often come into conflict with Taipei's desire to ensure continued economic growth in one of the most foreign trade-dependent major economies in the world.

This chapter analyzes and evaluates Taiwan's developing cross-strait trade and investment policies from 1979 to the present. It examines Taipei's policy battle between two opposing forces—the pressures to expand cross-strait economic relations and Taipei's uneven efforts to restrain or regulate Beijing's ability to pressure it economically. In particular, it stresses the numerous ways in which Taiwan has been forced to loosen many of its controls over cross-strait trade and investment, as well as the significant policy controls that still remain. The chapter closes by evaluating the relative effectiveness of the policies that remain.

Key Conclusions: Taipei's Powerful Dilemmas in Controlling Cross-Strait Trade and Investment

Since the mid-1980s, Taiwan's economic policy toward mainland China has constantly been pulled by two powerful opposing forces:

- Taiwan's government and its enterprises have felt a powerful desire to use China's rapidly growing economy as an engine to salvage Taiwan's increasingly challenged international competitive position.

- Taipei nevertheless knows full well that Beijing hopes that expanded cross-strait economic relations will help it to spin a political web around Taiwan and has been extremely wary of falling into excessive dependence upon China.

Consequently, no Taiwan government over the past 20 years—no matter how suspicious it has been of Beijing’s motives—has been either politically willing or administratively capable of completely blocking the rapidly growing cross-strait business relationship. In the 2000 presidential election, all three major candidates—even President Chen Shui-bian, who has consistently voiced suspicion of the PRC’s economic motives—campaigning on pro-business platforms of opening up cross-strait economic links. At the same time, every Taiwan government has groped to find new policy vehicles that could help it better control the pace of growth in the relationship, mitigate China’s capacity to do serious economic harm to Taiwan, and encourage Taiwan businesses to diversify their investments into less risky countries.

The emergence of a vibrant multiparty democratic system in Taiwan has made these crosscutting pressures on the government even more powerful and further complicated the management of cross-strait economic ties.

- The transformation of Taiwan’s political leadership—from old-line mainlander GMD officials committed to eventual reunification with China to increasingly pro-independence Taiwan officials—has given birth to powerful political parties, factions, and lobbies committed to avoiding excessive economic entanglement and dependence on the mainland.
- Meanwhile, many in Taiwan’s business community have been intent upon expanding their access to the Chinese market and have often voiced supreme confidence that any economic dependence on the mainland could be “controlled.” They have pressured the process in two powerful ways:
 - They have demonstrated an impressive ability to lobby the government to ease existing restrictions on cross-strait relations.
 - When they have failed to persuade the government, they have displayed remarkable business skill in creating economic “facts on the ground” by circumventing or breaking many of the remaining legal restrictions and moving into the mainland anyway. The rise of offshore banking and the inherent difficulty of monitoring investment in a knowledge-based, high-tech economy have strengthened their capacity to circumvent government laws and policies.
- Taiwan’s electorate has also complicated the government’s job by embracing seemingly contradictory positions. On the one hand, polls consistently indicate that voters are displaying a growing sense of a “Taiwanese” identity, a rising concern over mainland Chinese pressure, an overwhelming rejection of reunification under the mainland policy of “one country, two systems,” and a fear of losing jobs to low-wage mainland workers. On the other hand, as Taiwan’s once-torrid

economic growth rate has slowed, its citizens have consistently supported candidates who favored a liberalization of the “three links” (discussed below) and other policies for engaging the Chinese economy.

In our judgment, the Taipei government has been able to retain several effective policy measures for slowing or controlling the pace of growth in cross-strait economic relations—a view that is at odds with those of a number of experts. Despite the political pressure for a more rapid opening up of relations, the administrations of Presidents Lee Teng-hui and Chen Shui-bian have, at times, shown considerable willingness to resist business and popular pressure to open up more rapidly—most notably, on the key issue of negotiating with Beijing on the establishment of direct transportation, trade, and postal and telecommunications links with the mainland (the so-called *three links*, or *santong*). The Chen administration in particular has quietly but firmly insisted that any talks with Beijing on permanent direct transport links should involve some form of official government contact or auspices and not proceed under the official premise that both sides are part of “one China”—two conditions Beijing has thus far refused to accept.¹ So long as Beijing and the Chen administration each insist upon these positions they create a decisive obstacle to the long-anticipated establishment of the three links. Moreover, despite the steady erosion of the Taiwan government's limitations on cross-strait economic relations since the early 1980s, the government still retains some significant policy levers to restrain dependence on the mainland, including prior approval of major investments and limitations on investment and technology levels. In part as a result of these policies, there remains a significant “lag” or “gap” between the technology levels of Taiwan's domestically based firms and their mainland operations.

But the power of Taiwan's policy measures to restrain mainland influence should also not be overstated. On balance, the unmistakable overall trend has been a steady loosening of restrictions and a rapid expansion of cross-strait trade and investment flows. In one generation, Taiwan's economy has been transformed from having negligible links to mainland China, to a point where trade and investment with China plays a pivotal role in Taiwan's economic health (a process that is analyzed in greater detail in the next chapter). The Taiwan government has clearly been fighting a rear-guard action—frequently reduced to retroactively legalizing and regulating widespread business activities that have gone on underground for years. At times, the Lee and Chen administrations' policy record has appeared to be a jumble, with reforms designed to ease restrictions often coinciding with initiatives intended to prevent excessive dependence.

¹ Taipei has occasionally finessed this issue on “one-time” deals, such as the 2005 negotiations over special cross-strait flights during Lunar New Year, in which the status of the Taiwan aviation officials who were present was deliberately left ambiguous for the press, with Taiwan noting their status as government officials while mainland China only acknowledged their ties to private associations.

Taiwan's Major Policies Designed to Limit Mainland Influence

Since the early 1980s, when Taiwan dropped its initial across-the-board ban on economic exchanges with the mainland—known as the *three nos*—Taipei has relied primarily upon a handful of policy tools to try to limit cross-strait relations:

- designing measures to improve Taipei's capacity to monitor and evaluate the level and types of cross-strait investment and trade
- replacing the longtime ban on all trade with indirect trade through much costlier and inconvenient routes, such as Hong Kong, Macao, Japan, and South Korea
- regulating the types of goods traded in order to limit Taiwan's dependence upon the mainland for strategically important goods and denying the PRC access to strategically sensitive Taiwan goods
- replacing the initial ban on cross-strait investment with regulations designed to force investors to register their investments with Taipei and seek prior approval
- regulating and limiting both the value of investments and also the types of goods that Taiwan investors can produce on the mainland in an effort to control the total capital amount, technological level, and strategic importance of these investments
- encouraging Taiwan investors to diversify their investments into other countries
- discouraging Taiwan companies from listing shares of their stock on mainland stock markets and regulating investment in Taiwan's stock markets by Taiwan-invested mainland companies and other mainland financial sources in order to limit the PRC's capacity to dominate or harm the market; also, trying to expand and diversify non-PRC foreign investment in the Taiwan market
- protecting IT networks and information flows from mainland attack or disruption
- preventing large numbers of mainland workers from moving to the island
- making Taiwan's participation in negotiations with Beijing over the three direct links conditional on Beijing's acceptance of a framework that would tacitly acknowledge Taiwan's government as independent or a sovereign equal—a framework Beijing has thus far described as anathema.

Beijing's Initial Entreaties to Taiwan

From 1949 to 1979, there was virtually no economic interaction between China and Taiwan, including no direct trade, transportation, or postal and telecommunications links. The mainland Chinese and Taiwan political and economic leaders who opened up cross-strait economic relations after 1979 were driven by a variety of political and economic factors, including the following:

- Beijing's desire to encourage reunification with Taiwan while political and demographic trends in Taiwan remained favorable
- mainland China's powerful need for Taiwan's help in its economic reform and development campaign
- political and social liberalization and economic development in Taiwan that loosened political and economic restrictions and provided powerful incentives for traders and investors to go overseas
- the obvious and powerful economic complementarities in development levels and factor endowments of the mainland China and Taiwan economies.

China made the initial steps toward economic integration in 1979, portraying those steps as part of a campaign to encourage the "peaceful reunification" of Taiwan and China. In meetings with American visitors, Deng Xiaoping underscored this intention by mentioning that Beijing would no longer state that its goal was to "liberate" Taiwan. China further signaled its interest in 1980 by dispatching a trade mission to Hong Kong, which made a special purchase of \$80 million worth of Taiwan goods.²

Beijing spelled out its economic engagement policy in a landmark September 30, 1981, speech by National People's Congress³ Vice Chairman Ye Jianying, who put forward a nine-point formula for peaceful reunification. Ye's most famous proposal called for the establishment of "three links" between the mainland and Taiwan—transportation, trade, and postal and telecommunications links—and "four exchanges" (*siliu*)—academic, cultural, economic, and sports exchanges.

For China's leaders, this rapid establishment of economic relations was part of a broader effort to encourage reunification while the generation of the leaders of the GMD that had lived on the mainland was still alive. Behind this lay Beijing's fear—which ultimately proved correct—that Taipei's next generation of leaders would not have nearly the same desire for unification with the mainland as their predecessors and that the longer-term trends of nationality identification among the people of Taiwan would gradually undermine support for reunification.

But Beijing's economic motivations were equally powerful. Twenty-five years of torrid economic growth in China have almost obscured the fact that in 1979 Beijing almost certainly needed Taiwan more than Taiwan needed China. Owing to its autarkic economic policies in the late Mao years, China had missed out on East Asia's explosive economic growth and technological modernization during the 1960s and 1970s and desperately lacked the capital, technology, and managerial expertise that Taiwan possessed in abundance.

² Chen-yuan Tung, "Economic Relations Between Taiwan and China," UNISCI discussion papers, Madrid: Unidad de Investigación sobre Seguridad y Cooperación Internacional, January 2004.

³ The National People's Congress is China's national legislature and officially its highest organ of state authority. The annual session of the legislature, now usually held in the spring, is often the occasion for significant policy pronouncements such as Ye's speech.

To encourage the growth of economic ties, Beijing gradually adopted a series of preferential policies, laws, and regulations that offered increasingly attractive terms for Taiwan traders and investors to do business with the mainland. These included tax shelters and greater protections for Taiwan investments than even mainland businesspeople then enjoyed. To manage local ties to the growing Taiwan business community, China established local Taiwan Affairs Offices to assist Taiwan investors with investment applications and recruitment of local staff. In July 1988, the State Council (China's cabinet) also issued its Regulations of the State Council for Encouragement of Investment by Taiwan Compatriots, which allowed Taiwan investors to enter into joint ventures or wholly own their own companies, purchase the stocks and bonds of Chinese enterprises, and purchase real estate. The regulations also exempted Taiwan enterprises from many customs duties, industrial and commercial taxes, and import license requirements. Moreover, the regulations provided tax and duty exemptions for articles and vehicles in a reasonable amount imported by Taiwan staff members for their personal use during their service period in the enterprise.⁴ In addition, in May 1989, China established two special investment zones for Taiwan firms in the south-eastern port cities of Xiamen and Fuzhou.⁵

Beijing's trade policy has also complemented these special inducements for Taiwan businesspeople. Ever since the opening of the cross-strait relationship, Beijing has tolerated a very large trade deficit with Taiwan, with imports from Taiwan usually outstripping exports to Taiwan by a ratio of about three to one or more. In 1981, for example, of total two-way cross-strait trade of \$460 million, Taiwan enjoyed a \$310 million surplus. Likewise, in 2002, Taiwan showed a surplus of \$21.6 billion of total cross-strait trade of more than \$37 billion.⁶

Taiwan's Response: From Full Embargo to Rapid Opening

Taiwan initially resisted Beijing's first entreaties for economic exchange in 1979, declaring a rigid policy labeled the *three nos*—no contact, no negotiation, and no compromise with Beijing. Through the early 1980s, Taipei enforced a nearly complete ban on exports to the mainland and permitted only certain Chinese foods and medicines to be imported from China via Hong Kong. Taipei gradually began easing its three nos policy in 1982. Even while Taiwan's prohibition on trade with the mainland contin-

⁴ PRC State Council, "Regulations of the State Council for Encouragement of Investment by Taiwan Compatriots," July 3, 1988.

⁵ Karen M. Sutter, "Business Dynamism Across the Taiwan Strait: The Implications for Cross-Strait Relations," *Asian Survey*, Vol. 42, No. 3, May/June 2002b, pp. 522–540 [p. 524].

⁶ Suisheng Zhao, "Economic Interdependence and Political Divergence: A Background Analysis of the Taiwan Strait Crisis," in Shuiseng Zhao, ed., *Across the Taiwan Strait: Mainland China, Taiwan, and the 1995–1996 Crisis*, New York: Routledge, 1999, pp. 21–40.

ued, trade between the two sides reached nearly \$1 billion by 1985.⁷ In that year, the Taiwan government, perhaps recognizing the futility of enforcing the ban on trade, adopted a noninterference policy with respect to indirect exports to China.⁸ Although Taipei continued its official ban on direct investment in China by Taiwan companies, some investment was carried out through subsidiaries or front companies in Hong Kong. At this time, the Taiwan government generally tolerated such investment so as long as it was relatively small-scale and involved “sunset” industries.

The rapid growth in Taiwan's economic relationship with China in the mid-1980s was driven in large part by the major transformations that were then going on in Taiwan's economic, political, and social systems. Taiwan's business leaders, confronted with changes that undermined their long-successful low-wage manufacturing systems, began taking advantage of new opportunities to seek new overseas bases for production and expanded access to foreign markets. Taiwan's economic “miracle” of the 1960s–1980s sparked a dramatic increase in average standards of living and education levels. These were followed by political reform and democratization in the mid- to late 1980s, which created a labor force that is better organized, freer, and far more assertive than that under Chiang Kai-shek's authoritarian regime. The result was a significant increase in the cost of manufacturing labor, with nominal wage rates in Taiwan manufacturing increasing an average of 13.7 percent annually between 1975 and 1985. At the same time, nominal labor productivity grew only half as fast, at 6.8 percent a year.⁹

The major rise in the value of Taiwan's currency soon thereafter created further incentives for Taiwan firms to reduce their manufacturing costs by moving to the mainland. In the late 1980s, Taiwan came under increasing pressure from the United States and other countries to revalue its currency upward against the dollar, with its current account surplus increasing to 20 percent of its GNP in 1986 and its foreign exchange reserves soaring from \$23 billion in 1985 to \$77 billion in 1987. As economist Barry Naughton pointed out, such large trade surpluses with the United States were not “politically sustainable,” and Taiwan was forced to revalue its currency upward by 40 percent against the dollar between 1986 and 1988.¹⁰

With wages rising faster than productivity and a rapidly strengthening NTD, Taiwan's traditional low-wage, labor-intensive industries became less competitive internationally, and those industries began searching for what those in Taiwan have called a “second spring” in lower-wage countries such as China. Not surprisingly, the rush to

⁷ Ralph N. Clough, *Reaching Across the Taiwan Strait: People-to-People Diplomacy*, Boulder, Colo.: Westview Press, 1993, p. 43.

⁸ Clough, 1993, p. 43.

⁹ Barry Naughton, “Economic Policy Reform in the PRC and Taiwan,” in Barry Naughton, ed., *The China Circle: Economics and Technology in the PRC, Taiwan, and Hong Kong*, Washington, D.C.: Brookings Institution, 1997, p. 87.

¹⁰ Naughton, 1997, pp. 88–89.

invest in China was led by shoe manufacturers, whose competitiveness suffered especially from rising wages and labor shortages.¹¹

Mainland China was in many ways exactly what they were looking for. Soon after the initial opening of relations, it quickly became apparent that Taiwan and mainland China were, in Suisheng Zhao's words, a classic case of two economies with a highly complementary set of comparative advantages. Taiwan brought to the table large sums of capital, advanced production technologies—many of which were well suited to labor-intensive manufacturing—and experienced Chinese-speaking managerial talent. The mainland's comparative advantages were in cheap land, abundant foods and other raw materials, refined petroleum products (at that time), experience in manufacturing, and an enormous low-wage labor force that was relatively well-educated but still politically controlled.¹²

As part of the GMD's political and economic reforms of the late 1980s, the government lifted a series of repressive regulations that opened up the gates for greater economic ties—especially investment—with the mainland. In 1985, the government had rescinded the requirement for the central bank to give approval for remittances of capital in amounts over \$5 million.¹³ This was followed by three pivotal reforms in 1987: On July 15, the GMD leadership lifted martial law in Taiwan; in October, the government began permitting Taiwan residents to travel to the mainland to visit family (and this was eventually opened to all Taiwan residents); and Taiwan significantly relaxed its foreign exchange controls. The combined effect of these three reforms was that even though the government's official ban on investment remained, the government's capacity to monitor and enforce that ban was greatly undermined; as a result, investment quickly started taking off.¹⁴ In the summer of 1989—at the height of the crackdown on students in the mainland—Taiwan eased restrictions on the indirect import of goods from the mainland. Soon thereafter, in October 1990, Taiwan businesspeople were authorized to engage in indirect investment and various forms of technical cooperation with the mainland. In an effort to restore its ability to monitor cross-strait investment, the government began to permit businesspeople to register their investments in the mainland on a special approval list.¹⁵

¹¹ Clough, 1993, p. 44.

¹² Zhao, 1999, pp. 34–35.

¹³ Naughton, 1997, p. 102.

¹⁴ Taiwan politics expert Shelley Rigger writes, "At first, visits were restricted to Mainlanders visiting relatives, but the door soon opened to scholars, cultural groups and tourists. Taiwanese hoping to do business on the mainland soon followed. Despite legal restrictions on cross-strait investment, the wealth of opportunities awaiting Taiwanese on the mainland proved irresistible, and money poured into Hong Kong, destined for reinvestment in the PRC. Most investors set up small, labor-intensive manufacturing facilities to take advantage of China's low wages while minimizing risk" (Shelley Rigger, *Politics in Taiwan: Voting for Democracy*, London and New York: Routledge, 1999, p. 153).

¹⁵ Zhao, 1999, p. 22.

Cross-strait economic ties and contacts grew at a tremendous rate in the late 1980s and early 1990s, and Taiwan's trade with the mainland was soon growing faster than its trade with other regions of the world. The value of Taiwan exports to the mainland swelled quickly from a mere \$51,000 in 1978 to more than \$4.6 billion in 1991. Indirect trade through Hong Kong rose from about \$460 million in 1981 to about \$1.7 billion in 1987, and by 1995 had ballooned more than 11 times to \$20 billion.¹⁶ By the early to mid-1990s, China had emerged as Taiwan's number-three trading partner (behind the United States and Japan), and Taiwan was China's fourth-largest trading partner, following Japan, the United States, and Hong Kong.¹⁷

Still, there were no direct transportation, trade, or postal and telecommunications links between the two sides. In the absence of direct links, most cross-strait trade has been composed of goods shipped indirectly through Hong Kong or third-country ports. In all, however, there are five different channels for cross-strait trade: reexports via Hong Kong; transshipment through Hong Kong; transshipment through Korea and Japan; the "mini-three links" (which accounted for little more than \$1 million in trade in 2001); and illegal or semi-legal transit shipment and direct trade.¹⁸ About 80 percent of cross-strait trade is reexported or transshipped through Hong Kong, while about 20 percent is accounted for by transshipment via Japan and Korea, mini-direct links, and various types of semi-legal and illegal shipments.¹⁹

The magnitude of indirect investment was more difficult to gauge but was reported by the PRC government to have reached \$3.4 billion by 1991.²⁰ There is a solid consensus among analysts that since the late 1980s, however, Taiwan investment in the mainland has become the principal engine driving cross-strait trade. Most of this trade involves the transport of capital goods and intermediate goods across the strait to the mainland where they are turned into finished goods and reexported primarily to Japan and the United States. Taiwan political scientist Tung Chen-yuan estimates that by the mid-1990s between one-third and two-thirds of all goods exported from Taiwan to the mainland were being exported to Taiwan-invested enterprises.²¹

Prior to 1987, such investment had been virtually nonexistent, but the economic sanctions many countries imposed on mainland China in the wake of the 1989 massacre of protestors near Tiananmen Square opened a window for Taiwan investors, who swarmed in to fill the gap. The terrific increase in trade after 1989 was driven in

¹⁶ Chen-yuan Tung, 2004; Zhao, 1999, pp. 21–40.

¹⁷ Chen-yuan Tung, 2004.

¹⁸ For a full explanation of the different mechanisms by which cross-strait trade is conducted, see Jun Ma, Wenhui Zhu, and Alan Kwok, *China-Taiwan Economic Integration: Trends and Implications*, Hong Kong: Deutsche Bank, Asia-Pacific Equity Research, September 2002, pp. 29–30.

¹⁹ Ma, Zhu, and Kwok, 2002, p. 27.

²⁰ Clough, 1993, pp. 44–45.

²¹ Chen-yuan Tung, 2003a.

no small measure by Taiwan's investment in the mainland. Taiwan's mainland-based investors relied upon Taiwan for sources of key equipment, machinery, parts, components, and certain raw materials. Very soon, the mainland became the number-one target for overseas investment from Taiwan, and by 1993 mainland investment accounted for nearly two-thirds of Taiwan's total overseas investment.²²

Shifting Investment Patterns and Rising Concerns About Dependence

The explosive pace at which cross-strait economic ties expanded caught Taiwan's leaders badly off guard: Not only were economic links growing faster than anticipated, they were strengthening at a time when many GMD leaders were fundamentally reconsidering whether or not they ever really wanted Taiwan to reunify with China. As a result, throughout the early 1990s, the government's policies struggled to keep up with the pace of change. The government established a cabinet-level Mainland Affairs Council (MAC) in 1991 and charged it with "planning, coordinating, evaluating and partially implementing" policy toward the mainland.²³ The Cabinet's Guidelines on National Unification, adopted in March 1991, portrayed economic ties (especially the "three links") as a positive step toward gradual reunification. But President Lee's government also took the position that Taiwan and China could not reunify until China had reached levels of economic prosperity and political democracy equivalent to Taiwan—clearly a very long way off.²⁴

In October 1990, the Taiwan government made a major effort to restore its capacity to monitor and control cross-strait investment when the Ministry of Economic Affairs (MoEA) issued its Regulations on Indirect Investment or Technical Cooperation in the Mainland Area. The regulations required all mainland-invested firms to register the amount and nature of their investment. Companies that failed to report investment by an April 8, 1991, deadline were threatened with a variety of punishments, including denying the violator permission to travel, cutting off their credit and foreign exchange operations, denying future investment applications, and investigations of tax records. Companies that admitted they had made direct investments illegally were not to be punished and could convert to "indirect" status through paper companies established at a semiofficial Taiwan trading center established in Hong Kong.²⁵

To control the nature of investments, the regulations also stipulated that beginning in April 1991 all new investments over \$1 million required advance approval.²⁶

²² Chen-yuan Tung, 2003a.

²³ Rigger, 1999, p. 154.

²⁴ Rigger, 1999, p. 154; Denny Roy, *Taiwan: A Political History*, Ithaca, N.Y.: Cornell University Press, 2003, pp. 212–215.

²⁵ Peter Wickenden, "Taiwan in Drive to Track Down Capital Sent to China," *Financial Times*, April 10, 1991a, p. 4; Clough, 1993, p. 54.

²⁶ Wickenden, 1991a, p. 4; Clough, 1993, p. 54.

The regulations also permitted Taiwan firms to invest in the production of 3,353 products, mostly in labor-intensive industries such as apparel, footwear, household electronics, and food processing. This list of approved products was gradually expanded to 4,895 by 1996.²⁷ According to Suisheng Zhao, the government developed an approval system under which all cross-strait investment projects were categorized as either “permitted,” “prohibited,” or “special cases.” Permitted investments were typically small-scale manufacturing, services, land development, and real estate enterprises. Government-designated strategic industries, defense-related enterprises, financial institutions, and public enterprises were all prohibited. Other investment projects over \$1 million required special government approval before they could proceed.²⁸ As a companion measure, Taiwan also rigorously restricted visits to Taiwan by mainlanders, keeping them to less than 1 percent of the corresponding number of Taiwan residents who visited the mainland each year during the late 1980s and early 1990s.²⁹

The new regulations strengthened significantly the government's ability to track mainland investments.³⁰ More than 2,300 companies came forward under the new reporting regulations, and as a result the Taiwan government learned that mainland investments totaled at least \$750 million. In reality, this number was far below the actual value of the investments—China-approved Taiwan investments at that time were variously estimated at around \$2.2 to \$3.4 billion.³¹ But as the government became more involved in providing necessary support services for cross-strait investors over the next decade, the investors' incentives to report their projects to the government increased. In addition, the government did on several occasions use its authority to stall or deny major investment projects, sometimes citing the fear that excessive dependence could lead to “blackmail” by Beijing.³²

Taipei's Rising Concerns About Growing High-Tech Investment

But even while President Lee's government was struggling to reassert its control over the growing economic relationship, economic forces were causing a major shift in the pattern of Taiwan investments—toward larger projects and higher technology—that

²⁷ Sutter, 2002b, p. 525; Wickenden, 1991a, p. 4.

²⁸ Zhao, 1999, p. 30.

²⁹ Zhao, 1999, p. 30.

³⁰ Sutter, 2002b, p. 525; Wickenden, 1991a, p. 4.

³¹ For various estimates, see Clough, 1993, pp. 44–45; Sutter, 2002b, p. 525; and Wickenden, 1991a, p. 4.

³² In 1991, Taiwan delayed what would have been the largest mainland investment project to date—the Cheng Shin Rubber International Company's application to invest \$20 million in a tire factory in Xiamen. Premier Vincent Siew acknowledged business support for opening up the three links. But government officials expressed concerns that Beijing might exploit its control over such investments to blackmail Taiwan (Andrew Bolger, “Liberalisation on Trial—The Financial Moment of Truth Has Come,” *Financial Times*, October 10, 1991a, pp. 34–35; Andrew Bolger, “Taiwan: The Roulette Wheel Slows Down,” *Financial Times*, October 10, 1991b, pp. 34–35).

heightened the government's fears of excessive dependence on the mainland. Initially, most Taiwan investors had kept their investments small in scale, well below \$1 million. Moreover, the principal products of these early investments were labor-intensive products—including footwear, foodstuffs, textiles, electronic appliances, and toys.³³ Analyst John Tkacik has characterized these products as “older production lines with obsolescent equipment that had been crated up in Taiwan and shipped across the strait.”³⁴ Such investments were not thought to provide Beijing with substantial political leverage because their loss would not cause great harm to the Taiwan economy, and their benefits could, in any case, be readily substituted.³⁵

Beginning around 1991–1992, however, the focus of Taiwan's mainland investments began shifting to high-tech production and infrastructure projects, causing the average value of investments to increase greatly. These investments were gradually moving up the manufacturing chain. In addition to footwear, toys, and textiles, Taiwan investors began producing electronic appliances, such as calculators, television sets, tape recorders, and soon, computers on the mainland, causing Taiwan's share of exports in these products to important markets, such as the United States and Japan, to decline.³⁶ In 1992, eight Taiwan camera manufacturers set up plants in China to compete with low-end Japanese camera manufacturers.³⁷ Some economic scholars argue that many large businesses were motivated to move from Taiwan to the mainland by a desire to preserve their supply relationships with smaller Taiwan downstream production partners who had already transferred facilities to the mainland in quest of cheaper land and labor.³⁸

The Chinese government contributed to this process in 1992 by finally legalizing foreign and Taiwan investment in a number of products for the rapidly growing personal computer (PC) market. Soon thereafter, according to economist Barry Naughton,

Leading producers such as Acer, First International Computer, and Mitac wasted no time in moving Foreign Direct Investment (FDI) into China. In 1993 there were already 35 Taiwanese subsidiaries in China as against 10 in Thailand, nine in Malaysia, and four in Indonesia. The number increased to 41 in 1995, consti-

³³ For an overview of investments during this period, see Ralph N. Clough, *Cooperation or Conflict in the Taiwan Strait*, Lanham, Md.: Rowman and Littlefield, 1999, especially pp. 52–55.

³⁴ Tkacik, 2001, p. 46.

³⁵ Clough, 1993, p. 54.

³⁶ Clough, 1993, p. 55. Tkacik (2001) reports that, by 2000, of \$2.67 billion total new investment applications, 54 percent (\$1.4 billion) were in electronics and electrical equipment. Service-sector investment, though still small as a percentage of new investment applications (just \$160 million of \$2.67 billion), was growing at a very rapid rate. Plastics constituted \$180 million of this total (Tkacik, 2001, pp. 42–44).

³⁷ Clough, 1993, p. 56.

³⁸ Zhao, 1999, p. 29.

tuting 70 percent of all PC firms that were running overseas subsidiaries. China accounted for almost half of Taiwanese offshore production of motherboards in 1993, one of the latest items to go abroad, with the rest being supplied by subsidiaries based in Thailand and Malaysia.³⁹

This move by increasingly high-tech, capital-intensive industries (and many of their skilled engineers and managers) across the strait caused many in Taiwan to express fears that Taiwan's industry was losing a measure of its competitiveness to the mainland, and that a growing flight of capital would cause a "hollowing out" of Taiwan's industry.

Encouraging Diversification: President Lee's "Go South" Policy

Despite repeated assertions by President Lee Teng-hui's government that Taiwan's economy was becoming dangerously tied to China, Lee's efforts to slow the opening to China continued to face blunt criticism from a business community intent on outsourcing production, and also from many in the public at large. The government's relaxation of trade and investment restrictions were criticized as inadequate half-measures by many businesspeople anxious to see Taiwan and the mainland open up the full three links—direct transportation, trade, and postal and telecommunications. Criticism even came from within the leadership of President Lee's own GMD. GMD Politburo Member Chang Pen-Tsao, head of a major business council, argued that

[Most] industrialists are dissatisfied with the government's policies toward China . . . Its stance is negative, one of prohibition and non-assistance. Indirect trade does nothing to enhance our trade protection or our national security, and we are losing money paying commissions to trading houses in Hong Kong.⁴⁰

By 1993–1994, President Lee Teng-hui's government was searching for new policy vehicles to encourage Taiwan investors to diversify into other, less hostile markets. In 1994, President Lee and Prime Minister Lien Chan began using personal "vacation" trips to Southeast Asia to launch a "Go South" strategy that would encourage Taiwan industries intent on outsourcing production to focus more on Southeast Asia. Throughout the mid-1990s, Taiwan signed agreements with most of the nations of Southeast Asia designed to facilitate trade and investment, including agreements on

³⁹ Naughton, 1997, p. 186.

⁴⁰ Quoted in Peter Wickenden, "End of the Big Freeze," *Financial Times*, October 10, 1991b, pp. 33–34; Peter Wickenden, "The Last Lap to Reality," *Financial Times*, October 10, 1991c, pp. 33–34.

mutual protection of investment, avoidance of double-taxation, and customs.⁴¹ In an August 14, 1996, speech to the National Assembly, Lee argued that Taiwan's excessive reliance upon overseas investment—especially in the mainland—was diverting capital and attention from revitalizing Taiwan's domestic economy, and the government might have to put a lid on it.⁴² Lee was publicly criticized by a number of senior business leaders, including longtime ally Evergreen President Chang Yung-fa, who claimed Lee was backtracking on the government's own policy of internationalizing the economy.⁴³ Chang called on the government to move faster to open up direct commercial and transport links with the mainland. Lee was also criticized by some economists who argued—shortsightedly, as it turned out—that since most of Taiwan's mainland investment was at that time still in sunset manufacturing industries rather than high-tech sectors, it therefore did not constitute a serious threat. China added to Lee's woes by offering to open two ports to direct shipping from Taiwan—an offer Lee's government publicly ignored.⁴⁴

Most observers agree that under President Lee's administration, the "Go South" policy produced relatively modest, uneven results and did not succeed in stemming the tide of investment to the mainland.⁴⁵ President Lee's policy enjoyed some initial success. Taiwan FDI in nations belonging to the Association of Southeast Asian Nations (ASEAN) in 1998 totaled \$842 million, making Taiwan the seventh-largest investor in the ASEAN nations that year. But thereafter, the Go South policy suffered significantly from terrible timing. In the wake of the 1997–1999 financial crisis, Taiwan FDI in Thailand fell from \$2.78 billion in 1997 to \$158 million in 2001.⁴⁶ In 1998, in Indonesia—another key target of Lee's initiative—the collapse of the Suharto government and subsequent anti-Chinese ethnic violence caused Taiwan investments to suffer and spurred some Taiwan businesspeople to charge that the government had not made adequate preparations to support businesses in the region.⁴⁷ In 1997–1998, Lee's government led delegations to the region that tried to take advantage of the financial crisis in Southeast Asia by buying up promising companies in the region at bargain prices. But in 1999, Taiwan fell out of the top ten among ASEAN's sources of FDI, though by

⁴¹ *Taiwan Yearbook*, 2003, Taipei: Government Information Office, 2003, p. 122.

⁴² Matthew Fletcher and Laurence Eyton, "A Sharp Change of Course: President Lee and Big Business Spar over China," *Asiaweek.com*, August 30, 1996; Roy, 2003, p. 217.

⁴³ Fletcher and Eyton, 1996; Roy, 2003, p. 217.

⁴⁴ Fletcher and Eyton, 1996; Roy, 2003, p. 217.

⁴⁵ See, for example, Tkacik, 2001, p. 42.

⁴⁶ Goh Sui Noi, "'Go South!' But Do Taiwanese Businesses See the Harvests?" *Straits Times* (Singapore), August 31, 2002.

⁴⁷ Taiwan food giant President was among the firms most hard hit by the Indonesian economic downturn and racial violence. See Betty W. Liu, "Taiwan's 'Go South' Policy Hurt by Indonesia Events," Dow Jones Newswire, August 3, 1998.

2000 it had recovered to become the fourth-largest source, with \$802 million. Across the entire 1995–2000 period, Taiwan was the seventh-largest investor in the region with a total of \$4.45 billion in FDI. China has also attempted to block Taiwan's efforts to relocate more investment into the region by promoting the creation of an ASEAN-China free-trade zone that would exclude Taipei, and by subtly pressuring countries in the region to keep their relations with Taiwan to a minimum.⁴⁸

Vietnam has emerged as a relative bright spot in the Go South policy. Not surprisingly, many of the factors that attract Taiwan corporations to mainland China also are present in Vietnam—investors there generally characterize the workforce as “disciplined” and hardworking, and many enjoy what they regard as the extensive cultural similarities between the two countries. Taiwan businesspeople also report feeling far less political pressure than they do in their China operations. At the same time, Taiwan investors also report frequent miscommunications owing to the language differences. Others are critical of what they describe as the frequent unreliability or lack of credibility of Vietnamese firms, particularly in meeting production deadlines and quality, as well as high levels of government corruption.⁴⁹

Neither President Lee nor his successor Chen Shui-bian ever truly abandoned the push for more Southeast Asian investment, and each renewed his call for investment diversification on several occasions.

Tightening Administrative Oversight and Controls: “No Haste, Be Patient”

Even before 1997, Lee's government recognized that encouraging Taiwan capital to “Go South” was not, by itself, strong enough to reduce the movement of capital to the mainland, and, in any case, Taiwan needed to find ways to encourage renewed investment in the domestic industrial economy.⁵⁰ Consequently, in September 1996, the government also promulgated the “No Haste, Be Patient” (*jieji yongren*) policy. One of the policy's chief architects, Chen Po-chih, later claimed that No Haste, Be Patient was never intended to halt businesses entirely from moving to the mainland, but instead was intended to slow and manage the outflow of high-tech firms in particular, thereby giving new, cutting-edge industries an opportunity to spring up in their place.⁵¹ The cornerstone of the policy required case-by-case approvals for Taiwan investments in high-technology and infrastructure projects in China. The policy also placed limits

⁴⁸ Goh, 2002.

⁴⁹ “Taiwan Manufacturers Increasing Investments in Vietnam,” Taiwan Economic Newswire, March 31, 2003.

⁵⁰ Lee's August 1996 Speech to the National Assembly is an example of this thinking. See Fletcher and Eyton, 1996; and Roy, 2003, p. 217.

⁵¹ Goh, 2001.

on investments by companies listed on the Taiwan stock exchange and imposed a new ceiling of \$50 million on individual Taiwan investments in the mainland. The government followed up in July 1997 with a ban on Taiwan investment in most large-scale infrastructure and energy projects on the mainland. The government also enforced a maximum investment level of 20 to 40 percent of a firm's total net worth.⁵² In a related policy, notebook computer producers were banned from manufacturing complete notebooks on the mainland.⁵³ In support of the policy, Lee's MAC issued a report arguing that as long as Beijing continued its hostility toward Taiwan, unrestrained Taiwan investment in the mainland would undermine national security. The report buttressed its contention with numerous quotes from senior mainland leaders that called for expanded use of economic ties as a source of political leverage to prevent Taiwan's independence.⁵⁴

But Lee's cross-strait policies ran into a powerful wave of opposition—not only from his longtime critics in the business community, but increasingly from a highly conflicted electorate that was concerned over rising threats and political pressure from China, but nonetheless supported closer economic ties and the three links to help revive Taiwan's flagging economy. Even officials of Lee's own MAC conceded the contradictory views of the public, noting that “most Taiwanese are in favor of stronger links while at the same time retaining Taiwan's independence.”⁵⁵ President Lee's restrictive No Haste, Be Patient policy soon encountered rising opposition not only among influential business leaders but also among the broader Taiwan electorate. Among the most-vocal business critics was Formosa Plastics Group chairman Wang Yung-ching, whose proposed investments in power-generating factories and plastics production on the mainland ran afoul of the regulations. But public opinion surveys in early 2000 also indicated overwhelming popular support for closer economic ties—with three out of four adults supporting opening up the three links (transport, trade, and postal) and four out of five in favor of a cross-strait investment agreement.

Even the statistics of President Lee's own government seemed to testify that the No Haste, Be Patient policy was not effective in preventing Taiwan businesspeople from creating economic facts on the ground and was lagging badly behind the shifting high-tech focus of cross-strait trade and investment. A spring 2000 survey by Taiwan's MoEA indicated that officially registered mainland investment had risen to a 40 per-

⁵² These limits on infrastructure and energy investment are detailed in Debbie Kuo, “Taiwan Bans Investment in Mainland Infrastructure,” Central News Agency, July 5, 1997; and Kathrin Hille, “Taiwan Liberalises Some Links with China,” *Financial Times*, August 1, 2006.

⁵³ Philip Liu, “Time to Lift the ‘Don't Hurry, Be Patient’ Policy?” *Taiwan Economic News*, June 11, 2001b.

⁵⁴ Bear Lee, “MAC Defends ‘No Haste, Be Patient’ Mainland Investment Policy,” Central News Agency, June 16, 1998; Kuo, 1997; Mark O'Neill, “Young Turks Invest in Cross-Strait Ties: Taiwan's New Generation of Presidential Hopefuls Vows to Open Mainland Trade,” *South China Morning Post*, March 12, 2000, p. 11.

⁵⁵ MAC official James Chang, quoted in Stuart Young, “Taiwan's Voters Shrug Off China's Threat,” *Christian Science Monitor*, February 25, 2000, p. 7.

cent share of Taiwan's \$36 billion in overseas investment, more than twice the corresponding percentages for both the United States and Japan. Beijing's statistics put the figure even higher—totaling \$28.46 billion by the end of 2000⁵⁶ with two-thirds of approved new investment projects in 2000 in the electronics sector.⁵⁷ And nearly all experts agree that even Beijing's figures reveal only part of Taiwan's failure to monitor and restrain mainland investment, since many of Taiwan's investors avert government restrictions by funneling their investments through third countries, most notably Hong Kong, the British Virgin Islands, the Cayman Islands, and the United States. This led the U.S.-China Business Council's Karen Sutter to estimate that by 2002 contracted investment by Taiwan firms could be as high as \$70 billion to \$100 billion.⁵⁸

The strikingly large share of Taiwan's high-tech sector that had moved to the mainland by 1999–2000 also underscored the inadequacy of Taiwan's efforts to restrain investments in this strategic sector. By 1999, only half of Taiwan's \$40 billion worth of PCs, peripherals, and semiconductors were made at home,⁵⁹ and, by 2000, China displaced Taiwan as the world's third-largest producer of IT hardware, after the United States and Japan.⁶⁰ After the Taiwan government in 2000 lifted restrictions on manufacturing notebook PCs on mainland China, manufacturers quickly shifted much of their production to the mainland. By the end of the year, four of the five most-important Taiwan notebook PC makers—Inventec, Acer, Compal Electronics, and Arima Computer—had plants producing computer components in China.⁶¹

As the 2000 presidential election approached, the opposition DPP, anxious to attract business support while downplaying its longtime pro-Taiwan independence policies, joined the wave of criticism of Lee's restrictive cross-strait policies. DPP chairman Hsu Hsin-liang argued that "Taiwan should not be worried about the threat of military action from China in the new world order" and called for a "Go West [e.g., to China] without hesitation" policy.⁶² Chen Shui-bian, the DPP's eventual nominee for president, pledged to allow mainland Chinese firms to raise capital on the Taiwan Stock Market. Chen also promised to liberalize investment policy and allow direct transportation, trade, and postal and telecommunications links "on the condition of

⁵⁶ Sutter, 2002b, p. 528; O'Neill, 2000, p. 11.

⁵⁷ Cal Clark, "The China-Taiwan Relationship: Growing Cross-Strait Economic Integration," *Orbis*, Vol. 46, No. 4, Fall 2002, pp. 753–766 [p. 757].

⁵⁸ Sutter, 2002b, p. 528.

⁵⁹ Bruce Einhorn and Macabe Keliher, "Minds over Matter," *Business Week*, November 27, 2000, p. 142.

⁶⁰ Nicholas Lardy, *Integrating China into the Global Economy*, Washington, D.C.: Brookings Institution, 2002, p. 52.

⁶¹ Lardy, 2002, p. 53.

⁶² Soon after making these remarks, Hsu left the DPP chairmanship and ran as an independent candidate for president but still embraced an active policy of opening to the mainland.

not harming national security.”⁶³ All of the major candidates in the 2000 election embraced similar pro-opening policies, leading one experienced Taiwan journalist to summarize the shifting political balance of power by noting that “[w]hoever wins Taiwan’s presidential election . . . he will abandon Lee Teng-hui’s policy that discourages and limits investment and trade with the mainland.”⁶⁴

Cross-Strait Economic Ties Under Chen Shui-bian

The March 2000 election of DPP candidate Chen Shui-bian as president raised hopes that restrictions on trade and investment with the mainland would be eased. Chen had campaigned on promises of conditionally opening the three links, which would permit direct cross-strait trade and transportation. Like its predecessors, the Chen government has had to confront the reality that its political and administrative capacity to monitor and control cross-strait investment is limited. And also like its predecessors, Chen’s government has struggled to catch up to the rising tide of investment by repeatedly trying to forge a new policy balance.

Chen’s initial remarks on cross-strait economic relations mixed optimism with caution. In his May 20, 2000, inaugural address, Chen echoed his predecessors’ concerns about the impact of excessive industrial dependence upon the mainland. Chen also emphasized the need for Taiwan to move toward a more knowledge-based economy, with greater innovation among high-tech firms and a “transformation and upgrading” among more-traditional industries. In a December 31, 2000, speech on “bridging the new century,” Chen criticized the No Haste, Be Patient policy and called for “proactive liberalization with effective management.” Chen even expressed the hope that “the integration of our economies, trade and culture can be a starting point for gradually building faith and confidence in each other. This, in turn, can be the basis for a new framework of lasting peace and political integration.”⁶⁵

From “No Haste, Be Patient” to “Active Opening, Effective Management”

During Chen’s first year, Taiwan’s weak economy increased the pressure on him to ease policy on economic ties with the mainland. Taiwan’s rapid growth during the 1990s came to a grinding halt with the September 2000 global dot-com crash. Economic growth slowed in the fourth quarter of 2000, and in 2001, GNP contracted for the

⁶³ O’Neill, 2000, p. 11.

⁶⁴ “DPP Chief Says Business Should ‘Go West,’” *Financial Times*, Asia Intelligence Wire, January 16, 1998; O’Neill, 2000, p. 11; Young, 2000, p. 7.

⁶⁵ Quoted in *Taiwan Yearbook*, 2003, 2003, p. 94.

first time in decades, falling by 2.18 percent.⁶⁶ The collapse in global demand for electronics and computers precipitated a serious fallout in the high-tech sector. Predictably, advocates of faster opening to the mainland pointed to the economic downturn as one more justification for the policies they preferred and insisted that Taiwan companies needed to accelerate their move to the mainland with its cheaper labor rates and real estate and huge market to salvage their competitiveness.⁶⁷

Even while Taiwan faced a major economic slump with record unemployment, investment in the mainland accelerated. Taiwan's MoEA reported a record \$2.67 billion in mainland investment applications in 2001—more than double the total for 1999.⁶⁸ The wave of investment was broad as well—through the first quarter of 2001, more than 43 percent of the 384 companies listed on Taiwan's stock and over-the-counter exchanges had investments in the mainland.⁶⁹ High-tech manufacturers began pushing the envelope, with notebook computer manufacturers, such as Arima, Compal, Quanta, and Inventec, establishing major component production bases on the mainland in the hope that they would soon get the green light to manufacture entire computers there.⁷⁰

Support for this rising investment in the mainland was by no means universal in Taiwan, however, and many groups, including dedicated independence supporters, labor leaders, and a number of economists stepped up their charges that investment in the mainland was “hollowing out” Taiwan's economy and exacerbating unemployment. Restrictions on mainland investment, they argued, needed to be maintained. Their fears appeared to be confirmed during the first half of 2001, when Acer and several other top computer firms announced major layoffs in their Taiwan operations even as they were expanding employment and investment on the mainland. The Chinese government's actions also confirmed their worst fears that Beijing would take advantage of expanded economic ties to pressure Taiwan politically. Shortly after Chen's elections, Beijing's *Economic Times* attacked several Taiwan business leaders who had publicly endorsed Chen's candidacy on the eve of the election, indicating that Beijing did not welcome those “who make money here but support Taiwan independence back home.”⁷¹

⁶⁶ Republic of China, Ministry of Economic Affairs, Statistics Department, “Economic Indicators,” last updated October 31, 2006.

⁶⁷ Clark, 2002, p. 757

⁶⁸ Tkacik, 2001, pp. 43–44.

⁶⁹ Philip Liu, 2001b.

⁷⁰ Bruce Einhorn, “Facing a Shakeout, PC Makers Aren't Shrinking,” *Business Week*, April 16, 2000, p. 29; Philip Liu, “IT Migration to Mainland China Aggravates Unemployment in Taiwan,” *Taiwan Economic News*, March 12, 2001a; Philip Liu, 2001b.

⁷¹ Cited in “Separate Politics from Investment,” *China Post*, May 2, 2000.

But the powerful economic downturn undercut support for these opponents of cross-strait ties, and Chen Shui-bian's government initially sided with supporters of greater economic engagement. Even the more pro-independence Taiwan Solidarity Union (TSU; founded with support from former President Lee), which might have been expected to put up more of a fight, cautiously endorsed President Chen's economic policies.⁷² Chen's government thereupon moved quickly to loosen a number of restrictions:

- High-tech personnel from the mainland were permitted to work in Taiwan.
- Mainland economic officials and businesspeople were allowed to visit Taiwan to discuss deals.
- Taiwan's largest banks were permitted to open representative offices on the mainland, so long as they met strict regulations concerning their capital-to-risk asset ratio to prevent a flood of mainland capital.
- Offshore units of Taiwan banks were permitted to carry on transactions with a number of financial and economic actors based on the mainland.⁷³

In May 2001, President Chen reached out to Taiwan's business community for support by announcing the formation of an Economic Development Advisory Conference (EDAC). Chen charged the Conference with making recommendations on a wide array of major economic policy issues, including cross-strait relations.⁷⁴ The 125 members of the EDAC included prominent academics, think tank researchers, representatives from all of Taiwan's major political parties, and the chairpersons of many of Taiwan's most influential companies. The latter included such luminaries as Morris Chang (Taiwan Semiconductor Manufacturing Corporation [TSMC]), Robert Tsao (United Microelectronics Corporation [UMC]), Barry Lam (Quanta), Stan Shih (Acer), Frank Huang (Powerchip Semiconductor), and the dean of Taiwan's industrialists, Wang Yung-ching (Formosa Plastics).⁷⁵ The EDAC was divided into five panels, including one on cross-strait economic and trade relations that was co-chaired by Wu

⁷² In the words of a *Time* magazine correspondent, "Taiwan's two greatest assets—silicon chips and human brainpower—are fleeing to China" (Matthew Forney, "Taipei's Tech-Talent Exodus," *Time Asia*, May 21, 2001). See also Philip Liu, 2001a; and Asia Pacific Foundation of Canada, "Taiwan Accepts the Need to Expand Economic Links with China," *Asia-Pacific Bulletin*, August 30, 2001.

⁷³ Philip Liu, 2001b. To prevent an excess of mainland funding, these banks were required to have a capital-to-risk asset ratio greater than 8 percent, and they had to be among the ten largest banks in Taiwan in terms of net worth. To ease cross-strait business, the offshore banking units of Taiwan's banks were allowed to carry out transactions with the mainland branches of foreign companies and with mainland Chinese companies and citizens based abroad as well.

⁷⁴ Economic Development Advisory Conference, "Background for Convening the Economic Development Advisory Conference," Taipei: Office of the President of the Republic of China, 2001.

⁷⁵ For a complete list of EDAC members, see Economic Development Advisory Conference, list of EDAC members, Taipei: Office of the President of the Republic of China, no date.

Rong-I, director of the Taiwan Institute of Economic Research, Stan Shih of Acer, and MAC chairperson Tsai Ing-wen.

In August 2001, the EDAC announced 322 consensus recommendations, which President Chen pledged to implement in a speech at the closing meeting of the conference.⁷⁶ Among its key recommendations, the EDAC's mainland affairs panel urged the government to replace Lee Teng-hui's No Haste, Be Patient policy with one of "Active Opening, Effective Management" and to "actively promote" the establishment of direct cross-strait trade, transportation, and communications links. In its final summary report, the EDAC also recommended that the government allow businesses that had already invested in the mainland without obtaining official permission to "make the appropriate adjustments retroactively."⁷⁷

The Active Opening, Effective Management policy eliminated the \$50 million cap on individual investment projects in China and instituted a simplified review process for mainland-bound investments of less than \$20 million.⁷⁸ Moreover, the EDAC recommended that "sectors that have no further room for development in Taiwan or which can only survive by investing on the mainland should not be restricted," and those "sectors whose investment on the Chinese mainland may result in a transfer or loss of Taiwan's core technologies should be carefully evaluated."⁷⁹ In a related move, the Taiwan MoEA in August 2002 implemented new measures that require Taiwan companies with total investments of \$20 million or more on the mainland to submit quarterly reports and annual financial statements detailing their activities on the mainland to the government. The MoEA's Investment Commission also announced plans to further liberalize investment regulations by permitting direct investment in China and reducing the number of items in which Taiwan companies are prohibited from investing in on the mainland.⁸⁰ The government also announced that Taiwan companies would be permitted to invest directly in China rather than routing their investments through other countries. Additional relaxations implemented earlier in 2002 allowed

⁷⁶ For an overview of the EDAC's recommendations in the areas of economic competitiveness, investment, the financial sector, unemployment, and cross-strait economic and trade relations, see "Address at the Closing Ceremony of the Economic Development Advisory Conference: Chen Shui-bian, President, Republic of China," Taipei: Government Information Office, Republic of China, August 26, 2001.

⁷⁷ Mainland Affairs Division, Economic Development Advisory Conference, "Final Summary Report: Mainland Affairs Division, Economic Development Conference," Taipei: Government Information Office, Republic of China, August 26, 2001.

⁷⁸ For more on the relaxation of restrictions under the policy, see "Economic Ties with the Chinese Mainland," in *Republic of China Yearbook—Taiwan 2002*, Taipei: Government Information Office, Republic of China, 2002.

⁷⁹ Mainland Affairs Division, 2001.

⁸⁰ "MoEA Implementing New Measures on Investments in Mainland," *Taiwan Economic News*, July 31, 2002; "Government to Lift Investment Ban on More Items in Mainland China," *Taiwan Economic News*, August 7, 2002.

Taiwan insurance companies to establish branches in China and permitted Taiwan banks to make loans to Taiwan-invested companies operating on the mainland.

The “Mini-Three Links”

But in contrast to these major reforms, President Chen Shui-bian has proven, since his election in 2000, to be far more hesitant about following through on his conditional pledge to opening the full three links with the mainland. On January 1, 2001, President Chen offered a far more modest step in this direction by announcing that Taiwan would experimentally establish “mini-three links” (*xiao santong*). Under the mini-three links, residents of the Taiwan-held offshore islands of Jinmen (“Kinmen” or “Quemoy”) and Matsu (Matsu) are permitted to travel directly to the mainland and are permitted some direct shipping between the offshore islands and China. The mini-three links were later expanded in June 2002 to enable Taiwan businesspeople working in Fujian to travel between Taiwan and the mainland through Jinmen and Matsu and import a limited number of goods.⁸¹ As part of that expansion of the mini-three links, the Taiwan government also expanded the list of products that the offshore islands can import directly from China.⁸² In an effort to improve its ability to monitor cross-strait investment, Taiwan’s government required that these services be made available only to the families of businesspeople working for mainland-based firms that are officially registered with the MoEA.⁸³ Although the total number of direct crossings made between Taiwan and the mainland under the mini-three links is not particularly large, the relaxation of the ban on direct travel had allowed a total of 152,438 passenger trips between the offshore islands and Fujian Province, including 144,234 from the offshore islands to the mainland and 8,200 from the mainland to the offshore islands by February 2004.

Continuing Support for Diversification

President Chen’s administration also continued to support diversification into other markets, similar to Lee Teng-hui’s Go South initiative.⁸⁴ In early 2002, Chen Shui-bian again called for greater investment in Southeast Asia after he came under pressure from DPP hard-liners angry at his government’s decision to lift the ban on setting up wafer-fabricating plants on the mainland, and from mainland efforts to establish a

⁸¹ Hsieh Kuo-lien, “‘Mini Three Links’ Policy Expanded Further: Cabinet,” *China Post*, June 20, 2002.

⁸² “Cabinet Expands ‘Mini’ Links with China,” *Taiwan News*, August 1, 2002; Hsieh, 2002. The expansion of the list of commodities that can be imported directly from the mainland was intended to cut down on smuggling and to boost economic development on the offshore islands.

⁸³ “Government Expands Mini Direct Links with Mainland’s Fujian,” *Taiwan Economic News*, July 31, 2002.

⁸⁴ In August 2002, Lin Chia-lung, a senior advisor to the Taiwan National Security Bureau (NSB), said, “From a strategic perspective, Taiwan should diversify its investments by going to countries other than China to prevent a situation of over-concentration” (Lin Miao-jung, “NSC Official Claims ‘Go South’ Policy Would Help Security,” *Taipei Times*, August 28, 2002a, p. 3).

free-trade zone with ASEAN that would exclude Taiwan.⁸⁵ Huang Chih-peng, director general of the MoEA Board of Foreign Trade, said in November 2002 that he would continue to promote the Go South policy in an effort to diversify the flows of Taiwan FDI and spread the investments beyond the mainland. Southeast Asian leaders reportedly responded enthusiastically to Taipei's renewed efforts to stimulate investment in the ASEAN countries,⁸⁶ but Chinese leaders have criticized the Go South policy, alleging that it is "damaging" to cross-strait economic ties.⁸⁷

Efforts to encourage Taiwan firms to diversify their overseas operations elsewhere in Asia continue to enjoy moderate success, and, since 2001, Taiwan's trade with the region has also expanded.⁸⁸ Many experts continue to point to increasing investment in Vietnam as a relative bright spot in the Go South policy. By 2003, more than 80 percent of all Taiwan firms invested there reported that they were making a profit, and many planned on expanding their investments:⁸⁹

- Uni-President Corporation emerged as a leading supplier of animal feeds to the Vietnam market, with revenues forecast for 2003 at \$34.8 million, up more than 30 percent from 2002.
- Athletic footwear manufacturer Pou Chen—the leading contract manufacturer for Nike—decided in 2003 to double its number of production lines in Vietnam after several years of successful performance.⁹⁰

Still, the major shortcoming in Taipei's goal of using the Go South policy to minimize mainland economic leverage is that it has failed to entice Taiwan's most influential high-tech industries to see Southeast Asia as an attractive alternative to mainland China. To date, most of Taiwan's investment in the region remains in more traditional, low-tech manufacturing "sunset" enterprises.

Restricting Flows of Mainlanders to Taiwan

The record unemployment levels of the 2000–2003 recession caused the prospect of mainland Chinese workers coming to Taiwan to emerge as a highly charged politi-

⁸⁵ Keith Richburg, "Exploiting Asia's Crisis: Taiwan Buys Up Bargains and Widens Its Influence," *Washington Post*, January 22, 1998, p. A23; Goh, 2002.

⁸⁶ "Southeast Asian Nations Welcome Taiwan's 'Go South' Policy," *Taiwan Economic News*, October 27, 2002. Brunei and the Philippines are among the countries that Taiwan officials are targeting as part of the policy. Minister of Economic Affairs Lin Yi-fu visited the Philippines in 2002 and was scheduled to visit Brunei in November 2002 as part of the effort to promote Taiwan's investment in Southeast Asia.

⁸⁷ Fong Tak-ho, "Zhu Hits Out at Taipei for Damaging Trade," *South China Morning Post*, November 4, 2002.

⁸⁸ *Taiwan Yearbook*, 2003, 2003, p. 122.

⁸⁹ "Taiwan Manufacturers Increasing Investments in Vietnam," 2003.

⁹⁰ "Taiwan Manufacturers Increasing Investments in Vietnam," 2003.

cal issue in the run-up to the 2004 election. These concerns about Chinese workers are not limited to labor groups, who fear floods of low-wage semiskilled workers, but are also shared by many higher-skilled employees who worry about an influx of mainland engineers and technicians bringing down salaries. Political officials of both parties, moreover, are worried about large numbers of mainland workers producing increased crime rates, prostitution, fake marriages, and an inflow of potential spies and industrial spies. Over the past two decades, Taiwan has rigorously restricted visits to Taiwan by mainlanders, keeping them to less than 1 percent of the corresponding number of Taiwan residents who visited the mainland each year during the late 1980s and early 1990s.⁹¹

President Chen made the fight against the admission of mainland Chinese workers an important issue during the 2004 presidential campaign and a key part of his appeal to working-class voters. Interviews conducted for this project underscored the powerful emotional appeal Chen's hard line had for many workers. In June 2004, shortly after his reelection, Chen reaffirmed his policy in a meeting with labor leaders at DPP headquarters. "I will honor my six campaign promises to workers. . . . So long as I remain in office, I will not allow Chinese workers into Taiwan, and I'll continue pushing for workers' rights to be added to the constitution."⁹²

Financial Markets

With more than 60,000 Taiwan-invested enterprises now on the mainland, Chen Shui-bian's government has entered into an aggressive competition with Beijing to lure companies to hold their initial public offerings (IPOs) in Taiwan. Many government and business leaders believe that luring more capital—including foreign capital—into the Taiwan Stock Exchange is a key step in developing Taiwan's knowledge-based and high-tech economy and thereby loosening Beijing's economic influence over the island. Like Beijing, Taiwan also sees enormous potential to expand its markets through foreign investment in these growing mainland-invested firms.

Taipei's major dilemma is how to loosen restrictions on foreign capital coming into its markets while controlling mainland China's ability to expand its financial influence on the island. Before 2003, Taiwan's regulations permitted mainland-invested firms to list on the Taiwan exchange only if their mainland investments constituted no more than 20 to 40 percent of their net asset value. Since 2003, Taiwan has reportedly considered proposals to raise the maximum allowable mainland investment to 60 percent of net asset value while still allowing firms with higher percentages than that to list if they opened a major research and development center or a regional headquarters in Taiwan. But as of early 2006 this policy had yet to be adopted, and business experts were blaming the policy in part for a growing move toward Taiwan firms having their

⁹¹ Zhao, 1999, p. 30.

⁹² Chang Yun-ping, "Chen Promises to Ban Chinese Workers," *Taipei Times*, June 16, 2004, p. 3.

IPOs in Hong Kong. Some financial experts have argued that these policies aimed at luring Taiwan-owned firms to list in Taiwan would also have the benefit of enhancing the transparency of their ownership structures and improve Taiwan's ability to monitor cross-strait investment flows. Beijing has responded by granting approval to a few Taiwan-invested firms to list on the mainland's A-share market.⁹³

Using Technological Limitations and Recent Semiconductor Business

According to several experts interviewed for this study, limitations on technology remain one of Taiwan's more powerful systems for slowing and regulating Taiwan investment on the mainland. By requiring Taiwan corporations to seek approval before investing in production of advanced products on the mainland—approval that the government has often withheld for years—the government tries to maintain a significant technological “gap” or “lag” between the level of products these firms can produce in Taiwan and those it makes in China. The government hopes this gap will create powerful incentives for these firms to continue making major investments in the upgrading of Taiwan's domestic “knowledge-based economy.”

For several years, a major battle raged over Taipei's requirement that semiconductor companies apply for permission before investing in the mainland and the limitations Taipei places on the level of technology they can produce there. Taiwan's semiconductor manufacturers have, for a variety of reasons, pushed hard to obtain government permission to increase the technological level of their mainland investments.⁹⁴ The sheer size and rapid growth of China's market for semiconductors places terrific pressure on Taiwan firms to relocate there. China is expected to become the world's second-largest market for semiconductors by the end of this decade.⁹⁵ Until late 2004, one of the most widely cited justifications for new semiconductor investment had been the value-added tax that the PRC slapped on imported semiconductors used to manufacture products on the mainland, which is 14 percent higher than for domestically produced chips.⁹⁶ More recently, Taiwan firms have felt pressured to aggressively raise

⁹³ Ting-I Tsai, “Hong Kong's Pull Threatens Taiwan's Bourse,” *Asia Times*, June 16, 2006; Kathrin Hille and Richard McGregor, “Taiwan and China Play Tug of War,” *Financial Times*, October 7, 2003, p. 32.

⁹⁴ For Taiwan computer chip manufacturers, the prospect of moving to the mainland is not without its dilemmas. China's weak protection for intellectual property rights creates significant risks for Taiwan firms that relocate there, because their business model relies heavily upon their ability to protect the inviolability of the chip designs that other firms design for them. This dilemma is, of course, sharpest for TSMC's and UMC's most advanced chip designs, and these firms are less anxious to move production of these designs to the mainland. Of greater interest to these firms is getting a mainland foothold for production of their somewhat less-advanced chips that are widely used in computers, cell phones, and other products manufactured on the mainland. The author thanks RAND colleagues Michael Chase and James Mulvenon for clarifying this point.

⁹⁵ “Chipmakers Warned of China Threat,” *Taiwan Weekly Business Bulletin*, U.S.-Taiwan Business Council, May 14–20, 2004.

⁹⁶ On July 8, 2004, China reached an agreement with the United States to remove this subsidy after a U.S. claim against China with the WTO. Semiconductor industry experts believe that this agreement to remove subsidies,

the level of their mainland-produced chips in order to stave off new mainland-based foundry suppliers (most notably Semiconductor Manufacturing International Corporation [SMIC]), who reportedly have spent or plan to spend billions of dollars on new equipment to narrow the gap with their foreign rivals.⁹⁷

In the battle over semiconductor technology levels, President Chen found himself caught between these powerful companies and hard-liners within his own party and the TSU who have characterized such investments as perhaps the single greatest symbolic step toward “hollowing out” Taiwan’s economy.⁹⁸ Some Taiwan business experts have characterized President Chen as a powerful advocate of these regulations on technology and a “hurdle to semiconductor companies doing business with China due to his party’s pro-Taiwan independence leanings.”⁹⁹ Several of Chen’s key mainland policy advisors, on the other hand, feel that many top Taiwan businesspeople want to rush into expanded mainland investment too quickly. High-ranking MAC and economic advisors have argued if Taiwan high-tech firms simply relocated to the mainland to achieve a cost savings, they would never move into the type of higher-technology, higher-value-added operations needed to compete with China and with firms from more developed countries in areas such as services, product design, production integration, and distribution.¹⁰⁰

According to several sources, the Chen government held a series of meetings with TSMC and other semiconductor industry representatives during 2003–2004 to reconsider the technological limits on factory investment on the mainland, and, shortly before the presidential election, the Chen administration reportedly gave its word that it would permit Taiwan semiconductor manufacturers to move ahead with their plans to set up on the mainland.¹⁰¹ Right after the election, Chen reached out to the semiconductor industry by meeting with TSMC CEO Morris Chang. The result of the negotiations was government approval in April 2004 for TSMC to move 8-inch manu-

if it is applied to Taiwan companies, could “pave the way for fair competition among chip manufacturers, and lend a helping hand to Taiwan’s bid to keep its domestic chip producers at home” (U.S.-Taiwan Business Council, *Semiconductor Report*, second quarter 2004b, p. 19).

⁹⁷ According to a recent *Taipei Times* report cited in the *Taiwan Business Bulletin*, “Semiconductor Manufacturing [SMIC] plans to spend as much as TSMC—US\$2 billion (NT\$67.03 billion)—on new equipment” in 2004 in an effort to seize the number-three spot among the world’s contracted chipmakers. This report also states that mainland competitors are already planning their own 12-inch fabs (plants for the fabrication of 12-inch semiconductor wafers) (“Chipmakers Warned of China Threat,” 2004).

⁹⁸ As noted above, in early 2002, Chen reportedly faced protests from individuals within his own party who objected to the government’s decision to lift the ban on establishing wafer-fabricating plants on the mainland (Goh, 2002).

⁹⁹ “Chipmakers Warned of China Threat,” 2004; U.S.-Taiwan Business Council, *Semiconductor Report*, first quarter 2004a, p. 5.

¹⁰⁰ See, for example, interviews with Deng and Chen in Goh, 2001.

¹⁰¹ Quoted in U.S.-Taiwan Business Council, 2004a, p. 5.

facturing equipment to a new factory in Shanghai—making it the first Taiwan firm to receive official permission to finish a plant and begin producing semiconductors on the mainland. TSMC announced that it planned to invest \$898 million in the project.¹⁰²

But the delays caused by the negotiations may have subtly accomplished the Chen administration's goal of maintaining a technology gap. The equipment TSMC planned to move to the mainland factory was far from its best and was reportedly already idled on Taiwan. Even DPP officials who were critical of rapidly expanding cross-strait relations described the equipment as "outmoded."¹⁰³ And even though the U.S.-Taiwan Business Council noted speculation at the time that Taiwan was considering further loosening the technological restrictions on TSMC's mainland investments, CEO Morris Chang stated at the time that his company had no plans to try to move even 0.18-micron processing technologies—still below the company's best—across the strait anytime soon. In a June 2004 interview at Taiwan's Computex Computer Exposition, Chang stated that TSMC planned on expanding its domestic capacities in 0.13-micron technologies and expected to produce large quantities of chips using 65-nanometer processing technologies by late 2006–2007, and planned on opening several new 12-inch fabs in Taiwan by late 2005.¹⁰⁴

Moreover, many factors other than Taiwan government restrictions on technology levels limit cross-strait investment in semiconductor manufacturing and other high-tech products—and the relative importance of these factors and government restrictions is difficult to evaluate. Even industry experts who strongly support a loosening of restrictions on cross-strait investment note that "there are far more important considerations" that discourage these firms from establishing new operations on the mainland. These include tax breaks and low-rent land deals offered by the Taiwan government, continued Taiwan government restrictions on companies performing chip design on the mainland, China's still-lagging infrastructure for semiconductor manufacturers (such as chemical and gas suppliers and reliable sources of clean water), and the fact that companies such as TSMC gain far less advantage from China's lower labor costs than do companies in most other industrial sectors.¹⁰⁵ Finally, China greatly undercuts its own case for attracting high-tech manufacturers by its continued failure to provide serious legal protection for intellectual property—a pivotal element in the business strategy of firms such as TSMC and UMC whose reputations rely upon their ability to protect the chip designs of the companies for whom they produce. This failure has

¹⁰²U.S.-Taiwan Business Council, 2004b, pp. 5–13.

¹⁰³Lisa Wang, "TSMC Predicts 30% Growth for Industry," *Taipei Times*, June 4, 2004, p. 10; interviews conducted in Taipei and Beijing, 2004; "Chipmakers Warned of China Threat," 2004.

¹⁰⁴"Chipmakers Warned of China Threat," 2004; U.S.-Taiwan Business Council, 2004a, p. 5. TSMC reportedly announced it already had some 65nm designs in large-scale production by the end of 2005, according to industry reports (Jeff Chappell, "Have the Foundries Caught Up?" *EDN*, June 1, 2005).

¹⁰⁵U.S.-Taiwan Business Council, 2004b, pp. 7–9.

been underscored in recent years by a number of high-profile intellectual theft cases in the mainland semiconductor industry, such as TSMC's claims that SMIC had stolen its designs, or the highly touted case of the dean of Jiaotong University's (Shanghai) Microelectronics School, who was discovered to have stolen a Freescale Semiconductor design for an advanced digital signals processing chip and claimed to have invented it.¹⁰⁶

Although limits on high-tech investment remain, in the words of industry experts, "one of Taipei's main political tools against China," enforcement of these rules continues to be a problem. Many high-tech firms continue to show great creativity in skirting or violating the law. According to one report, although "the Taiwan government still enforces a ban on shifting chip design work to China . . . a number of firms have set up 'sales offices' there and are doing extensive collaboration with universities" to train mainland chip design engineers and are "shifting some lower-end design work to Chinese offices."¹⁰⁷

Ongoing Battles over the Full Three Links

President Chen's 2001 decision to authorize the mini-three links has not prevented the debate over the full three links from reemerging as a highly charged political issue, both within Taiwan and between Taipei and Beijing. On the one hand, Chen faces pressure from the business community and the major opposition parties—the GMD and the People's First Party (PFP)—to pursue the establishment of direct links and further ease investment restrictions. On the other hand, Chen must manage the demands of some of his own DPP constituents and his allies in the TSU, who fear that increasing economic integration with the mainland will accelerate the "hollowing out" of Taiwan's industry, increase unemployment, and diminish Taiwan's prospects for political independence.¹⁰⁸

President Chen has maneuvered to find a policy that would disarm critics who say he is moving too slowly on establishing the three links—especially business critics—while satisfying opponents of an excessively rapid opening to China within his DPP and other parties. Since 2002, Chen's strategy has been to consistently reaffirm that he in principle supports negotiating the three links with Beijing. But both Chen's government and Beijing have also insisted on preconditions to three-links talks that

¹⁰⁶CEO Fred Wong of Shanghai's BCD Semiconductor Manufacturing company notes, for example, that legal intellectual property protection in China is still weak and that companies like his must therefore "establish their own discipline—and retain employees through profit sharing and having a clear incentive program" (U.S.-Taiwan Business Council, 2004b, pp. 12–13). See also Richard McGregor, "Fake Chip Storm Rocks China's Scientific Elite," *Financial Times*, May 14, 2006; Peter Enav, "Taiwan Confident of Retaining Chip Lead Over China," *Ventura County Star* (California), May 15, 2006; and Mark Osborne, "SMIC's Growth Restricted in Sake of Profitability," *Semiconductor Fabtech*, March 27, 2006.

¹⁰⁷U.S.-Taiwan Business Council, 2004b, pp. 5, 12–13.

¹⁰⁸Jason Dean, "Strait Signals," *Far Eastern Economic Review*, June 20, 2002.

the other side claims to find unacceptable. Progress on the three links has, therefore, become intertwined with Taiwan and Beijing's highly charged, symbol-laden debates over such issues as Taiwan's sovereignty and willingness to accept the "one China" principle. Until one side or the other makes a significant concession on these issues, there is unlikely to be major progress on establishing the three links.

The limitations and conditions on President Chen's cross-strait economic engagement policy became clearer in 2002, when Beijing stepped up its efforts to drive a wedge between President Chen and supporters of expanded cross-strait economic ties. Speaking through Vice Premier Qian Qichen, Beijing signaled that it might be willing to adopt a more flexible approach to negotiations on establishing direct links, though it still insisted that any such negotiations be unofficial and held between "private" organizations. In a January 24, 2002, press conference, PRC Vice Premier Qian Qichen reiterated Beijing's charge that President Chen's refusal to accept the principle of one China and to recognize the "1992 consensus" was the crucial reason for the stalemate in cross-strait relations. But he also stated that "political differences must not interfere with economic and trade exchanges between the two sides of the strait" and that Beijing was "willing to hear opinions from people in Taiwan on the establishment of a mechanism for economic cooperation and the promotion of economic relations between the two sides."¹⁰⁹ Later, in an October 2002 interview with the Taiwan newspaper *United Daily News*, Qian said China views the three links as an economic, not a political, matter and indicated Beijing was willing to characterize the links as "cross-strait" rather than "domestic."

Qian's comments were seen by many analysts as indicative of Beijing's willingness to adopt a more flexible approach toward Taiwan. On October 18, 2002, Beijing's official English-language newspaper, the *China Daily*, repeated Qian's remarks and explicitly stated that they represented a "goodwill gesture, aimed at depoliticizing the definition of direct transport links between Taiwan and the mainland" and represented "a major effort by Beijing" to promote the establishment of the three links.¹¹⁰ More recently, Beijing reiterated its willingness to hold discussions on the three links despite President Chen's refusal to accept the "one China" principle. In a document issued in 2003 by the State Council's Taiwan Affairs Office, China once again proposed shelving political disputes and suggested authorizing nongovernmental trade organizations to negotiate the establishment of the three links. The document indicated, however,

¹⁰⁹Originally reported in *People's Daily* and Xinhua, January 24, 2002, quoted in Shirley A. Kan, *China/Taiwan: Evolution of the "One China" Policy—Key Statements from Washington, Beijing, and Taipei*, Congressional Research Service Report, RL30341, updated September 7, 2006, p. 71. Qian's statement also invited DPP members who were not "stubborn 'Taiwan independence'" advocates to visit the mainland and omitted a reiteration of Beijing's threat to use force.

¹¹⁰"Mainland Offers Taiwan Goodwill Gesture," *China Daily*, October 18, 2002.

that Beijing had not dropped its insistence that the participants in the discussions must be private groups representing the two sides, rather than government officials.¹¹¹

President Chen's government rejected Beijing's suggestion that nongovernmental groups alone could negotiate a resumption of direct links and continued to hold that official government representatives should play some role in the negotiations. Chen said in early November 2002 that Beijing had "misjudged the situation and wasted time" by insisting that civil groups alone could handle the negotiations. "This issue cannot be entirely handed down to nongovernmental groups. The government must eventually get involved," Chen said in a meeting with visiting U.S. scholars.¹¹² In a July 2003 interview with foreign journalists, President Chen pledged that Taiwan would not establish "direct links for the sake of direct links," and said cross-strait economic ties are "already close enough."¹¹³

Taiwan media reports at the time suggested that the government's position might be somewhat more flexible and that it might consider allowing a nongovernmental organization to represent Taiwan in the negotiations, as the Lee administration did during talks on flights between Taiwan and Hong Kong at the time of Hong Kong's return to China.¹¹⁴ In a possible sign that the Hong Kong talks might be a model for negotiations on the three links, a delegation of officials from the Civil Aviation Administration of China visited Taiwan for meetings with executives from China Airlines in early November 2002. According to Taiwan press reports, a Taiwan nongovernmental group arranged the visit on behalf of Taiwan's MAC.¹¹⁵

Business and Opposition Party Reactions

Among Taiwan's business community, initial evaluations of Chen Shui-bian's first two years in office were relatively positive. To be sure, many executives continued to press the government to enter into negotiations to establish the three links. But surveys of business leaders indicated that they were, by and large, satisfied with the easing of Lee

¹¹¹ The document is excerpted in "Mainland Reiterates Policy on 'Three Direct Links' Across Taiwan Straits," Xinhua, December 17, 2003.

¹¹² "Chen Says Beijing 'Misjudged' Situation on Three Links," *Taiwan News*, November 5, 2002; Lin Chieh-Yu, "Chen Insists Links Need Official Talks," *Taipei Times*, November 1, 2002.

¹¹³ For Chen's comments, see Jason Dean and Michael Vatikiotis, "Chen Shui-bian: Political Pugilist," *Far Eastern Economic Review*, July 31, 2003a; and Jason Dean and Michael Vatikiotis, "Taiwan: Politics First, the Economy Second," *Far Eastern Economic Review*, July 31, 2003b.

¹¹⁴ See, for example, Wu Tien-jung, "Government Assessment: Mainland Is Sincere in Pushing Forward Three Links," *China Times*, November 11, 2002.

¹¹⁵ "Mainland Chinese Aviation Officials in Taiwan for Visit," *China Post*, November 3, 2002.

Teng-hui's policies, the implementation of the EDAC's recommendations, and their generally improved access to Chen administration officials.¹¹⁶

But a real turning point came in 2002, when the combination of Taiwan's economic troubles and Qian Qichen's remarks, which seemed to signal some flexibility in Beijing's stance, led several senior Taiwan business leaders to call on the Chen administration to pick up the pace on negotiating direct cross-strait links.

- Formosa Plastics Chairman Wang Yung-ching, for example, repeatedly called for the early establishment of direct links, warning that the competitiveness of Taiwan companies operating in China would decline if China and Taiwan do not move quickly to establish the three links. "If they [the three links] are not open, all our businesses in China will lose their competitiveness in three years," Wang said.¹¹⁷
- Acer CEO Stan Shih took a more subtle approach, arguing that establishment of the three links was necessary to revitalize Taiwan's regional economic role—a goal the Chen administration supports. Shih has warned that without direct cross-strait trade and transport links to China's enormous market, Taiwan will find it hard to attract and retain foreign multinational companies that might otherwise wish to base their operations there.¹¹⁸

Several business leaders began calling on Taipei and Beijing to adopt negotiating proposals that would require greater concessions from both sides or to set aside disputes over such "political" considerations as the one China principle, the 1992 consensus, and the official status of talks and focus instead on economic engagement. Wang Yung-ching has put forward several such proposals over the years, calling for negotiations on the basis of a "one nation, two governments" formula, which suggested less independence and sovereignty than Chen Shui-bian's government has insisted upon and far more sovereignty for Taiwan than Beijing has been willing to accept.¹¹⁹ Wang has also disagreed with the Chen government's position and argued that Taipei should allow private businesses to enter into negotiations with their Chinese counterparts over

¹¹⁶In a September 2001 survey of Taiwan companies with operations on the mainland, for example, about 75 percent of respondents indicated that they support the Active Opening, Effective Management policy. Taipei Computer Association chairman Huang Chung-jen and Acer CEO Stan Shih were among those commending the government for its efforts to implement the EDAC's recommendations. These points were also raised in interviews with Taiwan businesspeople, Taipei, April 2002.

¹¹⁷See, for example, "Industry Leader Calls Again for Direct Links with China," *Taiwan Economic News*, April 16, 2002.

¹¹⁸See, for example, Tim Culpán, "Acer Laments Taiwan Links Ban," *South China Morning Post*, July 11, 2002.

¹¹⁹"Industry Leaders Pressing for '3 Direct Links' with Mainland China," *Taiwan Economic News*, May 22, 2002.

the establishment of direct links.¹²⁰ Uni-President CEO Kao Chin-yen said in May 2002 that all companies in Taiwan support the three links, and he called for shelving the thorny political issues that were obstructing negotiations and focus only on economic issues for the next 50 years.¹²¹

As with President Lee Teng-hui before him, President Chen's statements suggesting that Taiwan is already independent of China—and Beijing's reaction to those statements—have worried many within the Taiwan business community. Chen's August 3, 2002, public statement that Taiwan and China were two states, one on each side of the Taiwan Strait (*yibian yiguo*), and China's denunciation of the remark as a "brazen provocation" caused significant consternation among businesspeople and sparked a 5.8 percent one-day falloff in the Taiwan Stock Exchange.¹²² Although many of Taiwan's top chief executives were already firmly allied with the opposition GMD, by late 2003 even some of Chen's former backers in the business community, concerned about deteriorating cross-strait relations and frustrated with the lack of progress on direct links, were hinting that they were ready to throw their support behind the GMD opposition in the 2004 presidential election.¹²³

President Chen has also had to fight efforts by opposition GMD legislators to force a softening of Chen's conditional stance on the three links. In addition to pressure from business leaders and the GMD, Chen's government has also had to confront widespread, growing popular support for the establishment of the three links.¹²⁴ But Chen's conditional policy on the three links has found allies among independence advocates who are wary that establishment of the three links would increase Taiwan's dependence on the mainland, enable China to exert greater leverage against the island, and "totally undermine Taiwan's national security . . . leaving it fewer and fewer cards to play in its attempt to resist China's ever-mounting pressure and blackmail."¹²⁵

In addition to insisting on conditions for negotiating the three links, Chen's government has also since 2003 adopted what appears to be a delaying strategy designed

¹²⁰ "Businesses to Lose Edge for Lack of Three Links," *China Post*, October 25, 2002.

¹²¹ "Industry Leaders Pressing for '3 Direct Links' with Mainland China," 2002.

¹²² Keith Bradsher, "Taiwan Market Falls as Ties with Beijing Worsen," *New York Times*, August 6, 2002, p. 1. For the full text of Chen's remark, see *Taiwan Yearbook*, 2003, 2003, p. 94.

¹²³ See, for example, Jason Dean, "Losing Business," *Far Eastern Economic Review*, February 19, 2004. See also "Taiwanese Expats Exert Their Clout," *South China Morning Post*, February 23, 2004.

¹²⁴ Regular surveys in recent years conducted by the National Chengchih University had shown as many as 70 percent of Taiwan residents favoring the resumption of direct links across the Taiwan Strait. The survey results of this regular polling question are available at Mainland Affairs Council, "Public Opinion on Cross-Strait Relations in the Republic of China," last updated September 2006. See also Lin Miao-jung, "China Links Viewed with Caution," *Taipei Times*, October 26, 2002b, p. 4. Although most respondents favor opening direct links, roughly two-thirds said they were concerned that the links might result in increased capital outflow and unemployment as well as more movement of high-technology personnel to the mainland.

¹²⁵ "Dangers of Embracing China," *Taiwan News*, August 28, 2001.

to disarm his critics. His government has expressed support for the three links in principle, but also spotlighted a daunting list of specific economic, administrative, and national security obstacles that would have to be overcome before the links could be established. In February 2003, Premier Yu Shyi-kun, responding to pressure for faster progress toward the three links, ordered several cabinet agencies to undertake a further study of their impact. In August 2003, the Executive Yuan issued a cost/risk-benefits report analyzing the likely impact of direct transportation links. The report conceded that the opening of direct air and shipping links would greatly reduce the costs and inconvenience associated with cross-strait travel, investment, and commerce. The report's estimates include the following:

- Opening of direct sea transportation would result in a reduction of shipping costs of around \$820 million (NTD) per year (estimates vary between \$800 million [NTD] and \$1.2 billion [NTD]).
- Shipping times would be cut by about one half.
- Direct air transport would reduce passenger travel costs by \$13.2 billion (NTD) per year.
- Travel time annually between Taiwan and mainland locations, such as Shanghai and Beijing, would be reduced by about 8.6 million person-hours.
- The combination of direct sea and air transport links would cut the transport costs for some individual enterprises by an estimated 15–30 percent.
- Direct sea and air transportation would greatly enhance Taiwan's attractiveness as a regional corporate headquarters and air-cargo, air-passenger, and sea transport link, and strengthen the role of Taiwan's major port cities.

But the Chen government's report also placed as much emphasis on the numerous potential disadvantages, risks, and obstacles of direct ties as on the potential advantages. The report charged that a large increase in mainland imports "could deal a blow to domestic industries, reduce Taiwan's trade surplus, and cause deflation to emerge." It also stressed the potential negative impact on agricultural industry and fishing and on domestic investment in Taiwan (especially in high technology). Politically, the report's most notable charge probably was that direct transportation links "could exacerbate structural unemployment" and drive many higher-grade employees to leave for the mainland seeking work.¹²⁶

In particular, the report gave ample emphasis to recent concerns voiced by senior Taiwan national security officials regarding the potential security implications of direct links—especially direct flights from the mainland. In recent years, military and Ministry of National Defense (MND) officials have argued that cross-strait flights should

¹²⁶Related Agencies of the Executive Yuan, Republic of China, *Summary of Main Findings in the Assessment of the Impact of Direct Cross-Strait Transportation*, Taipei, August 15, 2003.

take somewhat circuitous routes rather than flying directly across the Taiwan Strait, and that it would be too dangerous to allow these flights to land at Sungshan Airport in Taipei.¹²⁷ Alluding to all of the problems that needed to be worked out, Taiwan National Security Council Secretary General Chiou I-jen said in early November 2002 that it might take as long as three to five years to complete negotiations on direct flights between China and Taiwan.¹²⁸

Holiday Direct Flights

For the past four years, in lieu of progress on negotiations toward a permanent establishment of direct transportation links, the central focus of these battles has been the cyclical issue of permitting temporary direct charter flights between Taiwan and the mainland during the Lunar (“Chinese”) New Year’s and other holidays. The ad hoc nature of the negotiations over flights, which did not permanently commit the government to any particular form of talks, plus their annual, cyclical character, has made them a convenient substitute for more fundamental progress toward the three links. And while each set of these talks raises hopes that permanent arrangements on direct transport will evolve out of them, it is often difficult to determine how much progress toward long-term arrangements they represent.

The issue was revived in October 2002, when opposition legislators called on the Chen government to allow direct charter flights between Taipei and Shanghai during the 2003 Chinese New Year holiday, when as many as 300,000 Taiwan workers employed on the mainland were expected to return to the island to visit friends and relatives. GMD legislators who organized a petition supporting the charter flights said they would give the government an opportunity “to test the feasibility of full-scale direct air links.”¹²⁹ But Chen’s government resisted the lawmakers’ entreaties, saying it would only grant permission for indirect charter flights routed through Hong Kong or Macao. Premier Yu Shyi-kun insisted that direct cross-Strait flights of any sort would require the completion of negotiations between the governments of China and Taiwan.¹³⁰ In the end, an agreement was reached that allowed charter flights in late January and early February 2003. But even though the passengers did not have

¹²⁷Brian Hsu, “MND Aims Direct Links Provisions,” *Taipei Times*, November 8, 2002, p. 1; “Intelligence: Taiwan’s Top Guns Ready for Air Link,” *Far Eastern Economic Review*, November 14, 2002.

¹²⁸“Direct Flight Links Still Three to Five Years Away,” *China Post*, November 10, 2002.

¹²⁹“Taipei’s Lawmakers Seek Charter Flights to China,” Associated Press, October 28, 2002; and Lin Miao-jung, “Charter Flight Issue Gains Steam,” *Taipei Times*, October 28, 2002c, p. 3.

¹³⁰See Crystal Hsu, “John Chang Wishes Government Would Be More Responsive on Charter Flights,” *Taipei Times*, November 13, 2002b, p. 3; and Crystal Hsu and Lin Miao-Jung, “Yu Sticks to His Guns on China Flights,” *Taipei Times*, November 13, 2002, p. 1.

to change planes, Taipei did require the flights to take a time-consuming "L-shaped" path including a stopover in Hong Kong.

After a failure to negotiate holiday flights for the 2004 Lunar New Year, the issue was revived again in 2005. This time, shifting political trends in Beijing and Taipei created an opening for greater flexibility on both sides. Press reports indicate that throughout the fall of 2004 the Chen administration, which was locked in an electoral campaign to retake control of the Legislative Yuan (LY), had made a number of entreaties to Beijing to resume talks on charter flights. Beijing, apparently unwilling to give Chen a pre-electoral victory, demurred until January. But the pan-Blue coalition's surprise victory in the December LY elections left Chen surprisingly weakened and desirous of reviving his support among the business community. Chen's defeat also coincided with the beginnings of a major reconsideration of Taiwan policy in Beijing, and the Hu government was anxious to reach a deal that would strengthen its appeal among Chen's business critics. In early January, Beijing suddenly announced that it was anxious to reach an agreement on the flights, and, as in 2002, it did not press for any prior assertion of Chen's acceptance of the one China principle. The two sides tacitly arranged a negotiating format that would allow each to claim its conditions on official government involvement had been satisfied. Taiwan's MAC delegated negotiating authority to its nongovernmental industry association, the Taipei Airlines Association (TAA), but sent along TAA board member Billy Chang, who is also Director General of Taiwan's Civil Aeronautics Administration, to take part in the discussions. A cabinet spokesman described the TAA's negotiating status as "entrusted by the government to act as representatives in negotiating the matter." Beijing was represented by the officially unofficial China Civil Aviation Association, and stressed the fact that no officials of either Taiwan's MAC or the Straits Exchange Foundation (SEF) were taking part, as though this satisfied its insistence upon "unofficial" talks. In the end, the two sides, meeting in Macao, agreed upon a schedule of 48 direct flights connecting Taipei and Kaohsiung and Beijing, Shanghai, and Guangzhou. The "Macao Model" that permitted both sides to claim they had reached the agreement without compromising fundamental principles was initially hailed as a breakthrough with potential long-term applicability, and a similar arrangement was negotiated in 2006. But the Chen administration has continued to insist that more explicit official government participation, involving, for example, customs, taxation, and transport safety officials, would be necessary to negotiate any permanent direct transportation arrangement.¹³¹

¹³¹ "Beijing Receptive to Direct Flights Between Mainland and Taiwan," *Voice of America*, January 3, 2005; Kathrin Hille, "China-Taiwan Chartered Flight Talks to Resume," *Financial Times*, January 4, 2005; "China Agrees to Direct Charter Flight Talks with Taiwan" Reuters, January 10, 2005; "Beijing Reveals Plan for Cross-Strait Charter Flights," *China Daily*, January 11, 2005; Ko Shu-ling and Melody Chen, "Optimism Rising Over Cross-Strait Flight Agreement," *Taipei Times*, January 13, 2005, p. 1; Xing Zhigang, "Call for Official Talks on Charter Flights Rejected," *China Daily*, January 12, 2005; Phillip Pan and Tim Culpan, "China, Taiwan Agree to Direct Flights," *Washington Post*, January 16, 2005, p. A21.

On balance, President Chen's government has shown considerable tenacity and political skill in resisting pressure to rush the permanent establishment of the three links, even in the face of widespread popular support for the general idea of opening up the three links. Chen has cautioned that the establishment of direct cross-strait links "is not a cure-all medicine" for Taiwan's economic problems, and Premier Yu Shyi-kun has warned that it would be incorrect for people to view the links as "a panacea to all of our problems."¹³² Before Taiwan's 2004 presidential election, many Taiwan researchers and journalists forecast that owing to Taiwan's difficult economic conditions and pressure from the business sector, Chen would have no choice but to cave in to pressure to establish the three links in the months leading up to the election.¹³³ Nearly two years after the election, however, Chen renewed his criticisms of excessively fast economic engagement, and forecasts of an immediate breakthrough on the three links remain unfulfilled.

Conclusion: Overall Evaluations of Taiwan's Government Policy

Since Taiwan began dropping its ban on economic relations with the mainland in the early 1980s, its government has been locked in a rear-guard action—trying to devise new policies that could limit Taiwan's dependence upon the mainland and Beijing's ability to use economic relations to pressure Taiwan politically. During this period, cross-strait economic ties have grown dramatically—from essentially negligible economic relations to a point where trade and investment with China now play a pivotal role in Taiwan's economic health (the extent of this growth is the topic of the next chapter). The administrations of Taiwan presidents Lee Teng-hui and Chen Shui-bian have both been pressured to loosen restrictions on cross-strait ties by political leaders, business groups, and popular opinion, and by the very fact of Taiwan's decelerating economic growth. But both have also tried to control and slow the pace of cross-strait ties, driven by their own personal concerns over PRC economic coercion as well as by demands from political groups fearing greater dependence on China, Taiwan independence advocates, labor interests, and their own security officials. Several powerful contextual factors have greatly complicated Taipei's efforts to manage the economic opening to China—the emergence of a vibrant political democracy in Taiwan, Taiwan's economic transformation away from a low-wage manufacturer, the rise of pro-Taiwan independence popular sentiments, and China's dramatic rise as both a low-cost producer and a vast market.

Overall evaluations of Taiwan's effectiveness in developing policies to limit its dependence upon China vary significantly. Political scientist Suisheng Zhao argues

¹³²"Chen Alerts 'Three Links' Not a Cure-All Medicine," *Taiwan News*, October 24, 2002.

¹³³Interviews with Taiwan researchers and journalists, Washington, D.C., January and February 2003.

that Taiwan's government has been "quite effective" in regulating the pace of economic relations across the two straits.¹³⁴

But virtually all of the sources interviewed for this study—including current and former DPP and GMD officials, Taiwan businesspeople, Western business analysts, and PRC experts—displayed a surprising consensus in their evaluation of the ineffectiveness of most Taiwan government policies designed to slow the expansion of cross-strait economic ties. When asked specifically to identify any policy that, in their evaluation, had been reasonably effective in limiting or regulating economic relations, nearly all were hard-pressed to name more than one or two such policies, and most said they could not think of any particularly effective policies.

Several PRC experts interviewed for this study shared this assessment. They noted that Presidents Lee and Chen have felt politically constrained to make several key policy changes loosening cross-strait economic links—raising the \$50 million cap on Taiwan investments in the PRC, easing limits on technology levels, establishing the "mini-three links," and other such changes. But, overwhelmingly, they evaluated Taiwan's past and current restrictions—the Go South policy; No Haste, Be Patient; investment-level restrictions—as largely ineffectual in doing more than making cross-strait business more inconvenient or slowing slightly its pace of growth.

Among the several shortcomings in Taiwan's efforts to limit economic ties to the mainland, experts from Taiwan, mainland China, and Western countries highlighted the following points:

- Many experts have stressed that Taipei has been forced repeatedly to loosen its restrictions and maximum limits on mainland investment under the original ban on investment, President Lee's now-defunct No Haste, Be Patient policy, and several other policies.
- The balance of Taiwan's investment in the mainland has clearly shifted from low-wage manufacturing "sunset" industries to higher-technology industries that are more essential to Taiwan's economic future.
- Although Taipei has devised numerous regulations and incentives to strengthen its ability to monitor cross-strait investment, the large gap between Taiwan's official estimates of mainland investment and those of the PRC and various foreign experts testify to the continued weakness of Taipei's monitoring ability.
- Persistent efforts by the government to encourage Taiwan businesses intent on outsourcing to "Go South"—investing in Southeast Asia rather than the mainland—have produced relatively modest, uneven results and did not succeed in stemming the tide of investment to the mainland or in encouraging Taiwan's high-tech firms to diversify to that region.

¹³⁴Zhao, 1999, p. 30.

Some of these pessimistic evaluations of Taiwan's capacity to limit mainland economic influence may be somewhat overstated. To be sure, Taiwan's policy efforts to limit dependence on the mainland have been uneven and in many cases not very effective. But it is also true, in the words of journalists Bruce Gilley and Maureen Pao, that "Taipei is not defenceless. It retains significant policy-based restrictions which protect its capital markets and economy from China."¹³⁵

Taiwan also still places significant restrictions on the products that can be imported from Beijing. One scholar has calculated that of more than 10,000 items listed on the Harmonized Tariff Schedule, Taiwan permits only about 53 percent of them to be imported from the mainland.¹³⁶ Government policies have also kept a lid on the number of mainland workers who can emigrate to Taiwan.

Many experts regard Taiwan's regulations limiting the technological levels of cross-strait investments as one of Taipei's more effective tools for governing the pace of cross-strait ties. Unquestionably, many firms have shown considerable skill in skirting or getting around these policies, while others have resisted moving their most advanced production to the mainland for reasons that have more to do with protecting corporate intellectual property rights than government regulations. Still, there remains significant evidence that these review processes are helping Taipei to maintain a technological gap between the domestic and the mainland-based operations of Taiwan companies.

Finally, on the pivotal issue of lifting Taiwan's ban on direct trade, air, and sea links to the mainland, the administration of President Lee and especially that of President Chen Shui-bian have been very adept politically in resisting pressure from the mainland and from Taiwan business interests.¹³⁷ President Chen has thus far been particularly effective in stalling negotiations with Beijing over the three links by insisting that these negotiations involve Taiwan's government officially in some regard and by refusing any preconditions that would even imply acceptance of Beijing's version of the one China principle—both conditions that Chen knows Beijing is very unlikely to accept. Even mainland experts who denigrated the effectiveness of Taiwan's efforts to limit its dependence on the mainland conceded that Chen has shown tenacious and, they would say, frustrating will in stalling negotiations over the three links. Presidents Lee and Chen have thus defied persistent forecasts by experts for more than 15 years that domestic business pressure and economic conditions would compel them to enter into negotiations over the three links "some time very soon," most likely on

¹³⁵ Gilley and Pao also point to Taiwan and China's entry into the WTO as a vehicle that could cast a light on any efforts by China to use economic discrimination to pressure Taiwan and to place such disputes in a multilateral forum. They write, "Such attempts could land Beijing in a WTO mediation hearing rather than a cross-strait political meeting" (Bruce Gilley and Maureen Pao, "China-Taiwan: Defences Weaken," *Far Eastern Economic Review*, October 4, 2001).

¹³⁶ Chen-yuan Tung, 2004.

¹³⁷ On this point, this study concurs with the findings of political scientist Shuisheng Zhao (see Zhao, 1999, p. 30).

Beijing's terms. To point up the two presidents' political success at resisting pressure to negotiate is not necessarily an endorsement of the policy's wisdom, particularly its economic wisdom. The result, as Taiwan businesspeople routinely point out, is that cross-strait trade and investment are significantly more expensive, slow, and inconvenient than would be the case without the ban. To what extent these added costs constitute a powerful disincentive that actually limits cross-strait commerce and investment, or are just an "added business cost" that makes cross-strait business more expensive but does not significantly reduce its volume, is more difficult to gauge. But there can be no denying the fact that Presidents Lee and Chen have to date already resisted an enormous amount of economic and political pressure to undertake what they consider ill-advised negotiations over permanent establishment of the three links under the political format demanded by Beijing.

Economic Factors: Evaluating Taiwan's Vulnerability

This chapter analyzes Taiwan's economic interdependence with mainland China in an effort to gauge the island's potential vulnerability to mainland economic pressure. It focuses on the magnitude and importance of Taiwan's cross-strait trade, investment, financial, and other economic relationships, as well as the vulnerability of Taiwan's key economic sectors and infrastructure to mainland disruption. Based on an analysis of these relationships and vulnerabilities, this chapter assesses Beijing's capacity to inflict economic pain or deprivation upon Taiwan as a source of economic leverage.

As noted in Chapter Two, many experts on economic diplomacy have pointed out that the level of economic pain an initiating country can inflict upon a target rarely, by itself, determines whether or not economic coercion is effective. Many political factors appear to play an equal or even more powerful role in determining whether economic coercion succeeds or fails. Chapter Five analyzes some of these crucial political factors.

Nevertheless, the capacity to inflict economic deprivation is clearly one of many important factors that help determine the effectiveness of economic pressure. Several of the same studies of economic diplomacy that downplay the overall effectiveness of economic coercion also find that, historically, attempts at economic coercion often fail in part because the initiating country was unable to inflict sufficiently serious economic pain upon its target country. Moreover, even if there were no objective link between economic vulnerability and the effectiveness of economic coercion, the perception of vulnerability can still have a powerful effect on decisionmaking in the target country. Political leaders within the target country may base their decisions about whether or not to make concessions in part on their perceptions or fears of the initiating country's capacity to inflict economic pain. If a target country's leaders develop a sense of inevitability, a fear that their country cannot endure the economic deprivation and disruption, they may be much more likely to make political concessions. Moreover, a detailed understanding of the economic relationship between the initiator and target countries enables analysts to forecast which groups or interests within the two countries are more, or less, likely to support concessions.

Interviews with Taiwan political and economic leaders and experts conducted for this study revealed vastly diverging estimates of mainland China's capacity to inflict

economic pain on Taiwan, and, perhaps more importantly, Taiwan's economic and political capacity to resist such deprivation. Some leaders—including some with senior responsibility for mainland affairs—were deeply convinced that China could inflict severe economic damage on Taiwan if it chose to do so. Others argued just as trenchantly that mainland China is, if anything, just as dependent upon Taiwan for its economic growth—and by extension, for its political stability—as Taiwan is upon mainland China.

The study of economic diplomacy has not provided analysts with clear, widely agreed-upon “yardsticks” that analysts can employ in assessing the level of economic leverage one country has over another, or the degree of economic damage and dislocation it can inflict on another. This study focuses on four major factors that help us assess the magnitude of the cross-strait economic relationship, its overall economic importance to Taiwan, and Taiwan's economic vulnerability to mainland China. These four factors are summarized below:

- *The portion of Taiwan's external economic activity that is tied up in relations with mainland China.* Among the possible measures of this factor are the percentage of Taiwan's total foreign trade, total FDI, and other key economic activities and resources that are tied up in the cross-strait relationship.
- *The importance of the externally oriented portion of Taiwan's economy within Taiwan's overall economy.* Taiwan's overall dependence on its external economy is measured, in part, by the percentage of Taiwan's total economy that is tied up in foreign trade and FDI.
- *The economic, strategic, or political importance of the goods or services that China might be able to sanction or cut off.* This more qualitative factor involves assessing the importance of the economic goods or services that Taiwan now has tied up in the cross-strait economic relationship.
- *China's capacity to inflict deliberate damage or disruption to key economic activities or infrastructure,* as distinguished from carrying out more formal trade or investment sanctions. Such key economic activities include China's ability to disrupt Taiwan's stock markets, information links, and other activities essential to the smooth functioning of the economy.

Main Findings

As this chapter will show, Taiwan's economic activities with the mainland Chinese economy have grown dramatically since Taipei began lowering its barriers to cross-strait ties in the mid-1980s, and mainland China has been Taiwan's premier external economic partner for several years now. Taiwan's cross-strait trade and investment now account for a very large percentage of all its externally oriented economic activity. In

turn, Taiwan's externally oriented economic activities constitute an even larger portion of Taiwan's overall economy, as measured by their percentage of GNP. Since the early 1990s, the composition of cross-strait trade and investment has shifted, and a large and growing share of Taiwan's most vibrant high-technology manufacturing now takes place in mainland-based facilities. In this regard, the continued shift of much of Taiwan's IT industry to the mainland is a source of great concern. Consequently, a hypothetical large-scale seizure of Taiwan's mainland-based assets or a cutoff or major reduction in cross-strait trade—whether the result of deliberate Chinese government actions or a downturn in China's economy—would almost certainly result in a major economic recession in Taiwan. Thus, China's hypothetical capacity to inflict short-term economic pain on Taiwan's economy is considerable.

China also knows it has considerable power to disrupt Taiwan's stock markets, and has done so on several occasions. Taipei, however, can draw on powerful administrative measures and very large financial resources to counter such disruptions in the short and medium term. Taiwan's major challenges are how to lure in more outside investment while limiting the increase in vulnerability to its markets, and finding ways to cope if China undertakes a major, sustained, long-term effort to undermine foreign investor confidence in the island's economy.

Even though mainland China could inflict substantial economic pain upon Taiwan, estimating the political impact that Beijing's pressure would have on Taipei's decisionmaking in a crisis remains very difficult. Historically, statistical studies of economic diplomacy have demonstrated that even countries with very high levels of trade dependency have rarely succumbed to pressure from key trading partners to make concessions on vital issues of sovereignty—the most likely scenario for the China-Taiwan case. When the China-Taiwan case is compared with statistical studies of successful historical cases of economic coercion, Taiwan's economic dependence upon mainland China is still only moderately high—although it is growing. Moreover, mainland China's own economic dependence on Taiwan is considerable; key regions and sectors of the mainland would suffer greatly in the event of major economic sanctions. These factors raise serious questions about the internal political impact that sanctions would have on Beijing.

Finally, Taiwan is far from the typical "target country" for economic sanctions. Indeed, among countries that are prospective targets of serious economic coercion, Taiwan might be unique because of the enormous economic, educational, and technological resources it could call upon to help it survive and recover from the initial shock of even a major breakdown in cross-strait economic relations. Most important among these resources are its enormous foreign exchange reserves (the third largest in the world) and its highly attractive package of high-tech companies that should be able to find new markets and production venues outside the mainland.

The Rapid Expansion of Cross-Strait Trade and Investment

Despite the absence of direct transport links between the main island of Taiwan and mainland China, the scope and scale of trade and investment flows across the Taiwan Strait have increased dramatically since the late 1980s. In late 2001, China displaced the United States as Taiwan's largest export market, and by 2003 China had emerged as Taiwan's largest overall trading partner. The growing cross-strait economic relationship has been driven in large part by the increasing integration of Taiwan's and the PRC's economies—initially focused on low-wage manufacturing industries but, since the late 1990s, increasingly on IT industries. Experts agree that mainland China has for several years been Taiwan's number-one destination for FDI, though it is more difficult to chart when this transition occurred, because much of this investment is still not reported to the Taiwan government and is funneled through third locations, such as the British Virgin Islands or Hong Kong.

Cross-Strait Trade

After a moderately slow start in the early 1980s, cross-strait trade mushroomed during the 1990s. Between 1979 and 1985, while Taiwan continued its formal ban on trade, two-way trade is estimated to have risen from negligible levels to just under \$1 billion by 1985.¹ Between 1990 and 2001, Taiwan's exports to China grew at an annual rate of 16 percent, increasing from \$4 billion to well over \$20 billion.² Although Taiwan's imports from the mainland remained well below its exports in terms of value, they actually grew at an even faster rate—about 20 percent per year—rising from \$800 million in 1990 to \$5.9 billion in 2001. Overall, two-way trade between mainland China and Taiwan grew from about \$10 billion to about \$30 billion in the decade from 1991 to 2001 (see Figure 4.1).³

The Bureau of Foreign Trade at Taiwan's MoEA estimates that exports to mainland China accounted for 23 percent of the island's total exports, while exports to the United States slipped to 21 percent of the total in 2001. Economists predict that the growth of Chinese demand for Taiwan imports "will almost certainly continue to outpace that from other major economies." Much of this growth in exports to the mainland is attributable to demand for parts and raw materials by Taiwan-invested enterprises located there.⁴

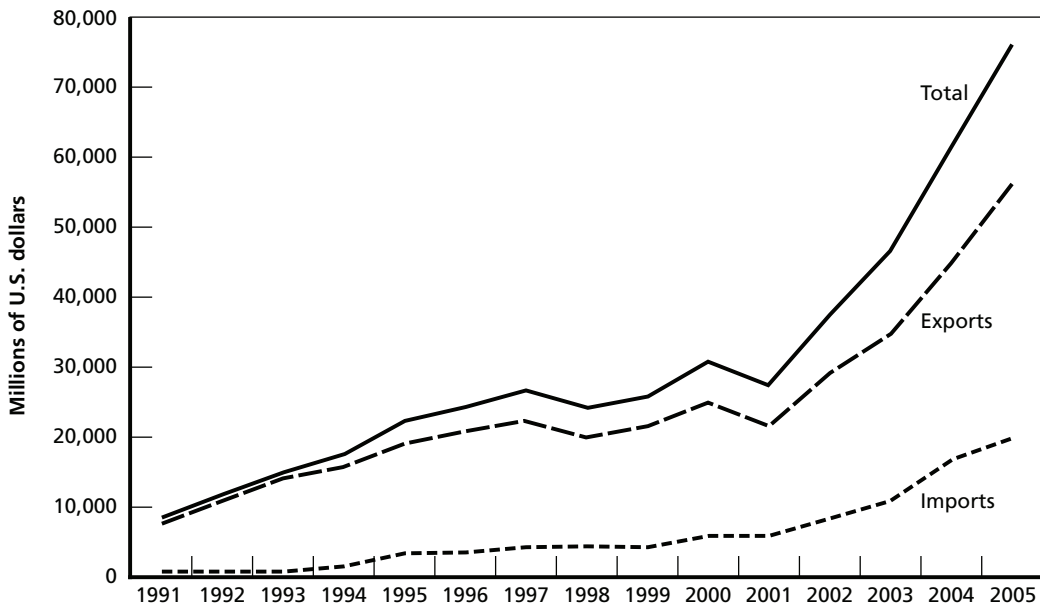
¹ Clough, 1993, p. 43.

² This rate is according to Deutsche Bank estimates. See Ma, Zhu, and Kwok, 2002.

³ Comparative year-by-year cross-strait trade estimates from the Hong Kong, Taiwan Customs, PRC Customs, and Taiwan's Mainland Affairs Councils are all summarized in Mainland Affairs Council, *Cross-Strait Economic Statistics Monthly* (March 2006). Note that these statistics have been revised upward somewhat over those reported in earlier years by the same MAC source. Unless otherwise indicated, all data on cross-strait trade flows in this study are from this source.

⁴ Ma, Zhu, and Kwok, 2002, p. 4.

Figure 4.1
Cross-Strait Trade 1990–2005



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The accession of China and Taiwan to the WTO appears to have further accelerated the flow of trade across the strait. Total cross-strait trade climbed rapidly from 2001 to 2005, rising from \$27.8 billion to \$76.4 billion, according to estimates by Taiwan's MAC. Taiwan's exports to the mainland surged from \$21.9 billion in 2001 to \$56.3 billion in 2005, while the island's imports from China nearly tripled from \$5.9 billion to \$20.116.7 billion.⁵ By 2005, shipments to the mainland accounted for more than 28 percent of Taiwan's total exports, and trade with the PRC represented one-fifth of Taiwan's total external trade.⁶

Cross-Strait Investment: Enormous, but Just How Enormous?

In recent years, this powerful increase in cross-strait trade has been driven in large part by the expansion of Taiwan's investments in China.⁷ As was detailed in the previous chapter, Taiwan firms began investing in China in the mid-1980s, with investment taking off after 1987 when the government lifted martial law, loosened currency

⁵ "Taiwan Relies More on Rival China for Exports: Official Figures," *Taiwan Economic News*, March 17, 2003.

⁶ Mainland Affairs Council, *Cross-Strait Economic Statistics Monthly* (December 2003).

⁷ Ma, Zhu, and Kwok, 2002, p. 3.

restrictions, and began permitting visits to the mainland. Many of these firms relied on parts and materials imported from Taiwan for their production.

The Taiwan government's gradual legalization of indirect investment in the mainland during the early 1990s resulted in a major shift in the geographical focus of Taiwan's overseas investments. China quickly surpassed Southeast Asian countries as the destination of choice for Taiwan investors (see Table 4.1). The Taiwan government's efforts to slow this concentration of investment in the mainland and encourage a diversification back into Southeast Asia have met with only modest success.⁸

During the first half of the 1990s, both the scale and composition of Taiwan investment on the mainland also began changing in politically significant ways, with larger, more valuable, and technologically more sophisticated projects moving across the strait. The first wave of Taiwan investments in the mainland during the late 1980s was characterized by small and medium-sized enterprises, mostly engaged in low-cost, export-oriented manufacturing, which were seeking lower labor costs and land

Table 4.1
Taiwan-Approved Foreign Direct Investment in China and Selected ASEAN Countries, 1986–1994 (in millions of U.S. dollars)

Year	China	Indonesia	Malaysia	Thailand
1986	0	18	4	20
1987	100	8	96	160
1988	421	914	317	455
1989	523	157	797	517
1990	984	618	2,345	420
1991	1,358	1,056	1,312	317
1992	5,543	563	589	130
1993	9,450	131	346	215
1994	5,395	2,480	1,150	83

SOURCE: Chung, 1997, pp. 166–167.

⁸ The Taiwan MoEA, using different statistics than those in Table 4.1 used by Chin Chung, reported that in 2003, for example, “approved” new Taiwan investment in Singapore had fallen from a high of \$378 million in 2001 to just over \$26 million, while investment in Thailand, which had reached \$149 million in 1990, had slid to just under \$49 million (Republic of China, Ministry of Economic Affairs, Statistics Department, “Approved Outward Investment by Area,” no date). See also Chin Chung, “Division of Labor Across the Taiwan Strait: Macro Overview and Analysis of the Electronics Industry,” in Barry Naughton, ed., *The China Circle: Economics and Technology in the PRC, Taiwan, and Hong Kong*, Washington, D.C.: Brookings Institution, 1997.

costs. Many of these were sunset enterprises that had trouble producing profitably amid Taiwan's rapidly rising standard of living and democratizing society. But by the mid-1990s, these investment pioneers were being joined by many large, publicly listed companies, increasingly engaged in capital and technology-intensive industries, and anxious to position themselves to exploit the rapidly growing Chinese market. According to research by economist Chin Chung, the average value of Taiwan investment projects in China more than tripled in just four years, rising from \$735,000 in 1991 to about \$2.78 million by 1995.⁹

As a result of these shifts in geographical distribution, scale, and composition of investment, China has emerged as the largest recipient of Taiwan FDI. But while the direction of these investment trends is relatively clear, solid quantitative data on the magnitude of cross-strait investment has proven far more elusive.¹⁰ Despite the significant liberalization of Taiwan's restrictions on cross-strait investment since 1990, much of the money that flows to the mainland still does so illegally—at least in the sense that it remains officially unreported. Over the course of 20 years, Taiwan investors have made an art form out of going offshore to circumvent restrictions. Thus, the information available from official Taiwan government sources—which captures only those deals that are government-approved and registered—represents only “a fraction of the overall picture,” according to many business and government sources.¹¹

Although it is widely believed that the statistics compiled by the Taiwan MoEA's Investment Commission understate greatly the actual amount of Taiwan investment in China, the official numbers provide a consistent time series, and thus a useful baseline estimate. The Taiwan MoEA's Investment Commission reports that from 1991 to December 2003, approved Taiwan investment in mainland China totaled \$31.2 billion. The Commission reports that approved investment in the mainland for 2002 was \$3.9 billion, and in 2003 investment rose by 19 percent to \$4.6 billion. From January to May 2004, total approved investment totaled just over \$2.7 billion, which represented an increase of 60 percent over the same five-month period during 2003 (a period that coincided with the severe acute respiratory syndrome [SARS] outbreak on the mainland).¹²

⁹ Chung, 1997, p. 173.

¹⁰ Analysts at Taiwan's Market Intelligence Center (MIC), which is widely regarded as one of the best sources of data on IT in the Greater China region, said it is difficult to gather accurate data on Taiwan investment in the PRC, especially because a significant percentage of it is still illegal, and Taiwan companies frequently channel investments through the British Virgin Islands and other countries to circumvent government regulations.

¹¹ Interview with a U.S. business community representative, Washington, D.C., April 2002.

¹² Mainland Affairs Council, Executive Yuan, “Preliminary Statistics of Cross-Strait Economic Relations,” December 2002; Mainland Affairs Council, Executive Yuan, “Preliminary Statistics of Cross-Strait Economic Relations,” December 2003; Mainland Affairs Council, Executive Yuan, “Preliminary Statistics of Cross-Strait Economic Relations,” May 2004b; Mainland Affairs Council, *Cross-Strait Economic Statistics Monthly* (December 2002, December 2003, and May 2004).

By the end of 2005, the Investment Commission estimated the total authorized investment since 1991 at over \$53 billion.¹³

The mainland Chinese government's official estimates of total contracted and paid-in Taiwan investment are far higher than the Taiwan authorities' figures. The Ministry of Foreign Trade and Economic Cooperation (MOFTEC) estimates that from 1979 to the end of 2003, the total contracted Taiwan foreign investment in the mainland equaled \$70 billion, while paid-in investment totaled just under \$36.5 billion.¹⁴ By the end of 2005, MOFTEC estimates that the total contracted value of Taiwan investment was just over \$100 billion—nearly twice the official Taiwan government figure for the same period—and total utilized Taiwan investment at just under \$44 billion.¹⁵

Yet, even these much-higher official mainland Chinese statistics greatly undercount Taiwan investment. One major reason for this undercount is that a large percentage of China's investment from Hong Kong—by far the largest single source of “external” investment in China—actually comes from Taiwan companies. There are no verifiable estimates of this percentage. But one Taiwan executive said that his best guess is that 50–70 percent of Taiwan's investments in Hong Kong are really destined for the PRC.¹⁶

A second, almost equally serious source of uncertainty in the cross-strait investment statistics is that much of Taiwan's investment in the mainland flows through holding companies in the Caribbean—in particular, the British Virgin Islands and the Cayman Islands. According to Taiwan statistics, in 1995, investment by Taiwan firms in the British Virgin Islands accounted for 15 percent of the island's total outgoing investment. The official number nearly doubled in just five years, reaching almost 30 percent in 2000 and making British Virgin Islands officially the second-largest recipient of Taiwan FDI after the mainland.¹⁷ Most sources interviewed for this study assert that a very large percentage of the Taiwan investment in the British Virgin Islands ultimately finds its way to the mainland. For example, during the same time period that the British Virgin Islands emerged as a major target of Taiwan's FDI, it also rose from being a negligible source of mainland FDI to one of the largest.

¹³ Mainland Affairs Council, Executive Yuan, “Preliminary Statistics of Cross-Strait Economic Relations,” February 2006; Mainland Affairs Council, *Cross-Strait Economic Statistics Monthly* (February 2006).

¹⁴ People's Republic of China, MoFTEC, cited in Mainland Affairs Council, Executive Yuan, “Preliminary Statistics of Cross-Strait Economic Relations,” January 2004a. See also “Taiwan Invests US\$3.4bln in Chinese Mainland,” *People's Daily* (Beijing), February 26, 2004; and National Bureau of Statistics of China, *China Statistical Yearbook 2004*, Beijing: China Statistics Press, 2004, Table 18-15, p. 732.

¹⁵ Mainland Affairs Council, Executive Yuan, 2006; Mainland Affairs Council, *Cross-Strait Economic Statistics Monthly* (February 2006).

¹⁶ Interview with a Taiwan business executive, Taipei, April 2002.

¹⁷ Mainland Affairs Council, “Taiwan's Approved Outward Investment,” no date.

In fact, over the past decade, the British Virgin Islands, the Cayman Islands, and other holding-company shelters have emerged as such major conduits for mainland investment that they significantly undermine the capacity of economic analysts to estimate the level of investment interdependence between mainland China and Taiwan. Between 1995 and 2000, the percentage of China's total FDI officially reported to have come from the British Virgin Islands rose from less than 1 percent to nearly 10 percent. In 2002, official Chinese statistics reported that more than \$6.1 billion of its FDI came from the British Virgin Islands—nearly 12 percent of China's reported total of \$52.7 billion in paid-in FDI for that year. The total for the British Virgin Islands is nearly twice the official Taiwan figure for the same year (\$3.97 billion) and constitutes a larger share of China's FDI than that of the United States (\$5.4 billion), Japan (\$4.2 billion), South Korea (\$2.7 billion), or any location other than Hong Kong (\$17.8 billion). The Cayman Islands—another well-known haven for such companies—also reportedly accounted for \$1.2 billion.¹⁸

The three intermediary investment venues commonly used by Taiwan investors—Hong Kong, the British Virgin Islands, and the Cayman Islands—introduce an enormous margin of uncertainty into estimates of total cross-strait investment. Taken together, in 2002, these three venues accounted for \$25.1 billion—more than six times the official Taiwan investment total, and nearly half of China's total official paid-in FDI for 2002. At present, there is no agreed-upon estimate of what percentage of the investment dollars from these three locations comes from Taiwan and what percentage actually comes from mainland Chinese investors trying to take advantage of special investment breaks their own government offers for “foreign” capital or from some other source.¹⁹

Thus, nearly all the Taiwan government officials, economic analysts, and other experts interviewed for this project agreed rather matter-of-factly that, as one put it, “none of the official data sources . . . provides a complete description” of cross-strait investment flows. Faced with these major sources of uncertainty, experts have put forward a broad array of estimates.²⁰ For example, Perng Fai-nan, governor of the Central Bank of China (Taiwan), estimated that by the end of 2001 cumulative Taiwan investment on the mainland probably reached \$60 billion, more than twice the official Taiwan estimate. Somewhat more conservatively, independent economic analysts estimated that, from the early 1990s to about 2002, Taiwan companies have invested approximately \$65 billion to \$75 billion in China.²¹ In 2002, some respected economists estimated that cumulative Taiwan investment in the mainland exceeded \$100

¹⁸ National Bureau of Statistics of China, *China Statistical Yearbook 2003*, Beijing: China Statistics Press, 2003, Table 17-15, pp. 672–674.

¹⁹ National Bureau of Statistics of China, 2003, Table 17-15, pp. 672–674.

²⁰ Ma, Zhu, and Kwok, 2002, pp. 2–3.

²¹ Interviews with economists and industry analysts, Washington, D.C., June 2003.

billion, and this figure was cited widely by many experts as a likely benchmark for several years.²² By early 2006, MAC and SEF sources were citing estimates of more than \$150 billion, and well-informed experts on the Taiwan economy were citing government sources privately estimating figures as high as \$200 billion or even \$250 billion (although there is no way to confirm these).²³ Several surveys of Taiwan businesses and investors conducted since 2002 assert that Taiwan investment in the mainland is unlikely to stop growing anytime soon.²⁴

Gauging the Importance of Cross-Strait Economic Relations to Taiwan's Economy

These raw statistics on trade and investment illustrate clearly the impressive rate of growth in cross-strait economic relations since 1979. But by themselves, they can do little to help us assess the degree of economic or political leverage that mainland China might be able to derive from these rapidly expanding ties. To assess Beijing's capacity to inflict economic pain or deprivation upon Taiwan, it is necessary to analyze the importance of these exchanges to Taiwan's economy. The importance of these activities will be a reflection of at least three factors:

- the relative weight of these cross-strait activities within the foreign-directed sector of Taiwan's economy
- their overall importance within the entire Taiwan economy
- the relative importance (strategic importance and substitutability) of the products, services, and activities involved.

Taiwan has become famous as a prototypical case of an economy that relied on "export-led" growth to generate its rapid modernization in the 1960s–1980s. For decades, foreign trade has played an unusually large role in Taiwan's overall economy as compared with most other industrialized and newly industrializing countries. This trade dependence is reflected in the high percentage of exports as a share of Taiwan's GNP (see Figure 4.2). As of 1991, Taiwan's total exports equaled \$76 billion, which accounted for more than 41 percent of the GNP, based on official statistics from Taiwan's Ministry of Finance and Council for Economic Planning and Development cited by the MAC. This dependence on trade, moreover, has actually increased in the

²² See, for example, Hwan C. Lin, "Taiwan Has Overinvested in China," *Taipei Times*, October 31, 2002, p. 8. See also Sutter, 2002b.

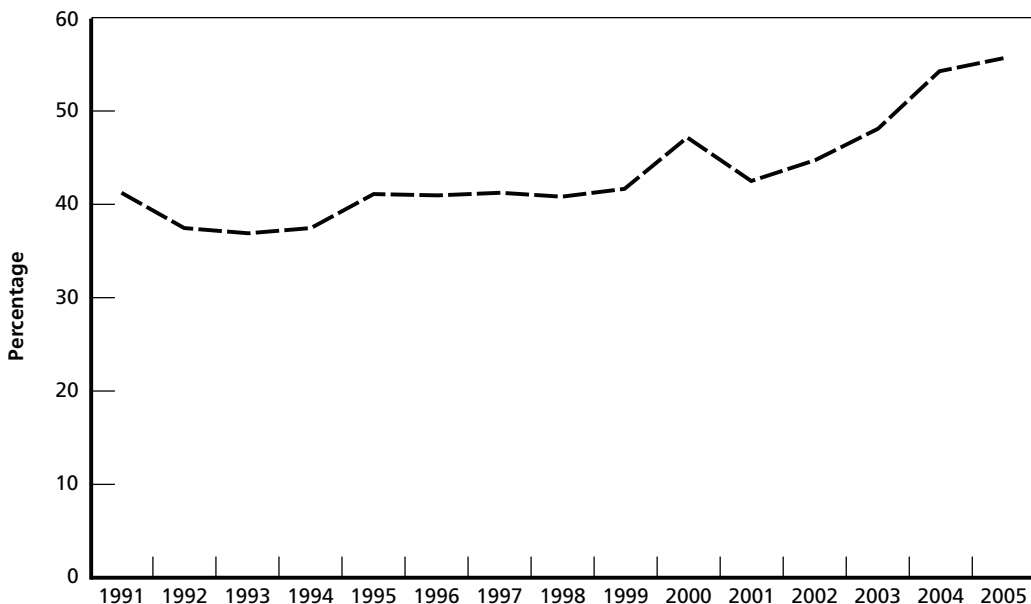
²³ Sources cited by Taiwan panelists during a 2006 presentation on cross-strait economic relations with the author, Washington, D.C.

²⁴ See, for example, "Survey of Investment Climate and Outlook for the Second Half of 2002," *Economic Daily News*, July 1, 2002.

past decade, despite Taiwan's having already attained a rather high standard of living and having established a diverse domestic market. By 2005, total exports had reached \$198 billion, which accounted for just under 56 percent of the GNP. Thus, the overall importance of trade to Taiwan's economy would be difficult to overstate.

Meanwhile, the weight of cross-strait trade and investment relations within Taiwan's foreign-directed economic sector has increased greatly since 1979, and in particular during the early 1990s. Although it is now investment that drives trade across the strait, indirect trade was actually the earliest portion of this relationship to begin expanding. In 1991, indirect cross-strait trade constituted a miniscule portion of Taiwan's total foreign trade (see Figure 4.3). Taiwan's Council for Economic Planning and Development estimates that total two-way trade was \$950 million, equivalent to less than 1.5 percent of Taiwan's total trade. Of this, exports totaled \$810 million, equivalent to just over 2 percent of its total exports of \$39.8 billion.²⁵ According to Taiwan's MAC, by 1991, two-way trade with the mainland had expanded to \$8.6 billion, equivalent to 6.2 percent of Taiwan's total reported trade, and exports in 1991 estimated the

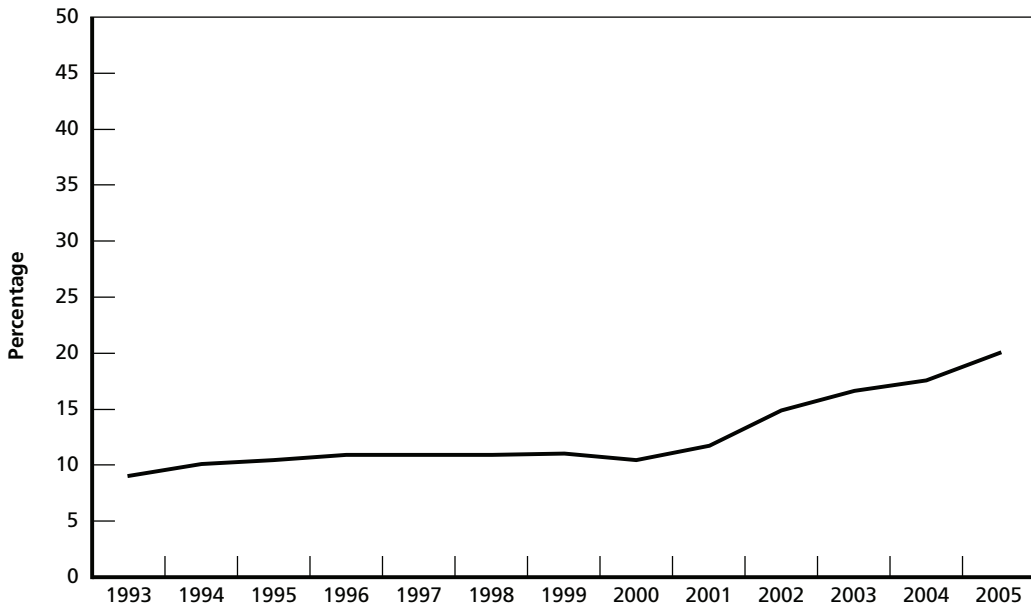
Figure 4.2
Taiwan's Total Exports as a Percentage of GNP, 1991–2005



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²⁵ The dollar figures of the Council for Economic Planning and Development are from *Taiwan Statistical Yearbook*, 1995, pp. 192–193, cited in Zhao, 1999, pp. 24, 28.

Figure 4.3
Cross-Strait Trade as a Percentage of Taiwan's Total Trade

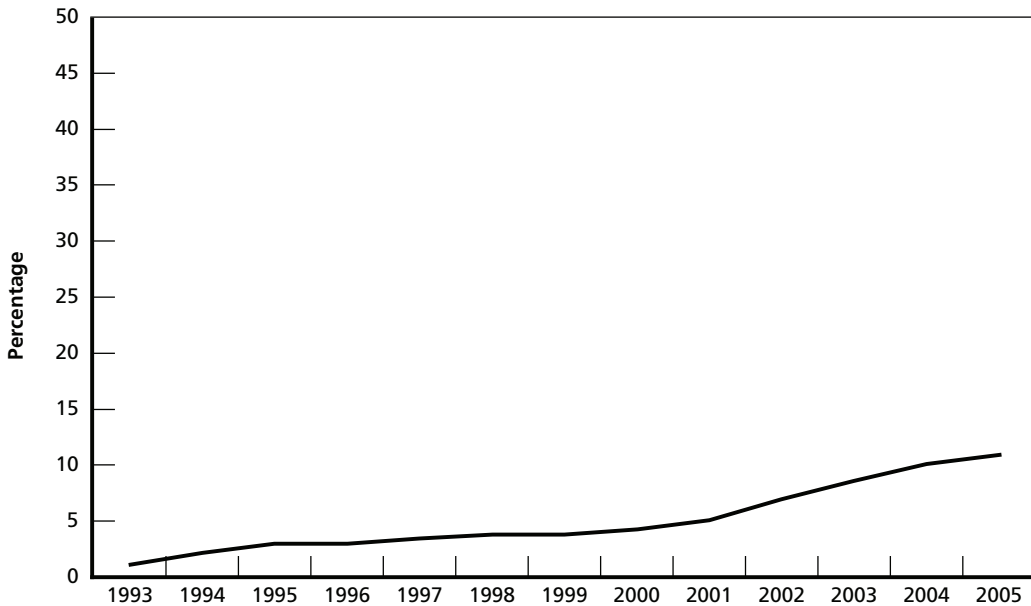


RAND MG507-4.3

amount at just under \$7.5 billion, equivalent to 9.8 percent of Taiwan's total exports. During the early 1990s, cross-strait trade occupied a rapidly increasing share of Taiwan's overall trade, with exports rising to 16.4 percent of total exports in 1993, then leveling off at between 17 and 18 percent throughout the mid- to late 1990s. Two-way cross-strait trade also inched upward as a percentage of Taiwan's total trade during this period, rising from 6.2 percent in 1991 to 9.3 percent in 1993, and then leveling off at between 10 and 11 percent for most of the 1990s. Figure 4.4 shows cross-strait imports as a percentage of Taiwan's total imports, and Figure 4.5 shows cross-strait exports as a percentage of Taiwan's total exports.

As expected, the growth in cross-strait trade accelerated after China and Taiwan joined the WTO in 2001 and 2002. Almost immediately, the overall importance of trade with the mainland—which had remained relatively constant in percentage terms during the mid- to late 1990s—began to shoot up again in 2001–2005. By the end of 2005, two-way cross-strait trade, as estimated by the MAC, totaled \$76 billion, with Taiwan's exports to China exceeding \$56 billion. Comparing 2000 with 2005, cross-strait trade rose dramatically from 10.8 percent to just over 20 percent of Taiwan's total trade, and exports increased from 16.8 percent of Taiwan's total exports to 28.4 percent.

Figure 4.4
Cross-Strait Imports as a Percentage of Taiwan's Total Imports



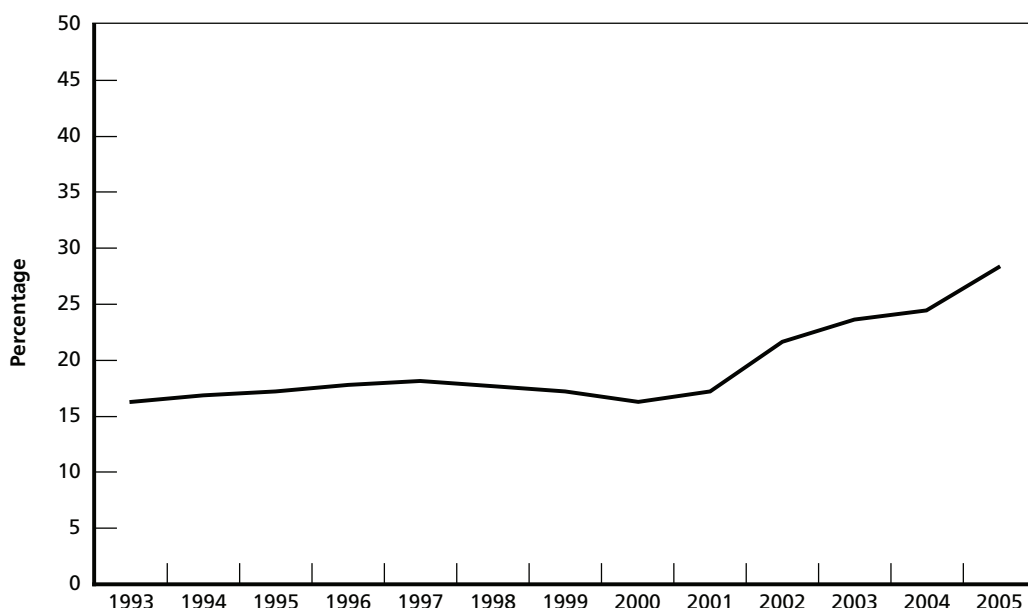
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Taiwan's persistent annual trade surpluses with the mainland continue to represent a vital portion of Taiwan's overall trade balance. Because of the large differences in the statistics on cross-strait trade reported by the PRC, Hong Kong, and various branches of the Taiwan government, these sources yield very different estimates of how large a percentage of Taiwan's annual trade surplus is constituted by the mainland balance. Estimates by Taiwan's MAC—which are usually Taiwan's highest official estimates of total cross-strait trade—have indicated that Taiwan's annual cross-strait surplus has exceeded its overall trade surplus every year since 1993. In other words, without the surplus with mainland China, Taiwan would be in a deficit overall. Estimates by other government units are usually substantially smaller. In either case, there appears to be widespread consensus among economists that “the mainland has been the largest source of Taiwan's overall trade surplus since 1991,” and, therefore, this trade relationship plays a pivotal part of Taiwan's overall economic health.²⁶

The economic dislocation that Taiwan would suffer as a result of any sudden loss of this trade relationship would be severe. Taiwan's exports to the mainland, as estimated by the MAC, grew from the already healthy figure of 5.9 percent of Taiwan's total GNP in 1993 to 7.3 percent of the GNP in 2001. By 2002, exports to mainland China were equivalent to one dollar out of every ten in Taiwan's GNP, and by 2005

²⁶ Ma, Zhu, and Kwok, 2002, p. 3.

Figure 4.5
Cross-Strait Exports as a Percentage of Taiwan's Total Exports



RAND MG507-4.5

they accounted for 15.85 percent of GNP. If one uses the estimates of Taiwan's exports to the mainland reported by the PRC Customs service, then exports rose to 21 percent of Taiwan's official GNP by 2005. It is difficult to dispute the conclusion of a 2002 Deutsche Bank study that stated, "If, for any reason, cross-strait trade comes to a sudden halt, the impact on final demand in Taiwan could be worse than any of the previous regional or global recessions."²⁷

In contrast to trade, Taiwan's investment in the mainland was much later to emerge as a major share of total FDI. Cross-strait trade in goods had already begun to take off before 1987–1990, when the Taiwan government lifted the major policy obstacles to cross-strait investment—martial law, the related ban on travel to the mainland, currency restrictions, and the official ban on investment. Taiwan investors, however, quickly became extremely adept at circumventing regulations forbidding investment in China, which proved to be increasingly ineffectual with each passing year. Taipei did not begin officially registering investment until 1990 (most of its cumulative statistics date from 1991), and statistics for the first years reflected previously illegal investments that were subsequently reported as part of an amnesty. As was noted earlier, efforts to

²⁷ Ma, Zhu, and Kwok, 2002, p. 3.

estimate the magnitude of Taiwan's total investment in China are further plagued by uncertainty because of the tendency of many investors to funnel their money secretly through third venues. As a result, it is difficult to assess when cross-strait investment first began to constitute a substantial percentage of Taiwan's total foreign investment, or its overall investment.

But even if we limit ourselves to examining the official Taiwan government estimates, it appears that the percentage of Taiwan's total outwardly directed investment that flows to the mainland has increased greatly in recent years—though this percentage has also fluctuated widely at times. The MoEA estimates that from 1991 to mid-2003, approved investment in the mainland constituted about 45 percent of Taiwan's total foreign investment. According to the Chung-Hua Institute for Economic Research, more than 64 percent of Taiwan's outbound FDI went to China in 2000, up from around 43 percent in 1999.²⁸ In 2002, the MoEA estimates had risen to just over 6 percent of total foreign investment, and the PRC was the number-one FDI destination. In 2003, total FDI had slipped to about 54 percent—a decline many experts attribute to a temporary slide caused by the 2003 SARS outbreak. Through the first five months of 2004, investment rebounded, and mainland China received more than 72 percent of all Taiwan government-approved FDI.²⁹

Although these official totals should probably be considered as little more than baseline estimates, they are nevertheless substantial in their own right. When we consider the enormous volume of unaccounted-for capital that is coming into mainland China from Hong Kong and the Caribbean, however, it becomes apparent that for now the best one can say is that a very substantial percentage of Taiwan's FDI—almost certainly well over 50 percent—is tied up in mainland China.

The Strategic Significance of Current Cross-Strait Economic Ties

In cases of economic coercion, the raw levels of trade and investment are far from the only—or even the most important—determinants of leverage. The economic and strategic significance, or substitutability of the goods traded or the assets invested between two antagonists, is one among many important factors that determine the amount of leverage an initiating state has over a target state. In this regard, two aspects of Taiwan's economic relationship with the PRC merit special examination: the changing composition of the goods produced by Taiwan-invested mainland enterprises, and the extent of the mainland's control over strategic resources that Taiwan requires.

²⁸ Lawrence, 2002.

²⁹ Mainland Affairs Council, Executive Yuan, 2002, 2003, and 2004b; Mainland Affairs Council, *Cross-Strait Economic Statistics Monthly* (December 2002, December 2003, and May 2004).

The Rising Importance of Mainland-Based Production: The Information Technology Sector

The changing composition of Taiwan's cross-strait investments—away from low-wage, labor-intensive sunset industries and toward production of high-tech products—greatly increases the economic and political importance of the Taiwan assets that are now potentially within the mainland's grasp. Taiwan business leaders and political leaders of all major political parties have long argued that in order to avoid being “swallowed up” or “marginalized” economically by the mainland, Taiwan must continually expand and deepen its most knowledge-based economic activities and production. But as this deepening has continued, Taiwan's most influential IT manufacturers have found the lure of the mainland's lower wages and land prices and its large market just as attractive as did their predecessors in the toy, shoe, and garment industries.³⁰

Consequently, since the late 1990s, a very large portion of the production volume of Taiwan's IT goods have been manufactured in Taiwan-owned, mainland-based factories. Research conducted by the Taiwan-based Market Intelligence Center's Institute for Information Industry (MIC/III) has documented the magnitude of the Taiwan IT sector's reliance upon mainland manufacturing.³¹ According to a 2003 report, mainland-produced goods accounted for more than 37 percent of Taiwan's IT hardware in 2001 and 49 percent in 2002. A September 2004 report put the figure over 61 percent. The MIC/III estimated the production value of these mainland products at more than \$22.5 billion in 2002. In the past three years, for a variety of key IT components, the percentages became even more glaring. In the first six months of 2004, the MIC/III estimated that the percentages listed in Table 4.2 of several key IT goods produced by Taiwan companies were manufactured in mainland China.

Earlier estimates indicate that the percentage of these products manufactured on the mainland has increased markedly—the percentage of some more than doubling—in the past few years.³²

As the previous chapter noted, Taiwan's government has tried to slow and limit this rising dependence of its IT industry on the mainland by using its investment pre-approval authority. Its apparent goal has been to maintain a significant technological “gap” or “lag” between the goods Taiwan firms produce at home and those they produce on the mainland. The Taiwan IT firms themselves have also been hesitant to manufacture their most advanced goods on the mainland, where intellectual property protections often seem virtually nonexistent. While the rush of IT production to

³⁰ For a comprehensive recent study of the cross-strait IT industry, see Michael S. Chase, Kevin L. Pollpeter, and James C. Mulvenon, *Shanghaied? The Economic and Political Implications of the Flow of Information Technology and Investment Across the Taiwan Strait*, Santa Monica, Calif.: RAND Corporation, TR-133, 2004.

³¹ “74% of H1 Notebook Output Relies on Mainland Production,” *China Post*, September 6, 2004; “Taiwan: Productive Year Ahead for Hardware,” *Asia Computer Weekly*, January 13, 2003.

³² Chase, Pollpeter, and Mulvenon, 2004, pp. 64–67.

Table 4.2
Percentage of Selected Taiwan IT Products Produced in
Mainland China, 2004

Product	Percentage
Servers	22
Cellular telephones	44
Desktop computers	52
Notebook computers	74
LCD (liquid crystal display) monitors	82
Motherboards	83
Digital cameras	94
CD-ROMs	95

SOURCE: MIC/III estimates.

the mainland discussed previously has indeed been rapid and substantial, the government (and industry) has enjoyed some success in this goal. As noted earlier, semiconductors produced by Taiwan firms on the mainland, for example, still lag well behind these companies' most advanced designs and standards. The MIC/III report indicates, however, that maintaining the current cross-strait technology gap and division of labor may become increasingly difficult. "[T]he current practice that retains the research and development teams" of these companies in Taiwan "may change in the near future." With the mainland's rapidly improving IT industry and its large stock of well-trained, low-salaried engineering talent, "It will be more economical if R&D also moves to China."³³

Thus, from the standpoint of economic leverage, the fact that an increasingly larger share of the most economically viable and politically influential "crown jewels" of Taiwan's IT industry are migrating to the mainland is certainly a source of growing concern. Were China able to seize, close down, or harass a significant number of these Taiwan-invested IT enterprises, beyond any actual assets seized, this could cause a major loss of export income and employment (from lost sales of components shipped to mainland factories) by some of Taiwan's most important and promising companies.³⁴

At the same time, the fact that these are the crown jewels of one of the world's most important IT industries means that the politics and economics of mainland import or investment sanctions against these industries would be very different from those of, for example, a developing country that relied upon exports of primary goods

³³ "74% of H1 Notebook Output Relies on Mainland Production," 2004.

³⁴ Chase, Pollpeter, and Mulvenon, 2004.

for its income. If mainland China became truly inhospitable to Taiwan-invested IT firms, there is a very high likelihood that these firms could find alternative production bases in South or Southeast Asia that would be eager to enter into joint ventures with Taiwan's major IT firms. Moreover, the short- and medium-term costs that several economic sectors and localities in mainland China would suffer from the loss of such investments would be enormous—a point to which this report will return later.

Strategic Resources: Vulnerability to Cutoff

As an economy heavily reliant upon trade, Taiwan's level of dependence upon imported sources of key raw materials and commodities is an important determinant of the island's potential vulnerability to external economic pressure.

Energy resources rank among Taiwan's most important sources of potential economic dependency. As a 2004 U.S. Department of Energy (DOE) analysis points out, "Taiwan has very limited domestic energy resources and relies on imports for most of its energy requirements."³⁵

Oil is by far the dominant fuel in Taiwan's energy mix, accounting for 48 percent of total primary energy consumption. Coal also plays an important role (34 percent of total energy consumption), followed by nuclear power (9 percent), natural gas (8 percent), and hydroelectric power (less than 2 percent).³⁶

Taiwan's domestic crude-oil production is only about 1,000 barrels per day—not even equivalent to 1 percent of its 886,000 barrel-per-day consumption. The DOE reports that most of the island's crude oil is imported from the Persian Gulf, with West African countries as important secondary suppliers. In December 2002, the *Taipei Times*, citing a report by a Taiwan National Defense University (NDU) Military College professor, Chung Chien, reported that two-thirds of Taiwan's petroleum comes from the Middle East and one-third comes from Southeast Asian countries.³⁷ Neither report notes mainland China as a significant source of petroleum for Taiwan. Mainland China is, however, one of Taiwan's two major suppliers of its second-largest energy source—coal (Taiwan's other major coal supplier is Australia).

Taiwan maintains a strategic petroleum reserve as a protection not only against cutoff of supplies by mainland China, but also against the vicissitudes of Middle East oil sources. Taiwan's petroleum refiners are legally required to maintain stocks equal to 60 days' consumption. Taiwan's strategic petroleum reserve became an object of significant public debate in 2001–2002 as a result of increased market competition within

³⁵ U.S. Department of Energy, "Energy Information Administration, Country Analysis Briefs: Taiwan," August 2005.

³⁶ U.S. Department of Energy, 2005.

³⁷ Ko Shu-ling, "Warning on Taiwan's Oil Stocks Given," *Taipei Times*, December 18, 2002, p. 1.

the industry, the looming U.S. war with Iraq, and the highly critical NDU report. In September 2002, President Chen and National Security Council Secretary General Chiou I-Jen chaired cabinet meetings that focused on the potential threat to Taiwan's petroleum supply posed by the war with Iraq. At the same time, the government moved to ease a price war among gasoline manufacturers in Taiwan's gradually privatizing energy industry that some believed was eroding fuel supplies and destabilizing prices. Professor Chung, speaking at a Cabinet-sponsored research symposium in December 2002, charged that Taiwan had only a 30-day supply of oil in its strategic reserve and cited a report by "U.S. Intelligence sources" claiming the actual supply would be only nine days in the event of a blockade. Chung claimed that the nation "will be cast into complete chaos if something goes wrong with supplies of crude oil."³⁸ In a March 2003 statement to the legislature, however, Premier Yu Shyi-kun repeated the government's long-standing claim that current strategic reserves of the China Petroleum Corporation (CPC) were equivalent to roughly a 120-day supply, and private stocks were equal to a 60-day supply. Premier Yu also reported that Taiwan's government-controlled CPC was diversifying its sources of petroleum in response to the Iraq war.³⁹

Taiwan is not dependent upon mainland China as a significant source of petroleum, and in order to use energy as a lever against Taiwan, China would have to take bold diplomatic or military moves to squeeze Taiwan's sources from the Middle East, Africa, and Southeast Asia. It is worth noting that some cross-strait cooperation in petroleum exploration has begun in recent years, though it remains at a very early stage and does not constitute a source of leverage for Beijing. Since 1996, CPC of Taiwan and the mainland's China National Offshore Oil Corporation (CNOOC) have been working on a joint venture to explore for oil in the Tainan Basin of the Taiwan straits. According to the DOE, the two companies completed initial seismic surveys in October 1999 and signed a joint venture agreement in May 2002. In March 2004, CPC received approval to open up representative offices in Beijing and Shanghai.⁴⁰

Vulnerability to Deliberate Economic Disruption: Stock Markets

China has also learned that it can inflict significant economic damage on Taiwan simply by manipulating threats and uncertainty, thereby causing temporary but pain-

³⁸ Ko Shu-ling, 2002.

³⁹ "Taiwan to Increase Oil Reserves on Fears of Middle East War," BBC Monitoring International Reports, September 9, 2002; "Taiwan Not to Be Used by US to Gain China's Support for Iraq War," BBC Monitoring International Reports, March 7, 2003; Lilian Wu, "Short Iraq War Would Have Little Impact on Taiwan: Premier," Central News Agency, March 7, 2003; U.S. Department of Energy, 2005.

⁴⁰ U.S. Department of Energy, 2005.

ful downturns in the economy. One of Beijing's favorite targets has been Taiwan's stock market, which has often fallen off sharply in response to cross-strait tension.

- Between July 1995—when Beijing responded to President Lee Teng-hui's trip to his alma mater, Cornell University, with a series of threats and military exercises off of Taiwan—the Taiwan stock market lost nearly 30 percent of its value.⁴¹
- In July 1999, during the week following President Lee's statement that the cross-strait relationship was a "special kind of state-to-state relationship," the Taiwan stock market dropped 13.24 percent, with the estimated loss in market value equivalent to one-sixth of Taiwan's projected GNP in 1999.⁴²
- One week before Chen Shui-bian was elected president in March 2000, Chinese Premier Zhu Rongji publicly admonished Taiwan voters that if they selected a government that tried to declare independence, war could result.⁴³ On the first trading day after Chen Shui-bian was elected, the Taiex fell by more than 2.7 percent before the government intervened to stop the slide. On May 20—Chen's first day in office—the market fell by 3.3 percent.⁴⁴
- China has sometimes inspired industry- or company-specific stock sell-offs. In June 2004, Chinese newspapers publicly criticized the pro-DPP CEO of Chi Mei Corporation, Hsu Wen-Lung, and threatened all "pro-Green" Taiwan business-people saying they were not welcome to invest on the mainland. Beijing's remarks sparked a short-term stock market panic, causing a 5 percent fall in the stock of the Chi Mei TFT (thin-film transistor)/LCD manufacturing subsidiary, which was planning to open a factory in Shanghai or Ningbo.

Although investor nervousness has sometimes been sufficient to cause a sell-off even without a major overt threat from Beijing, on other occasions China's use of this technique has been surprisingly open and deliberate. This was evidenced by a May 2004 report in its official newspaper *People's Daily*. On the eve of President Chen's second inauguration, Beijing was anxious to pressure Chen not to use his second inaugural address to advance pro-independence policy proposals, in particular certain constitutional reforms. On May 17, Beijing issued a stiffly worded restatement of old threats urging Chen not to continue on the road to independence. The following day, *People's*

⁴¹ "Prepared Testimony of David N. Laux, President, USA-ROC Economic Council, Before the House Banking and Financial Service Committee," Federal News Service, March 20, 1996.

⁴² "NT\$1.5 Trillion Wiped Off Stock Market in Past Week," *Taiwan Economic News*, July 19, 1999; "Cash-Rich State Funds Strive to Staunch Market Decline," *Taiwan Economic News*, July 20, 1999; "Political Uncertainties Cloud Taiwan's Stock Market," *Taiwan Economic News*, July 26, 1999.

⁴³ "Taiwan Gov't Halves Daily Slide Limit to Stabilize Stock Market," *Taiwan Economic News*, March 27, 2000.

⁴⁴ "NSF Will Bolster Stocks on May 20, Says MOF Official," *Taiwan News*, May 19, 2004; Tim Culpan and Nichole Chen, "Taiwan's Prospects Brighter in Long Term," *South China Morning Post*, March 23, 2004, p. 3.

Daily, reporting on the statement, exulted that “the strong mainland warning, coupled with political uncertainty arising from recounting of votes [from Taiwan’s disputed presidential election], sent Taiwan shares into a sharp dive Monday. The Weighted Price Index of the Taiwan Stock Exchange closed down 294.36 points, or 5.1 per cent, at 5,482.96.”⁴⁵ The paper’s self-congratulatory (and probably somewhat exaggerated)⁴⁶ assertion that Beijing had caused the fall in share prices underscored China’s willingness to manipulate uncertainty as a financial weapon against Taipei.

At the same time, when it comes to resisting mainland financial disruption, Taiwan hardly fits the profile of the financially defenseless developing country. Taiwan possesses foreign exchange reserves estimated at more than \$256 billion as of February 2006—the third largest in the world, outranked only by Japan (\$836 billion) and mainland China itself (\$856 billion). And since the mid-1990s, Taipei has developed a package of financial countermeasures that it has repeatedly used to offer short-term stability to the markets, greatly slow down any sudden slide in prices, and give investors the kind of reassurance that will bring them back into the market.⁴⁷

- The government enforces a 7 percent daily limit on how far individual stocks may fall. The Ministry of Finance also has the authority to reduce this daily limit if it fears that nonmarket factors are likely to cause a severe sell-off. In the face of threats from Chinese Premier Zhu Rongji on the eve of the March 2000 presidential election in which Chen Shui-bian came to power, the Ministry of Finance employed this authority, reducing the daily fall-off limit for individual stocks from 7 percent to 3.5 percent, while keeping the daily limit on stock rises at 7 percent. The government is reportedly planning to increase the daily 7 percent limit, however, in an effort to make the Taiwan Exchange more attractive to foreign capital.⁴⁸
- The government has also called upon government-run savings, pension, and insurance funds—many of which are extremely cash rich—to intervene with major stock purchases to reassure the market in the face of a major sell-off. On March 23, 2004, as stocks plummeted in response to the results of Taiwan’s controversial presidential elections, four such government-run funds injected between

⁴⁵ “Separatism Obstacle to Reunification,” *People’s Daily* (Beijing), May 18, 2004.

⁴⁶ Several senior financial journalists interviewed for this study noted that on the same day as the Taiwan stock sell-off, stock markets throughout Asia and Latin America had slumped sharply in response to rising oil prices. One expert noted that this would not have been the first time that Beijing had exaggerated its “credit” for causing panic in the Taiwan markets—something the expert alleged Beijing does to increase Taiwan’s sense of Beijing’s economic power.

⁴⁷ Republic of China, Ministry of Economic Affairs, Department of Investment Services, “Foreign Exchange Reserves of Major Countries,” statistics for February 2006, updated October 2006. See also Central Bank of China, “Foreign Exchange Reserves at the End of October 2006,” press release, November 3, 2006.

⁴⁸ “Taiwan Gov’t Halves Daily Slide Limit to Stabilize Stock Market,” 2000.

\$5 billion (NTD) and \$10 billion (NTD) (around \$150 million to \$300 million U.S.) into the Taiwan Stock Exchange. The government encouraged a similar intervention after the July 1999 stock slide.⁴⁹

Finally, the government maintains a National Stabilization Fund backed by banks and insurance companies—currently funded at about \$3.8 billion—that it has periodically activated to slow downturns caused by nonmarket forces. The Fund's executive secretary is Vice Minister of Finance Chen Shuh (Gordon Chen). But to discourage its abuse for partisan political purposes, the fund is overseen by a board of directors that must approve its deployment for a specified short period of time. The Fund was established by President Lee Teng-hui and Premier Lien Chan in February 1996, with an initial capitalization of \$7.3 billion, in response to a nearly yearlong stock slide that followed President Lee's trip to the United States and mainland China's subsequently threatening military exercises across the straits. In recent years, the Fund has been used a few times to stop market slides—including right after Chen Shui-bian's 2000 inauguration, in the wake of the disputed 2004 presidential election, and again in May 2004 in response to threats from Beijing and concerns over the impact that efforts to "cool" China's economy might have on Taiwan. For the most part, however, the government has maintained a judicious public stance in employing the fund, preferring instead to shepherd its resources while reassuring investors by stressing what it sees as the fundamental health of Taiwan's economy and its corporations. This self-restraint has earned the Fund high marks from some businesspeople and investment experts.⁵⁰

Several experts stressed that, in the longer term, Taiwan is caught on the horns of a dilemma regarding its stock market policies and financial vulnerability to the mainland. To generate more capital, it needs to attract more foreign investment. The problem is how Taiwan can attract more foreign investors without making the market more susceptible to deliberate buy-up and manipulation by the mainland. Since the 2004 election, the Chen government has reportedly been moving to reform some of the very market restrictions that help protect the Taiex from mainland manipulation—such as gradually easing the 7 percent daily rise/decline limit and loosening limitations on the percentage of an investment fund that can be invested in one stock.⁵¹

⁴⁹ "Taiex Caught in Volatile Trade as Political Crisis Fails to Abate," *Taiwan News*, March 24, 2004; "Cash-Rich State Funds Strive to Staunch Market Decline," 1999.

⁵⁰ "President Lee Reaffirms Measures for Dealing with China," *Chung Kuo Shih Pao* (Taipei), February 29, 1996, p. 2; "Prepared Testimony of David N. Laux," 1996; "NSF Will Bolster Stocks on May 20," 2004; Culpan and Chen, 2004; "Taiex Dives as Protests Continue," *Taiwan News*, March 23, 2004.

⁵¹ "Taiwan State Stabilization Fund Panel Does Away with Investment Caps," AFX-Asia, July 9, 2004; Kathrin Hille, "Taiwan Aims to Ease Mainland Investment Rules: Interview with Hu Sheng-Cheng," *Financial Times*, June 28, 2004c, p. 2; Jadd Cheng, "Taiwan Plans to Act on Trading Limits in Stock Markets," *Financial Times*, July 21, 2004, p. 28.

"Taiwan's stock market is a real problem," according to the director of one of Taiwan's most respected economic think tanks. A key issue concerns whether many of these mainland-invested Taiwan firms would have their IPOs in Taiwan, Hong Kong, or the mainland. Many of these top firms badly need to raise funds, and financial analysts have reported that more than 100 Taiwan firms—including major high-tech firms—were considering spinning off mainland operations to hold IPOs in Hong Kong. At present, the Taiwan government will not permit these firms to list their stocks on the mainland stock markets, and it restricts the amount of capital raised on Taiwan or overseas markets that can be put into these firms' mainland operations.⁵² A widespread fear, particularly among Taiwan independence supporters, is that "the money goes to the mainland, but the debt all stays in Taiwan." But the government's dilemma also reflects another more ominous concern—that mainland investors, particularly government-linked investors—would gradually buy up the equity in Taiwan companies that list on the mainland, and the Taiwan government would have no way of knowing this or responding. These experts fear that the mainland could thereby establish its influence over these companies or use its equity to deliberately exacerbate volatility in the market. For now, argue experts interviewed for this study, such activity is still prohibited, although reforms in the market designed to lure in more foreign capital may cause this situation to change.

Even if the mainland did not "buy up the market," the experts stressed that Taiwan must find new ways to address China's ability to "say something threatening and make the market fluctuate." To ease the dangers of investor skittishness, Taiwan would prefer to attract more institutional investors, because they tend to be more stable than individual investors. But even institutional investors remain vulnerable to panic as a result of political instability and volatility in cross-strait relations. According to the economic think tank's director, "We are vulnerable [to mainland manipulation] . . . and I do not know how we can become less vulnerable."⁵³

These experts report that there is a great deal of debate going on in Taipei over how to handle this problem. The government is reportedly considering new policies that would permit Taiwan firms to list overseas only if they invest a certain fixed percentage in Taiwan. These experts note that Taiwan firms once again feel caught in the middle—fearful that they may offend either Taipei or their Chinese partners depending upon where they choose to list. The head of Taiwan's Financial Supervisory Commission, Lu Daung-yen, has also reportedly said that Taiwan plans to gradually ease the daily limit on the rise and fall of stock values from 7 percent to 10 percent or perhaps to 15 percent.⁵⁴

⁵² Ho Hsujun, "100 Taiwan Firms Ponder HK Listings," *The Standard* (Hong Kong), April 7, 2004.

⁵³ Interview, Taipei, June 2004.

⁵⁴ Interview with a senior financial journalist, June 2004; Jadd Cheng, "Taiwan Plans to Act on Trading Limits in Stock Markets," *Financial Times*, July 21, 2004, p. 28.

Moreover, Taiwan's market stabilization measures, such as the National Stabilization Fund, are clearly intended as short- or medium-term responses to sudden shocks—intended to reassure investors, to give them a breather to refocus on the fundamental value of Taiwan stocks, and perhaps to lure them back to purchase the stock “bargains” that a temporary downturn can create. There is evidence that this is exactly how some market analysts responded in 2004.⁵⁵

But, obviously, Taiwan's capacity to endure such financial disruption in the long term is the more crucial question. The foreign exchange reserves Taiwan has available to defend itself are so large—larger, indeed, than the entire GNPs of many important countries—that they place Taiwan in an almost unique category among the countries of the world that are likely to become targets of economic coercion. But the willingness of investors to stay in the Taiwan market—or to return after a temporary downturn—will always depend in large measure on the length and severity of any cross-strait crisis and investors' perceptions of China's capacity and resolve in exerting long-term pressure on the island or even using military force. On balance, the conclusions voiced a decade ago by longtime U.S. government Taiwan specialist David N. Laux seem every bit as reasonable today. While explaining Taiwan's newly enacted financial stabilization mechanisms to Congress, Laux argued,

While the fact that Taiwan has little or no foreign debt and the world's second largest foreign exchange reserves substantially reduces the prospects that Beijing's actions will create a financial crisis, much depends on how long China keeps up its program to unnerve Taiwan. A protracted campaign over the rest of the year might seriously tax Taiwan's capabilities to deal with the problems involved.⁵⁶

The precise economic impact of any longer-term threats by the mainland—though potentially very severe—would depend on investor psychology, which is far more difficult to gauge. Certainly, if continued pressure on Taiwan caused markets to continue slumping for a prolonged period, this would eventually undermine long-term capital accumulation in the Taiwan economy and undermine the government's ability to lure in new foreign capital.

Disruption of Taiwan's Information Networks

Beginning in the late 1990s, the prospect of mainland Chinese efforts to attack Taiwan's computer networks as an act of economic disruption has been a growing source

⁵⁵ As reported in the article “Buying Opportunity in Taiwan,” *Straits Times* (Singapore), March 28, 2004, for example, a major Singapore investment house urged investors to take advantage of Taiwan “bargains” after the “short-term” sell-off following the election.

⁵⁶ “Prepared Testimony of David N. Laux,” 1996.

of concern in Taipei. According to one former senior Taiwan official, during the late 1990s, officials of the MND, NSB, MAC, and other government departments formed a task force to focus specifically on these issues. In 1999, President Lee Teng-hui's government reportedly initiated work on a comprehensive national security network (*guojia anquan wang*) incorporating every government department and intended to strengthen cross-agency coordination of security policies as Taiwan's dealings with the mainland expanded—including strengthening protection of computer networks and information (as well as finance, immigration, transportation, and many other sectors). Implementation of the network and other information-protection systems continued under the Chen Shui-bian administration.

Both former and current senior officials interviewed for this study have described Taiwan as potentially “very vulnerable” to economic disruption as a result of such Internet attacks. Since 2000, mainland hackers have attempted numerous cyberattacks designed to harass, disrupt, or paralyze Taiwan's financial, transport, shipping, military, and other networks.⁵⁷ One senior official indicated that, in his view, most government bureaucrats had been rather slow to recognize the importance of even some very basic computer network security precautions, although precautions were improving. A former official did not believe that such attacks would be a regular occurrence, however, and would be more likely to occur sporadically, or perhaps as part of a much larger military attack, if that were to come. At the same time, these officials hinted that Taiwan was not without means of retaliating. “Both sides [China and Taiwan] have so many hackers. China is vulnerable, too.”⁵⁸

Coda: China's Economic Dependence on Taiwan

While Taiwan's reliance upon its ties to the mainland is considerable, the relationship is not one of simple one-way Taiwan economic dependence but rather one of “asymmetric interdependence.” China relies on Taiwan for economic goods and services that constitute a far smaller percentage of China's economy but are still highly important both economically and politically. Many Western economists have argued that FDI has been one of China's two major sources for the capital that has helped fuel its rapid economic growth over the past 25 years (the other being citizens' savings accounts in state-owned banks).⁵⁹ According to official mainland statistics, Taiwan was the source

⁵⁷ “Army Says Mainland Cyberattacks Thwarted,” *Liberty Times* (Taiwan), March 14, 2000; John Leyden, “Taiwanese Engineer ‘Assisted Mainland Hackers,’” *The Register* (UK), May 27, 2004; “Hackers Attack Taiwan Military News Agency Ahead of Drill,” Agence France Presse, July 20, 2000.

⁵⁸ Interviews with current and former Taiwan officials involved in cross-strait security issues, June 2004.

⁵⁹ For a summary of economists' views on the sources of Chinese growth and the role of FDI, see K. C. Yeh, “China's Economic Growth: Recent Trends and Prospects,” in Shuxun Chen and Charles Wolf, Jr., eds., *China*,

of at least 7.5 percent of China's FDI during 2002 (\$3.97 billion of a total \$52.7 billion), and when capital from intermediary investment venues is included, the figure almost certainly exceeds 10 percent of China's total.⁶⁰ A sudden loss of capital inflows from Taiwan—even if they were not accompanied by a downturn in FDI from other investors—could have a major impact on economic growth in the mainland.

Since Taiwan's economic relations with the mainland are by no means equally distributed across China—either in terms of geography or sectoral distribution—some regions and sectors would suffer far more severely from a major disruption of economic relations.⁶¹ In particular, China's electronics industry and the politically influential provinces in which much of it is based—Shanghai/Jiangsu, Guangdong, Fujian, Shandong, and others—would likely suffer the most from a loss of capital, component-part sources, managerial skill, export earnings, and tax revenues. Industry experts estimate that by 2002 more than 70 percent of the IT products manufactured in China were produced in Taiwan-invested enterprises. Shanghai/Jiangsu has become the new center of gravity for high-tech industries in which Taiwan is heavily invested. Almost 1,100 enterprises in which Taiwan companies have invested were established in Shanghai and Jiangsu Province in 2001, and there are now more than 10,000 Taiwan companies operating in the area. Jiangsu Province has approved investments in more than 11,700 Taiwan-funded companies, and during the first four months of 2003, Jiangsu Province—in particular the city of Suzhou—registered more than \$2.2 billion in contractual investment from Taiwan, according to Chinese government statistics.⁶² Still, as of 2002, Shanghai and Jiangsu were still second to Guangdong, where there were more than 14,000 Taiwan-invested firms.⁶³ The percentage of total FDI in many of these provinces that comes from Taiwan sources far exceeds China's overall nationwide reliance upon Taiwan capital. According to official Chinese government statistics, Shanghai and Jiangsu, for example, reported a combined paid-in FDI of \$14.46 billion in 2002. Taiwan's MAC, in turn, estimates that in the same year, Taiwan investment in Jiangsu/Shanghai was \$3.17 billion—nearly one-quarter of the region's total. This official FDI figure, moreover, excludes capital filtered through intermediary countries or regions.⁶⁴ Unfortunately, data on the number of mainland workers employed in these factories are not available, but the number is certainly substantial.

the United States, and the Global Economy, Santa Monica, Calif.: RAND Corporation, MR-1300-RC, 2001, pp. 69–97.

⁶⁰ National Bureau of Statistics of China, 2003, Table 17-15, pp. 672–674.

⁶¹ For a detailed discussion of the geographical and sectoral distribution of Taiwan's IT investment in the mainland, see Chase, Pollpeter, and Mulvenon, 2004.

⁶² See "More Taiwan Investment Flowing into Jiangsu," *Xinhua*, June 2, 2003.

⁶³ Ma, Zhui, and Kwok, 2002, pp. 9–11.

⁶⁴ National Bureau of Statistics of China, 2003, Table 17-16, p. 675; see also Mainland Affairs Council, *Cross-Strait Economic Statistics Monthly*, all dates.

Moreover, as some economists have pointed out, the goods and services that Taiwan provides to China—capital, management, technology, and intellectual property—provide far greater value added to the Chinese economy than China's goods and services provide to Taiwan. Indeed, some Taiwan economists have estimated that, for every dollar of goods China imports to a Taiwan-invested enterprise, China derives five dollars in exports from the goods those enterprises produce.⁶⁵ Hence, gauging the level of economic pain and dislocation that each side would suffer as a result of a major economic crisis is far more complicated than simply totaling up the dollar value of cross-strait trade or investment flows, or even estimating them as a percentage of each side's GNP.

Conclusion: Putting Taiwan's Economic Vulnerability in Perspective

As this chapter has shown, Taiwan's reliance on mainland China's economy is now quite large, and the mainland economic relationship carries very substantial weight within Taiwan's overall economy. This relationship provides China with the potential to inflict very severe economic pain and dislocation upon Taiwan during a major crisis and has permitted Beijing to inflict measured, less-severe economic pressure on Taiwan repeatedly over the past decade.

- Mainland China is Taiwan's number-one trade partner, and cross-strait trade is a major component of Taiwan's economic activity, with exports to the mainland probably constituting at least 15 to 21 percent of Taiwan's entire GNP by the end of 2005. Mainland China is also very likely the recipient of well over half of Taiwan's total FDI—though the actual amount of this investment is difficult to estimate with precision.
- The absence of relatively complete and reliable statistical reporting on cross-strait trade and investment—the margin of uncertainty for FDI is particularly large—means that the available statistical indicators, impressive as they are, almost certainly underestimate the percentage of Taiwan's exports and FDI that are tied to the mainland.
- The economic importance and substitutability of the products tied up in this relationship present a somewhat more mixed picture. A very large and growing share of many of Taiwan's most important IT exports undergoes final assembly on the mainland. On the other hand, Taiwan's dependence upon the mainland

⁶⁵ Taiwan professor Tung Chen-yuan, a respected expert on cross-strait relations, cites a 1999 econometric study by the respected Taiwan think tank the Chung-hua Institute for Economic Research, which estimates that the "correlation multiplier" between Taiwan's exports to China and China's exports produced by Taiwan-invested enterprises was 20 percent in 1997. "[T]hat is," the study states, "if Taiwan's exports to China were disrupted by one dollar, China's exports produced by TIEs would decline by five dollars" (Chen-yuan Tung, 2003b, p. 144).

for petroleum and other key natural resources is far less (coal is a noteworthy exception, though alternative sources would be relatively easy to arrange, so long as China did not blockade the island). The 2002–2003 public disputes over government estimates of Taiwan’s strategic petroleum reserve are a source of concern, however, and merit closer research and ongoing monitoring.

- Taiwan officials have at their disposal powerful administrative systems, extensive experience, and enormous financial resources to ease the disruption China can—and has—inflicted upon Taiwan’s stock market. In the near future, a key uncertainty requiring close attention is just how much Taiwan’s ongoing efforts to attract needed foreign capital by liberalizing the market will lay Taiwan bare to greater disruption from the PRC. The fundamental threat to the market remains the mainland’s capacity to bleed the market’s vibrancy through sustained, long-term pressure and uncertainty; the magnitude of this threat, however, will be determined by political, diplomatic, and military factors, rather than economic ones.
- The mainland’s capacity to disrupt Taiwan’s economically vital information networks has been a source of great and growing concern to Taiwan officials for close to a decade, and current and former senior officials admit Taiwan was slow to recognize the magnitude of the threat. But these officials were hesitant to speak on these matters in detail, and the seriousness of the threat is far harder to judge and must remain the focus of further detailed research.

Levels of trade and investment that constitute such a high percentage of Taiwan’s total trade, total investment, and GNP clearly justify serious concern about the potential political leverage they confer on the PRC. Still, the available evidence on other countries that have been the target of economic coercion does not provide us with any clear “red line” level of trade or investment dependence that constitutes a “tipping point,” automatically making successful economic coercion much more likely. And even if such a “red line” of dependence existed, it would appear that Taiwan is still below it, although its level of dependence is rising to levels of concern.

In what is probably the most respected comparative-historical statistical study of economic coercion, Hufbauer, Schott, and Elliott estimate economic vulnerability using a measure of what they call “trade linkage.”⁶⁶ These scholars measure trade linkage as an average of two variables: (1) the target country’s exports to the initiating country as a percentage of the target’s total exports and (2) the target country’s imports from the initiating country as a percentage of the target’s total exports. Hufbauer, Schott, and Elliott do find some positive correlation between the initiator and target country’s level of trade linkage and the likelihood that economic pressure will succeed. But that correlation is not strong, nor does the correlation always hold, even at very

⁶⁶ Hufbauer, Schott, and Elliott, 1985, pp. 58–76.

high levels of trade linkage. Several target countries that caved in to economic pressure were far less dependent upon their adversary for trade than Taiwan is on the PRC. Conversely, other target states that were far more trade dependent on their adversary than Taiwan is on mainland China have nevertheless endured severe economic pressure for prolonged periods without making major policy concessions or falling victim to regime destabilization. On balance, however, in cases where the target country relies upon the sanctioning country for a very high percentage of its imports or exports, the sanctioning countries have been *somewhat* more successful in forcing the target country to make moderate policy changes, or in forcing regime change.

Using Hufbauer, Schott, and Elliott's measures, Taiwan's trade dependence on mainland China is rather high—and growing—but in comparative terms it still falls solidly below the level of most target countries that have made major concessions in the face of economic pressure.⁶⁷

Using MAC trade statistics and the Hufbauer, Schott, and Elliott formula, Taiwan's index of trade linkage with mainland China for 2005 was 19.68, a figure that is fairly high but is still significantly lower than the average trade linkage figure for cases in which the target country made significant concessions to the initiating country (27). Indeed, the current Taiwan figure is still closer to the average figure for cases in which economic sanctions failed (14 percent). If the estimate of Taiwan's trade linkage is calculated using the higher trade figures published by PRC Customs, Taiwan's trade linkage with the PRC would rise but only to about 23.35, closer to but still below the average for successful economic coercion.⁶⁸ The historical trends in Taiwan's trade linkage, however, are less reassuring. If we calculate the level of trade linkage for as recently as 2000, we find that both the Taiwan MAC and PRC Customs data yielded a far lower index of just over 10. Thus, given recent economic trends, Taiwan could reach the 27 level, at least by the higher PRC measures, within as little as another year or two. This would still not place Taiwan at a level where the majority of countries that have faced economic coercion did make major policy concessions, but it would put it near the average level of those countries that did.

It is also far harder to assess the economic harm and dislocation that Taiwan would suffer if China were willing and able to carry out a nationwide seizure of Taiwan's investment assets on the mainland than it is to gauge the dislocation that would be caused by a cutoff of cross-strait trade. Clearly, in the short run, a large-scale seizure of Taiwan assets would result in major losses of capital for the owners of many of Taiwan's most important corporations and major job losses for those workers whose jobs depend upon exports of parts for mainland assembly facilities. The value of their stocks would also plummet. Many of the first-wave "sunset" industries that relocated

⁶⁷ Hufbauer, Schott, and Elliott, 1985, pp. 58–76.

⁶⁸ Hufbauer, Schott, and Elliott, 1985, especially Tables 4.1–4.5, pp. 70–76, and the discussion on pp. 58–59.

to the mainland in need of lower production costs would probably not survive such a blow.

But a key question concerns the prospects for Taiwan's higher-tech industries to recover and revive themselves in the medium term and especially in the long run. Many of the most profitable aspects of these firms—their intellectual, executive, and managerial talent and many of their most skilled production workers, many of their key production facilities, their design, research, and development facilities, much of their best intellectual property, and many of their marketing facilities—would remain on Taiwan outside of mainland China's hands. The mysteries surrounding these firms' financing are considerable, and as the official Chinese FDI statistics cited above make clear, Beijing's grip on cross-strait investment flows is only marginally better than Taipei's. Thus, it could be that at least a very large share of their capital would escape the mainland as well. These firms' prospects stand in stark contrast to most export-reliant developing countries whose key finished products are raw materials, textiles, low-tech manufactured goods, and other goods for which their major markets could easily find substitute sources. Taiwan's high-tech sector would still have a very attractive package of goods and services and could very likely find both new markets and new competitive production bases in other countries (one might speculate on India, Thailand, Malaysia, Indonesia, or other longtime objects of Taipei's "Go South" campaign). The severity and duration of damage to Taiwan's economy would be shaped by a variety of factors, including Taiwan investors' capacity to temporarily move assembly of finished goods back to Taiwan (an activity that is still carried on there, which many workers are still able to do) until they were able to raise the capital and arrange for outsourcing facilities in alternative countries.

Finally, if one were to step back from a more purely economic analysis—the focus of this chapter—and compare Taiwan with other historical objects of economic coercion, one would find that there is very little evidence that even levels of trade and investment dependence as high as Taiwan currently has with the PRC tend to make target countries significantly more likely to make truly major policy concessions, such as yielding sovereign territory or withdrawing troops from a war (in considering the discussion of "trade linkage" above, it is worth remembering that Hufbauer, Schott, and Elliott's notion of "major" policy concessions in most cases falls far short of a country yielding its self-defined "sovereignty").⁶⁹ And yet, this is precisely the caliber of issue that would almost certainly be at stake in a serious, no-holds-barred cross-strait economic confrontation. Consequently, while the analysis of economic factors in this chapter is an important consideration in assessing Taiwan's vulnerability to economic pressure, the focus on economic factors by itself is inadequate, and must be complemented by a careful review of political factors, which are the topics of the next chapter.

⁶⁹ Hufbauer, Schott, and Elliott, 1985, pp. 57–59, 70–77.

Political Factors: Converting Economic Influence into Political Leverage

Political Factors Influencing the Success or Failure of Economic Pressure

A central theme of this study, long stressed by experts on economic coercion, is that one country's economic influence over another country does not automatically translate into political leverage. Chapter Two analyzed several of the intervening political factors that have historically had a powerful impact on the effectiveness of economic coercion, and are likely to influence mainland China's capacity to convert its growing economic influence over Taiwan into effective leverage for achieving its key political goals. Briefly, these factors include

- the historical relationship among the initiating and target countries
- the nature of the goals or demands sought by the initiating country, and the political capacity of the target country to comply with these goals and demands
- the domestic balance of power and levels of political unity within both the target country and the sanctioning country
- international support for either the initiating country or the target country.

As discussed in Chapter Two, the bitter historical animosity between mainland China and Taiwan clearly makes many in Taiwan especially fearful that making major policy concessions to China might erode Taiwan's long-term security and undermine the island's credibility in defending its interests against its key adversary. And unquestionably, any major PRC effort to pressure Taiwan economically is likely to involve extremely emotional, high-stakes demands concerning issues of independence, sovereignty, and national identity. In recent years, despite occasional, very modest overtures by both sides aimed at finding a common ground, Taipei and Beijing have largely portrayed the main issues between them as powerfully symbolic, "zero-sum," "indivisible" issues of Chinese and Taiwanese sovereignty. Any effort at compromise on such goals would be highly vulnerable to charges of a "sellout" of fundamental national interests. Thus, not surprisingly, studies of economic coercion forecast that these political circumstances generally decrease the likelihood that Taiwan would be willing to make

major concessions on these issues, even in the event it was faced with strong economic coercion from the mainland.

Domestic Politics and Their Influence on Economic Coercion

The manner in which China's economic pressure interacts with Taiwan's domestic politics and balance of political power has a major impact on the effectiveness of economic coercion. This is the focus of most of this chapter—it assesses Beijing's effectiveness in converting the growing cross-strait economic relationship into political leverage within Taiwan politics.

For Beijing—as for any government that tries to use economic coercion—the greatest challenge is finding “levers” or “channels” in Taiwan's political system through which it can transform its economic influence into political power. Beijing must identify and effectively exploit *conduits of influence* within Taiwan's political system—politically influential classes or groups in Taiwan that feel that they have a stake in promoting the policies that Beijing also supports.

Conversely, for Taiwan to defend itself against this economic pressure, it must develop political strategies to blunt or undermine Beijing's political leverage. To accomplish this, Taipei must find ways of neutralizing Beijing's efforts to develop and exploit its political conduits of influence in Taiwan. Taipei may also try to “go on the offensive”—identify, develop, and exploit its own potential conduits of influence within mainland China's political system. That is, Taiwan may try to leverage politically influential classes, groups, or regions on the mainland that feel they have a stake in opposing, limiting, or undermining Beijing's efforts to use economic coercion against Taiwan.

Most of this chapter assesses Beijing's successes and failures in developing political support through three potential conduits of influence—reshaping Taiwan's mass public opinion, shifting the center of gravity among Taiwan's political party elite, and, most important, making use of Taiwan's business community. The closing section of this chapter briefly turns the problem around: It examines whether or not China's economic dependence on its relationship with Taiwan might create political pressures that undercut Beijing's will and effectiveness in employing economic coercion against Taiwan.

Major Findings: Obstacles to Beijing's Political Leverage

The major findings presented in this chapter are that Beijing has probably overestimated the ease with which it would be able to convert economic influence into political leverage, and its economic influence strategy has encountered significant frustrations.

- The growing dependence of many Taiwan's citizens on cross-strait economic relations for their livelihood has not generated greater public support for closer political ties with the mainland, nor is there evidence that these economic forces dampened the willingness of voters to reelect President Chen Shui-bian and the DPP.
- The center of gravity in Taiwan elite politics over the past decade has shifted away from candidates who actively promote closer cross-strait *political* relations and eventual reunification (at least any time in the foreseeable future).
- Most important, from Beijing's perspective, Taiwan's mainland-invested business community has disappointed Beijing's hopes that it would emerge as a unified, effective, and public lobby for Beijing's most important political interests. Instead, most businesspeople—faced with political pressure from Beijing and counter-attacks from President Chen's pan-Green coalition—have adopted a lower political profile on cross-strait relations (as several sources put it, “flying below the radar”). Other businesspeople have pushed for greater economic opening to the mainland, as Beijing hoped, but they have largely limited their policy activities to narrowly economic issues.

Turning Economic Influence into Political Leverage: Beijing's Strategies

Beijing's most fundamental and enduring tactical goal in employing economic pressure has been encouraging a subtle form of “regime change” in Taiwan. Beijing has long sought to exploit the growing cross-strait relationship to undermine the domestic political power of Taiwan officials whom it regards as pro-independence and build support (or at least acceptance) for reunification among Taiwan's citizenry and elite. To be sure, Beijing officials hope China's economic power will also serve many parallel policy goals. These other tactical goals include

- strengthening Beijing's power to pressure, marginalize, or disrupt Taiwan's economy in the event of a crisis
- signaling to Taiwan and the world that Beijing is absolutely determined to prevent independence
- buttressing Beijing's domestic legitimacy as a tough-minded “Chinese nationalist” government.

But Beijing's predominant tactical concern remains trying to reshape the political mainstream in Taiwan's emerging democracy, so that Beijing's anti-independence demands and pro-reunification overtures to Taipei will be greeted with increasing political acceptance. Beijing has already achieved some success in encouraging the political mainstream in Taiwan to reject or “self-censor” overt moves toward greater

independence (though it is unclear to what extent this is due to Beijing's economic or military leverage, or simply to the reflexive cautiousness of the Taiwan people). But if Beijing fails to create greater domestic support or acceptance for its policies within Taiwan's polity, it may be left with little choice but to resort to far more overtly coercive measures. These would risk backfiring by creating a permanent militant anti-reunification majority in Taiwan and drawing in greater international support for Taiwan.

Seeking Conduits of Influence in Taiwan

As Chapter Two noted, studies of economic coercion indicate that, historically, most attempts to use economic leverage to subvert or change target governments have not succeeded. For Beijing to succeed in using economic pressure to transform Taiwan's political balance of power, it must develop effective conduits of influence within Taiwan's political system. At least three potential conduits of influence in Taiwan could play a pivotal role in Beijing's efforts to turn economic ties into political leverage:

- *Mass Public Opinion.* Beijing hopes that mainstream Taiwan public opinion will come to feel its security and economic well-being are inextricably tied to Beijing. From a harsher point of view, Beijing hopes that in the event of a cross-strait crisis, Taiwan's voters would be motivated by economic interest to vote out pro-independence Taiwan politicians rather than "rallying round the flag" of their leadership. Less coercively, some mainland leaders and experts hope that economic interdependence will eventually forge a sense of common national identity across the strait.
- *Taiwan Political Elites.* Beijing hopes that closer economic ties will create an anti-independence center of gravity within the Taiwan political party leadership that would mobilize opposition to pro-independence political leaders in the event of a crisis.
- *The "Taishang"—Mainland-Invested Taiwan Businesspeople.* Unquestionably, Beijing has staked its greatest hopes on transforming the business community into a politically irresistible domestic lobby against Taiwan independence. As the central point of their economic-influence strategy, mainland officials have banked on the willingness and capacity of Taiwan businesspeople with investments in the mainland to influence Taiwan's political elites—by pushing stronger cross-strait relations, preventing a slide toward independence, and providing critical campaign support for candidates that Beijing prefers.

Public Opinion: Economic Closeness, but Political Drift

Analysts of economic diplomacy have long argued that political attitudes among average citizens and voters are a crucial factor—albeit difficult to measure—that can affect whether or not economic coercion succeeds. To successfully resist severe economic coercion, target governments must struggle to mobilize a popular rally-round-the-flag response, or perhaps organize mass discipline in the face of severe economic deprivation. Targeted governments must also find ways to neutralize potential opposition groups that might step up the pressure to make concessions, or even try to overthrow the government.

Some mainland Chinese advocates of relying on economic leverage have staked their dreams of reunification on economic forces producing a gradual shift in Taiwan public opinion. Their hope is that stronger cross-strait economic integration would strengthen mutual understanding and integration and eventually produce a shift in the political center of Taiwan's politics, leading the island's people to embrace closer political links with the mainland. China's top leaders, in an effort to reassure Taiwan, have often voiced this view in their public pronouncements.¹ During periods when he sought to reassure Beijing, even President Chen Shui-bian has paid at least lip service to this long-term integrationist viewpoint. During his 2000 New Year's Eve address, in which he announced an easing of cross-strait economic links, Chen stated,

The integration of our economies, trade and culture can be a starting point for gradually building faith and confidence in each other. This, in turn, can be the basis for a new framework of permanent peace and political integration.²

But trends in Taiwan's public opinion over the past two decades have proven to be a bitter disappointment for these mainlanders. As many observers of Taiwan's politics have noted, while cross-strait economic ties have increased rapidly, public support for reunification or closer political links on Beijing's terms has remained low and, in some ways, even declined. In the words of Taiwan politics expert Shelley Rigger, "[A] plurality of Taiwan's citizens still favors the status quo. The status quo entails political autonomy for Taiwan, but eschews formal separation from China."³ According to public-opinion surveys conducted between 1998 and April 2004 for Taiwan's MAC by several top polling institutions, the percentage of Taiwan residents who support rapid reunification with the mainland has always fluctuated in a very low range (between 0.8 and 4.2 percent). The number that favor maintaining Taiwan's status quo now but eventually moving toward reunification gradually increased from 16 percent in 1998 to

¹ See, for example, Hu Jintao, 2003.

² Speech by Chen Shui-bian on January 31, 2000, cited in Rigger, 1999, p. 216. On Chen's efforts to reassure the mainland, see Chien-Min Chao, "Introduction: The DPP in Power," *Journal of Contemporary China*, Vol. 11, No. 33, November 2002, pp. 605–612, especially p. 607.

³ Rigger, 1999, p. 191.

21 percent in 2001 but has drifted downward since 2001 to about 9 percent as of early 2006. At no time since 1998 has the combined number advocating reunification—either now or sometime in the future—reached even 25 percent of the population, and today it languishes at a mere 13 percent. Those who prefer either maintaining the status quo indefinitely or the status quo with a deferred decision on the independence issue command a great and increasing majority.⁴

Beijing might wish to take a little solace from the fact that, in the MAC surveys, the number of citizens who support an immediate declaration of independence has rarely exceeded 7 percent. But another major survey conducted by Duke University political scientists in December 2002 suggests that a significantly higher percentage of Taiwan's citizens—more than one-quarter—would support a declaration of independence, even if they felt it would probably result in war with the mainland.⁵

Support for Beijing's announced reunification plan ("one country, two systems") has also never been high over the past decade, usually fluctuating in the high single digits and occasionally rising up to 12–16 percent but mostly stuck around 7–9 percent over the past few years. Opposition to the mainland's "one country, two systems" plan has consistently remained very high—between 70 and 85 percent.⁶

Indeed, more recent MAC polls reveal that instead of embracing Taiwan's growing economic links with China, most in Taiwan are rather suspicious of these relationships. From 2001 to 2006, a consistent majority of those polled has responded that the Taipei government needed to tighten—not loosen—government restrictions on cross-strait investment. Support for liberalizing mainland investment has always been a weak minority opinion, hovering at around 20 to 25 percent of the population.⁷

In short, based on the data from the MAC surveys, there is little evidence that the dramatic increases in cross-strait trade and investment flows over the past decade have produced an increase in popular support for a closer political relationship with mainland China. Among the broad citizenry in Taiwan, economic integration does not

⁴ Mainland Affairs Council, "Reunification or Independence?" public opinion poll, ongoing(a). The MAC polls are conducted with a sample of approximately 1,100 Taiwan adults age 20 to 69. No margin of error is stated. Duke University political scientist Emerson Niou has argued that measures such as the questions used by the MAC are inadequate because most respondents "opt for ambiguity" by choosing positions in the center. This leaves policymakers no way of knowing under what circumstances most in Taiwan might abandon their "status quo" positions and support stronger policies for either reunification or independence (Emerson M. S. Niou, "Understanding Taiwan Independence and Its Policy Implications," *Asian Survey*, Vol. 44, No. 4, July/August 2004, pp. 555–567).

⁵ Niou, 2004. Niou's survey of 1,225 adults found that "about 26.7 percent of the respondents favored independence even if that implied war with China." If they thought they faced the prospect of no war, an overwhelming 72 percent of the respondents supported independence from China.

⁶ Mainland Affairs Council, "Is the 'One Country, Two Systems' Formula Applicable to Solving the Problems Across the Straits?" public opinion poll, ongoing(c).

⁷ Mainland Affairs Council, "How Should Our Government Handle Taiwanese Investment on Mainland China?" public opinion poll, ongoing(b).

seem to be yielding much payoff in support for either cultural or political integration that Beijing could use to promote its agenda. If anything, there is slight evidence that, while economic ties have strengthened, reunification with the mainland has dwindled as a dream for most in Taiwan.

Of course, polling data such as these, taken in relatively peaceful times, is inadequate to forecast how the people of Taiwan might respond in the face of major economic pressure from the mainland—whether they would be more likely to “rally round” their government leaders, or split and give support to opposition leaders who support concessions. The bitter 2004 presidential election may have left latent cleavages that GMD-PFP leaders might exploit during a crisis to argue that Chen was illegitimately elected and is now recklessly leading Taiwan down the road to disaster. The data do, however, cast significant doubt on mainland hopes that cross-strait economic integration will feed a desire for political integration.

Neutralizing Potential Leverage: The Shifting Center of Taiwan’s Elite Politics

Divisions among Taiwan’s political elites constitute another potential conduit for Beijing to transform its economic influence into political leverage. In the event that Beijing attempted to initiate economic coercion during a crisis, the Taipei government would be under even greater pressure if a significant portion of Taiwan’s political elites responded by mobilizing opposition to the regime or insisted that Taipei make concessions to Beijing’s demands.

The 2004 Taiwan presidential campaign, however, dealt at least a temporary blow to any hopes Beijing might have had in that regard. President Chen’s highly effective campaigning continued a longtime shift in the center of gravity in Taiwan’s elite politics. Chen successfully dictated the agenda of issues during the campaign and in many ways transformed the campaign from a referendum on Chen’s rather weak economic and administrative record into a referendum on whether or not the opposition pan-Blue coalition is sufficiently “Taiwanese.” Chen and his allies combined this pressure with a campaign of “red-hatting”—painting critics and GMD supporters among Taiwan’s business community as potential Quislings of Beijing. As a result, Lien Chan and his running mate James Soong felt obliged to harden a number of traditional GMD policy stances that were premised upon a nominal long-term goal of reunifying China. In the words of one U.S. analyst who was sympathetic to President Chen’s efforts,

The pan-Blue camp has moved substantially toward pan-Green positions. The opposition parties dared not speak as approvingly as they once had about reunification. Where four years earlier Chen had to calm fears that he might be too radically pro-independence, the pan-Blue parties in 2004 had to settle for diluting, rather than stopping, Chen’s calls for referenda on cross-Straits security issues. Lien and Soong were forced to defend proposed initiatives for better relations with the mainland against the charge that they were insufficiently protecting Taiwan’s interests. Chen mocked the GMD as the “Chinese Nationalist Party” and the

pan-Blue candidates were reduced to kissing the ground as a public demonstration of their fealty to Taiwan.⁸

Following their second consecutive presidential defeat, the internal divisions within the GMD-PFP alliance, coupled with their struggles to find new standard-bearers, temporarily weakened the parties as potential points of leverage for economic pressure.

Although the pan-Blue opposition soon enjoyed a dramatic reversal of its political fortunes, winning both December 2004 Legislative Yuan elections and the December 2005 local elections, these events produced only a partial reversal in the elite politics center of gravity. In the spring of 2005, GMD chief Lien Chen made his dramatic visit to the mainland, where he met with President Hu. Beijing followed this trip with offers of greater economic opening to Taiwan's farmers, students, and other groups. But Lien's successor as head of the GMD, Ma Ying-jeou, was initially cautious in his stance on economic engagement, simply affirming the need for greater opening up of relations and eventual establishment of direct flights. More importantly, Ma has thus far resisted voicing support for any significant move toward Beijing's fundamental political goals—most notably eventual political reunification. Unquestionably, with Ma as president, Beijing would be far less fearful of Taiwan taking more active steps toward permanent formal separation from the mainland. But Ma has also embraced two powerful propositions of the Taiwan-elite political mainstream that do not bode well for Beijing's goals. Ma insists on a fundamentally Taiwan-based electoral sovereignty, arguing that no cross-strait deal can be accepted unless it is approved by Taiwan's 23 million voters voting by themselves. Second, Ma has bluntly played the "democracy card"—insisting that Taiwan should not even consider formal political reunification until such time as China is a more developed political democracy similar to Taiwan—a prospect Ma clearly considers a long way off. The last significant party whose leadership has hinted at support for political reunification any time in the foreseeable future—the PFP of James Soong—is currently losing many of its members who are fleeing to the much stronger Kuomintang. Thus, despite the vicissitudes of Taiwan's electoral politics in recent years, the emerging center of elite political gravity does not suggest that the rapid growth in economic relations has prompted greater support in Taiwan for Beijing's long-term political goals. Some Western analysts of Taiwan politics see this as a gradual shift of the political elite back into line with the mainstream of popular opinion, which prefers the continuation of a "status quo" defined by no major movement toward either formal political independence or political reunification.

⁸ Jacques deLisle, "The Aftermath of Taiwan's Presidential Election: A Symposium Report," Foreign Policy Research Institute, June 18, 2004.

The “Taishang”: Business as the Key Conduit for Beijing’s Influence?

Virtually every expert consulted for this project agreed that Taiwan businesspeople engaged in commerce with the mainland—known as Taishang for short—are the most important conduit through which Beijing hopes to exercise its economic influence. Beijing’s long-stated goal has been to transform economic power into political power by “using business to pressure government” (*yi shang cu zheng*).

In Taiwan politics, the role of the Taishang and their relationship to Beijing has long been the focus of bitter debate. Some politicians and analysts portray the Taishang more charitably as “lobbyists” who “share in Taiwan’s governance” on key issues of cross-strait economic relations. Many others, however, fear the Taishang’s influence and portray them as the mainland’s “hostages,” “agents,” or “cats’ paws,” or as a “Trojan horse” undermining Taiwan’s vigilance from within. Those who disparage the Taishang as mainland hostages fear that China would use the threat of cutting off economic and trade relations to prevent the Taiwan government from consolidating or establishing Taiwan’s independence. Afraid of the harm Beijing could inflict on these businesspeople and to the economy, Taipei’s political leaders would slacken their resistance to Beijing’s pressure—in the Chinese idiom, they would “refrain from stoning the rat for fear of smashing the porcelain” (*toushu jiqi*).⁹

Beijing has indeed long hoped to exploit economic relations with Taiwan to transform the business community into a politically irresistible domestic lobby. By patiently strengthening cross-strait business links, Beijing wants to use these relationships to encourage or to pressure Taiwan businesspeople to push the Taipei government to

- stop undertaking policies that inch Taiwan closer to formal independence from China
- make significant political concessions to Beijing on key issues, such as accepting some version of the “one China” principle as a basis for cross-strait negotiation
- further deepen cross-strait economic relations as a source of greater future leverage for Beijing.

In recent years, as Chen Shui-bian’s DPP and his coalition partner, the TSU, have emerged as influential voices for moving Taiwan closer to de jure independence, China has increasingly prodded Taishang to support the GMD opposition as the best available hope for promoting its policies.

⁹ A thoughtful analysis of the Taishang’s political roles and how they are perceived in Taiwan is in Keng Shu, “Tu Cheng Mu Ma? Taishang Zhengzhi Juese de Fenxi” (“A ‘Trojan Horse’? An Analysis of the Political Roles of Taiwan Businesspeople”), draft manuscript, National Chengchih University, Taiwan, June 2004.

Beijing's Questionable Assumptions About the Taishang

Fundamentally, Beijing's scenario for using business influence has always rested on the several key assumptions about the power of business within the Taiwan political system:

- The Taishang can exercise an enormous amount of power in Taiwan's political system—an assumption partially rooted in Beijing's impression that Taiwan's democratic political system is highly corrupted by illicit political funds (known as “black gold”).
- The Taishang are not merely powerful enough to change Taiwan's economic or security policies but can even help effect a change of government in Taipei—decisively influencing who gets elected to the presidency and the legislature.
- With the rise of cross-strait economic relations, the Taishang will feel a strong and growing interest in closer political relations and will use their leverage to support advocates of closer relations and to oppose or check independence advocates.

But a close examination of the Taishang's role and power in Taiwan's politics suggests that while some of Beijing's assumptions are reasonable, many are badly oversimplified. As Chapter Three demonstrated, the Taishang have indeed exercised great political influence in changing economic policy, but not to the degree or in the manner that many in Beijing have hoped.

- The Taishang did not display sufficient electoral power and unity to drive Chen from office, nor have they forced the Chen government to make significant concessions on the most controversial issues of cross-strait relations, such as negotiating the “three links” without conditions Beijing finds unacceptable.
- While most observers agree that the majority of Taishang opposes Chen and his policies of recent years, there is also evidence that Taishang were not nearly so unified in opposition to Chen and the DPP/pan-Green coalition as the mainland had hoped. Unfortunately, the available solid evidence about Taishang political attitudes and behavior from polling and other sources is thin and does not provide a clear picture.
- Taishang political influence has been undermined by pressure from both the mainland and Taiwan:
 - Mainland pressure on the Taishang has sporadically been heavy-handed and counterproductive.
 - Taiwan domestic critics, who fear that the Taishang do not have Taiwan's true interests at heart, have often been effective in undermining their influence through “red-hatting”—portraying the Taishang as being influenced by Beijing. Beijing's occasionally heavy-handed pressure on the Taishang simply makes these red-hatting charges more credible.

- In response to this pressure from both sides, most Taishang have learned to fly below the radar politically—keeping their views to themselves and further limiting their influence on the most controversial issues.
- As Beijing recognizes that the Taishang are a less effective lever of influence than it had hoped, it is growing increasingly frustrated with the Taishang as a source of influence in the near term.

Beijing's Efforts to Leverage the Taishang

Beijing's inconsistent tactics, from seductive entreaties to petulant attacks to hollow threats, have undermined its own efforts to leverage the Taishang. During periods of cross-strait crisis, China has sometimes tried to soothe nervous investors. In March 2003, for example, Hu Jintao publicly reassured the Taishang that they have a role to play in peacefully building ties across the strait—a theme he returned to often after the spring of 2005. On other occasions, however, Beijing has been its own worst enemy—sporadically lashing out at several of Taiwan's most revered business leaders for allegedly supporting pro-independence politicians back home. Despite its periodic outbursts, however, Beijing has often been far less stern in following through on its threats against the Taishang—a fact that may undermine the credibility of these threats.

The 1990s: Private Reassurance

During the relatively early years of cross-strait engagement, when China relied more heavily on Taiwan for investment, Chinese officials—especially local officials—went out of their way to reassure Taishang investors that their businesses would be insulated from downturns in Beijing-Taipei relations.

- During the 1995–1996 crisis—when Beijing used missile tests and military exercises to threaten Taiwan in retaliation for President Lee's visit to Cornell University—Chinese officials explicitly reassured Taiwan investors that their holdings would be safe.¹⁰
- Likewise, in July 1999, despite Beijing's anger over President Lee's statement that China-Taiwan relations were a “special form of state-to-state relationship,” Beijing “showed restraint,” making no effort to use economic sanctions against Taiwan investors, according to one expert.¹¹

¹⁰ Chen-yuan Tung, 2003a.

¹¹ Chen-yuan Tung, 2003a.

It is unclear to what extent these reassurances reflected nationwide policies promoted by Beijing, or were largely initiated by local mainland governments that were fearful of the impact that a cutoff of Taiwan business might have on their local economies.¹²

Political scientists who have investigated the Taishang conclude that relatively few of them made concessions to mainland pressure in 1999. Shortly after President Lee's "special state-to-state relationship" remarks, Beijing ordered local Communist Party Taiwan Affairs Offices to lobby the Taishang in their area, urging them to publicly denounce Lee's comments. But based on a review of mainland newspapers, these analysts conclude that very few Taishang spoke up to criticize Lee. Instead, most kept silent. Some organized Taishang "mutual support networks" or rented planes to fly Taishang home to vote in the 1996 Taiwan presidential election—reportedly voting for Lee in large numbers.¹³

The 2000 Taiwan Presidential Election: Turning Up the Heat

Beijing turned to more open threats in the wake of the March 2000 presidential election, in which several top Taiwan CEOs frustrated Beijing by providing public endorsements that proved critical in helping to elect Chen Shui-bian.¹⁴ The list of Taishang luminaries who either supported Chen's election or at least promised to serve as his advisors included Nita Ing (Taiwan High-Speed Rail), Stan Shih (ACER Computer), Hsu Wen-lung (Chi Mei), and Chang Yung-fa (Evergreen). Beijing—clearly frustrated by Chen's unexpected election and the crucial legitimacy the Taishang had bestowed upon him—retaliated shortly after the election with its most public attack against the Taishang to date. Xinhua, the official news service, railed against businesspeople whom it said felt free to make millions on the mainland while undermining Beijing's reunification efforts back in Taiwan.¹⁵

Some people in Taiwan's industrial and commercial fields openly clamor for "Taiwan independence" and advocate the "Lee Teng-hui" line, which preaches the break up of the motherland. . . . Meanwhile, they scrabble for profits by engaging in business and economic operations on the mainland of China.¹⁶

¹² Chen-yuan Tung, 2003a.

¹³ Interviews with Taiwan political scientists and experts on business and politics, June 2004.

¹⁴ Lin Chieh-Yu, "Change History, Says Chen," *Taipei Times*, March 12, 2000, p. 1; Monique Chu, "Top Businessman Boosts Chen," *Taipei Times*, March 14, 2000, p. 3; "Leading Industrialist Endorses Chen," *China Post*, March 14, 2000; Mark Landler, "Taiwan's Politics Are Straining Trade with China," *New York Times*, June 27, 2000; James Kynge and Mure Dickie, "China Warns Taiwan Businessmen," *Financial Times*, April 10, 2000.

¹⁵ Two of the most respected Western financial journalists in the region characterized the threats as "the boldest attempt yet by Beijing to promote its political goals by exercising commercial leverage over Taipei's business community" (Kynge and Dickie, 2000).

¹⁶ Xinhua, quoted in Kynge and Dickie, 2000.

In the Xinhua article, Li Bingcai, the Deputy Director of the PRC's Taiwan Affairs Office, threatened that "such a situation will definitely not be allowed to continue." Despite its harsh language, the report failed to specify which Taishang Beijing regarded as guilty of supporting independence, or how it intended to punish them.¹⁷ But a lower-circulation, government-owned financial newspaper reportedly singled out by name the four prominent Taishang listed above.¹⁸

The credibility of Beijing's threats is, of course, crucial to its willingness and capacity to exploit its leverage. But sources differ greatly over how tough Beijing was in following through. Political scientist Tung Chen-yuan, one of Taiwan's closest observers of cross-strait economic relations, argues that, following April 2000, China did not follow up on these threats with "concrete sanctions."¹⁹ It does appear that none of companies headed by the four prominent Taishang who backed Chen actually suffered a major shutdown of their mainland operations. On the other hand, many financial correspondents report that mainland officials harassed several of these firms by launching aggressive, selective investigations of their compliance with Beijing's notoriously vague tax, labor, industrial, and environmental regulations:

- Chinese officials reportedly called and visited "pro-Chen Shui-bian" Taishang companies in Beijing to express their "concern" over their political leanings, according to workers at those factories.²⁰
- Senior Chinese officials reportedly snubbed ACER CEO Stan Shih by refusing to meet with him during his April 2000 visit to a technology conference in Beijing.²¹
- In the summer of 2000, Chinese government officials from several departments reportedly subjected five of Chi Mei's six mainland petrochemical and electronics plants to unprecedented environmental and industrial inspections. Some sources claim that state companies were also ordered not to do business with Chi Mei, at least temporarily.²²
- Mainland officials reportedly closed down a "preparatory office" that was developing long-term business prospects for Chang Yung-fa's Evergreen Corporation. Reports also circulated that customs officials in Hong Kong cost Evergreen

¹⁷ Xinhua, quoted in Kynge and Dickie, 2000.

¹⁸ Cited in Tkacik, 2001.

¹⁹ Chen-yuan Tung, 2003a.

²⁰ "China Targets Pro-Chen Businesses, Reports Say," *Taipei Times*, April 10, 2000, p. 17.

²¹ Landler, 2000.

²² According to Chi Mei Vice President C. H. Hsu, "We have never had such a situation before in the 10 years Chi Mei has had operations in China" (Mure Dickie, "China and Taiwan: Inspections Raise Temperature," *Financial Times*, June 9, 2000, p. 4; Landler, 2000).

business by deliberately holding up its containers, although Evergreen officials denied this report.²³

In addition to this reported harassment, Beijing's public threats by themselves also constituted a real financial sanction on some of the companies that were publicly traded at the time. Taiwan sources charge that Chinese authorities engaged in deliberate rumor-mongering to hurt these companies' reputations in the minds of investors.²⁴ These rumors pressured these companies through the stock markets—for example, ACER Inc.'s stock reportedly fell 5 percent in the three days following the April 2000 Xinhua threats.²⁵

While Beijing's threats were relatively successful in changing the public political activities of some Taishang, they encountered tougher responses from others.

One of Beijing's apparent victories involved ACER's Stan Shih, who in any event had not been one of Chen Shui-bian's more vocal supporters before the election. Shih and other ACER officials quickly began publicly distancing themselves from the Chen administration in particular, and cross-strait politics in general. Both Shih and other company officials flatly told reporters that they did not favor an independent Taiwan, and Shih stressed that he was "always neutral in election campaigns." "The fact is, President Chen appointed me as one of his advisors. I couldn't say no."

Even so, Shih also countered with a subtle threat to Beijing that he might pull out his highly prized computer investments, saying, "If they [Beijing] welcome me, I will contribute to their country. If they don't welcome me, I have so many other things to do." In 2003, Shih was reportedly even blunter in an interview with the *San Francisco Chronicle*: "I can survive without China . . . If they try to take my small Chinese investment, I'm fine."²⁶ Financial journalists who are well-acquainted with Shih argue that he distanced himself from Chen Shui-bian not only because of mainland pressure, but also out of sincere disappointment that Chen's cross-strait policies turned out to be far less moderate than he had promised in the 2000 campaign. Shih publicly expressed

²³ "China Targets Pro-Chen Businesses," 2000; "Uneasy Collaborators: To China, Taiwan Investors Are Both Welcome and Suspect," *Business Week*, August 14, 2000, p. 52.

²⁴ During the spring of 2001, unsourced reports circulated in mainland business circles claiming that Chi Mei's petrochemical plants in south China were going to be closed down in retaliation for Hsu Wen-lung's support of the DPP—reports that mainland officials waited several days to deny publicly. See "Editorial: China Resorts to Rumor-Mongering," *Taipei Times*, March 12, 2001, p. 8; and "Editorial: In China, Everything Is Politics," *Taiwan News*, March 15, 2001.

²⁵ "Acer's About Face," *Business Week*, April 24, 2000.

²⁶ Mure Dickie and James Kynge, "Business in Taiwan Heeds Warning on Independence," *Financial Times*, April 11, 2000, p. 12; Landler, 2000; "Acer's About Face," 2000; Hsu Chin-lung, P'eng Hui-ming, and Hsu Tung-hai, "Enterprises That Support Ch'en Shui-pien Deny Being Suppressed," *Lien-Ho Pao* (Taipei), April 13, 2000; "China's Political Pressure Doesn't Worry Acer's Shih," *Taipei Times*, March 28, 2002, p. 17.

particular exasperation with Chen after his August 2002 “two states on either side of the strait” remarks.²⁷

The irascible Hsu Wenlong, by contrast, managed to strike a more defiant posture while still keeping his mainland business interests going. Chi Mei Petrochemicals officials initially responded to the threats by vaguely stressing their “non-involvement” in political issues.²⁸ And one Hong Kong journalist claims that “Hsu . . . sent executives to Beijing to explain his ‘mistakes’ in an act of contrition. Central government officials backed off [their investigations] and his company was back in business.”²⁹

But several Western financial journalists report that Hsu has continued to make public statements that irritated many on the mainland—and on Taiwan, as well (most notably some strongly pro-Japanese comments)—to the apparent chagrin of his fellow Chi Mei executives. In 2001, when some other senior business advisors to Chen Shui-bian stepped down, Hsu kept his position.³⁰ According to a *Tai-Wan Jih-Pao* report, Hsu made public comments on the eve of the 2004 election that implied his continued support for the Chen administration.³¹

Chang Jung-fa of Evergreen was able to maintain a quieter, more balanced posture. Evergreen’s EVA Airlines could clearly profit greatly from direct cross-strait transport links, but Evergreen remains one of the most famously “pro-Taiwan” corporations on the island (as symbolized by its trademark jets painted “Taiwan green”—which is also the color of the DPP). Soon after the April 2000 threats, Evergreen Corporation quickly announced that it did not support Taiwan independence and endorsed closer economic ties between Taiwan and the mainland.³² But journalists and economic experts report that Evergreen remains a key DPP corporate supporter, and China’s threats have not had a large impact on its political activities. Still, Chang personally has also avoided highly public statements that would anger Beijing, and between the 2002 and the 2004 elections began criticizing Chen’s government for failing to establish the “three links” and strengthen cross-strait economic relations.³³

²⁷ In response to Chen’s August 2002 “one state on each side” comments, Shih was quoted as saying, “It is hard to understand the thinking of the leader in charge” (“Biz and Industry Leaders Fear Harms on Taiwan Economy,” *Financial Times*, August 6, 2000; also, interviews with senior Western financial journalists based in Taipei and Beijing, May–June 2004).

²⁸ Dickie and Kynge, 2000, p. 12.

²⁹ Allen T. Cheng, “Cross-Strait Spying Game Traps Pawn,” *South China Morning Post*, January 24, 2004.

³⁰ Crystal Hsu, “Few Changes Seen Among Aides,” *Taipei Times*, May 20, 2001, p. 2.

³¹ Interviews with senior Western financial journalists based in Taiwan and Beijing and with the director of a major Taiwan economic policy think tank, Taipei and Beijing, May–June 2004. For Hsu’s endorsement of Chen, see “Selection Report: Taiwan Press 6 Feb 2004,” No. 1, *Tai-Wan Jih-Pao* (Taipei), February 6, 2004.

³² Dickie and Kynge, 2000, p. 12.

³³ Interviews with senior Western financial journalists based in Taiwan and Beijing, the director of a major Taiwan economic policy think tank, and a Taiwan political scientist specializing in business-government relations, Taipei and Beijing, May–June 2004.

Overall, Beijing's threats and harassment met with mixed success—alarming several key Taiwan business leaders into publicly reaffirming that they did not support Taiwan independence. Many returned to their past practice of remaining relatively silent on cross-strait politics, at least until Chen's "one state on each side" remarks in 2002. But there is very little evidence that Beijing's threats caused these CEOs and firms to support Beijing's preferred political policies.

At the same time, without downplaying the disruption caused by China's harassment of firms such as Chi Mei, Beijing has allowed all of these major firms to continue expanding their profitable business operations on the mainland. None chose to relocate major operations from the mainland back to Taiwan or to alternative bases in Southeast Asia—although some, such as ACER, appear to have counterthreatened Beijing with such a move. In this regard, the business costs and dislocation Beijing inflicted upon these Taishang for their public support of Chen Shui-bian in 2000 were significant, but only moderate, and did not last.

Failed Regime Change: The Taishang in the 2004 Elections

This cycle of threats played itself out again during the 2004 presidential election, when Beijing tried to mobilize the business community to prevent Chen Shui-bian's reelection. Initially, Beijing appeared to have good reason for optimism. Chen had originally won the presidency in 2000 with a weak plurality, in large measure because a split within the GMD had divided the GMD vote between Lien Chan and James Soong. The GMD rift was now healed. Moreover, during most of President Chen's first term, Taiwan's economy had suffered its worst downturn in decades, which seemed certain to undermine Chen's support not only among business voters but among Taiwan's working-class residents as well. Throughout most of the campaign, moreover, Beijing appeared to demonstrate much greater sophistication about influencing democratic politics than it had shown in the past. China engaged in efforts to mobilize anti-DPP Taishang on the mainland and encourage them to return home to vote. Beijing largely refrained—though not entirely—from the type of finger-wagging public threats against the Taiwan electorate that had proven disastrously counterproductive in the 1996 and 2000 elections.

The "Taiwan Spy" Case: "Killing the Chicken . . . "

While Beijing did maintain a lower profile throughout much of the campaign, it could not resist periodically harassing some businesspeople in an apparent effort to drive a wedge between them and the Chen government. Beginning in December 2003, Chinese security officials arrested at least two dozen Taiwan businesspeople and charged them with spying for Taiwan. Beijing then tried to portray the Chen government as having a cavalier attitude toward the Taishang's physical safety on the mainland. State security officers—who are usually mum about their sources—took the unusual step of publicly claiming they had been "tipped off" to the existence of the "spy ring" when

Chen publicly “leaked” an official intelligence estimate that Beijing had 496 missiles aimed at Taiwan. Chinese television interviews conducted with the alleged spies intimated that the men had been tricked into spying for Taiwan’s military, and when Chen cravenly tried to score propaganda points by revealing the number of missiles Beijing possessed, he blew the cover of his own spies.

One senior financial journalist argues that the “spy case” was an example of Beijing trying to use “little guys” to intimidate more prominent Taishang—the famous Chinese tactic of “killing a chicken to scare the monkey.” As a result of private investigations with many Taiwan business sources, this correspondent felt confident that the arrested businesspeople were not, in fact, involved in any espionage work—though the source allowed that these men, like many other international businesspeople, may have had some contacts with persons who are involved in intelligence work back in Taiwan. The real motivation for their arrest, this source argues, was almost certainly intimidation.³⁴

Ultimately, however, Beijing’s gambit largely backfired. Many Taiwan businesspeople told Western reporters that the arrests made them feel more fearful and alienated toward Beijing. The arrests also unmasked Beijing’s “charm offensive” toward the average Taiwan voter. Perhaps most seriously, it almost certainly undermined the political influence of Taishang who opposed Chen Shui-bian by casting the Taishang—almost literally—as mainland “hostages.”³⁵

Beijing’s efforts to facilitate pro-pan-Blue and anti-pan-Green political organizing among Taishang on the mainland also proved to be rather heavy-handed and counterproductive, according to many Western and Taiwan observers. Both Western and official Chinese reports carried interviews with Taishang organizers of these groups, making exaggerated claims that 200,000 to 300,000 Taishang and their relatives would return home in March and win the election for the pan-Blue coalition.³⁶ Senior DPP officials claim that during the recent campaign, while pro-pan-Blue Taishang were encouraged to organize in many mainland cities, pro-DPP businesspeople on the mainland were harassed and silenced by officials there. One official claimed that Dai Shentong, a Chen Shui-bian supporter doing business on the mainland and the

³⁴ Interview with a senior economic journalist, Beijing, May 2004. For a report by another senior financial journalist who gives greater credence to Beijing’s charges, see Kathrin Hille, “Taiwan Recruits Business People to Spy on Mainland,” *Financial Times*, January 21, 2004a, p. 2.

³⁵ “Taiwan Man Arrested on Spy Charge,” *People’s Daily* (Beijing), January 16, 2004; Hille, 2004a, p. 2; Willy Wo-Lap Lam, “China Spy Drama Aims to Spook Chen,” CNN, January 21, 2004.

³⁶ “RMW Article on ‘Taishang’ Being Wooed by Taiwan’s Blue, Green Camps,” *Renmin Wang* (China), January 31, 2004; “Taiwan Expats Exert Their Clout,” 2004; Kathrin Hille, “Taiwanese in China Turn Political at Home,” *Financial Times*, January 30, 2004b. By early March, however, Taiwan airline sources were reporting that only about 100,000 persons were booked on flights from Hong Kong to Taipei for the several days before the election (“Flights from PRC Nearly Filled as 100,000 Head to Taiwan for 20 Mar Election,” Agence France Press, March 8, 2004).

head of the small business association, was seriously harassed by tax investigators and security officials on the eve of the election. Pro-DPP press outlets took obvious glee in publicizing this selective harassment, which clearly strengthened their party's "pro-Taiwan" credentials.

Chen's Reelection and Beijing's Frustration

Chen Shui-bian's March 2004 reelection came as a great blow to Beijing—in particular, the last minute assassination attempt that probably provided Chen's final margin of victory. Several Chinese foreign policy experts privately conceded that, on the eve of the election, Beijing felt confident that its supposedly more "restrained" public actions and the Taiwan voters' economic dissatisfaction would result in the GMD's Lien Chan winning the election. Beijing's frustration was heightened by the fact that, despite its efforts to encourage opposition by Taishang to Chen Shui-bian, the business community had failed to play the active, public, and decisive anti-Chen role that Beijing had assigned to it.

In retrospect, there are several reasons why Beijing was not as successful as it had hoped in transforming the large and growing cross-strait economic links into comparable levels of political leverage.

- Beijing undermined its own efforts through heavy-handed attempts to pressure or encourage Taishang into supporting its policies. Instead of helping to establish the Taishang as a credible voice for stable, improving cross-strait relations, Beijing's high-profile pressure allowed Beijing's critics to portray many of the Taishang as mainland puppets.
- Many Taiwan businesspeople, facing pressure on one side from Beijing and criticism from Taipei, have responded by becoming extremely adept at "flying below the radar" politically—keeping their true political inclinations and activities hidden from political leaders in both Taiwan and China. Their lower political profiles are frustrating Beijing's efforts to monitor their political activity and pressure them into forming a ready-made "lobby" for its interests.
- The Taishang community's political influence has been more limited than Beijing assumed. It has often been successful in encouraging the government to loosen economic restrictions on cross-strait ties. But it has been far less successful in mobilizing electoral support for Chen's opponents or in pressuring Taipei to make significant political concessions to Beijing on issues such as direct talks on the three links.

DPP Counterattack: Neutralizing Taishang Influence

Taiwan's political leaders have not sat passively as Beijing has attempted to exploit its burgeoning economic might. Rather, Presidents Chen and Lee and their allies have

vigorously used several classic political tools that target countries can exploit to resist economic coercion.³⁷

As discussed in Chapter Three, both President Lee Teng-hui and President Chen have shown surprising willingness to resist political pressure—especially from their own business sectors—to speed up the opening of cross-strait relations. President Chen has also proven himself to be fairly adept at politically disarming many advocates of more-rapid cross-strait opening. Shortly after coming to office, Chen undertook a major liberalization of economic relations with the mainland. In recent years, however, he has often voiced support for greater economic opening in principle, while attaching conditions that Beijing is unwilling to meet and that Chen's domestic critics find difficult to oppose.

President Chen and his allies have worked to undermine the political position of those who have pressured them to make major concessions to Beijing. In particular, they have weakened Beijing's sources of leverage by counterattacking some Taishang, discrediting their motivations, impugning their loyalty, and narrowing their political influence to strictly "economic" policy questions. Chen's overall strategy has been to show a willingness to negotiate with the Taishang for a continued opening to the mainland, while permitting allies to subtly impute that they don't have Taiwan's overall best interests at heart. In Taiwan, this practice of labeling political opponents as allies of Beijing is known as red-hatting.

Taiwan political scientists point to Vice President Annette Lu as one of the more enthusiastic and deliberate red-hatters, who has attacked many mainland-invested businesspeople and called on them to be more patriotic.³⁸ Lu has attempted to discredit these Taishang's political views by charging that their economic interests have completely clouded their judgment. Speaking at an October 2004 legislative campaign rally, for example, Lu told her audience,

So many tourists go to China every year, and so many businessmen make investment there. They follow what China wants them to do. If China says that it is against the holding of referendums, they would reject the idea. If China advocates "one China principal [sic]," they would believe the idea as well. They cannot tell who's the enemy and who's the friend.³⁹

Another senior DPP official, interviewed soon after the election, also deftly impugned the motivations of the party's business critics, charging that "many businessmen [and] business leaders" who pressured the government to move faster toward

³⁷ Many of these tactics are outlined in Chapter Two.

³⁸ Vice President Lu's quotes are analyzed in Tung Chen-yuan, "Do Not Alienate Business Interests," *Taipei Times*, February 28, 2003c, p. 8.

³⁹ Vice President Annette Lu, quoted in "Lu: Taiwan's Facing Immediate Threat," *ET Today English News*, October 18, 2004.

the three links had been “mobilized” by the mainland. This official even charged that Taishang in Shanghai were permitted to organize pro-pan-Blue groups with offices adjacent to the mainland government’s Taiwan Affairs Office (*taiban*) in that city.⁴⁰ The pro-DPP *Taipei Times* went even further, charging five weeks before the election that Chang Yang, a pan-Blue campaign organizer among Taishang in northern China, was “a fugitive who has been sentenced for committing fraud, forgery, and breaking bank laws in Taiwan.”⁴¹ Other anti-mainland politicians, interest groups, and newspapers have been even harsher—labeling some Taishang as being “taijian”—literally, “traitors to Taiwan”—or “Taiwan’s ‘Wu Sangui’”—an infamous Chinese traitor who, at the end of the Ming Dynasty, allied himself with Manchu invaders to help establish the Qing Dynasty. Other Taiwan sources have characterized some Taishang as “Quislings,” a potential “fifth column,” or simply dismissed the loyalty of businesspeople in general, claiming that “they have no native land” (*shangren wu zuguo*).⁴²

Many experts agree that Chen Shui-bian employed a variety of more subtle attacks against Taishang during his 2004 reelection campaign, though he has tended to leave the more direct assaults to his vice president and other allies. Chen effectively played on workers’ fears that Taiwan businesspeople wanted to open up Taiwan to massive inflows of low-wage mainland workers who would snap up jobs from Taiwan citizens and even constitute a security threat.⁴³ Chen promised that he would not open up the island. According to political analysts, Chen’s rhetoric left many workers very fearful and very suspicious of businesspeople and their motives for supporting the opening to mainland workers.⁴⁴ When the pan-Blue opposition raised corruption allegations against Chen, his family, and his staff, the DPP was able to undermine their credibility by countering that the corrupt businesspeople making the allegations had mainland links and had fled to the mainland. Chen occasionally benefited from GMD ineptitude—such as when the GMD listed many heads of mainland-invested Taiwan companies among their backers, even while mainland authorities were promoting these advocacy organizations on their territory. In the words of one senior Western financial journalist, “These pro-pan-Blue businesspeople ‘red-hatted’ themselves.”

Perhaps the most important impact of the counterattack has been to limit the political influence of the Taishang to economic and business policy issues, narrowly defined. Some political analysts indicate that, for the most part, the DPP has focused its most severe red-hatting for businesspeople who advocate Beijing-backed *political*

⁴⁰ Interview with a senior DPP leader, Taipei, June 2004.

⁴¹ “China Employs New Wrecking Tactics,” *Taipei Times*, February 12, 2004, p. 8.

⁴² Many of these characterizations were cited by a senior Taiwan political scientist and specialist on businesspeople in politics, Taipei, June 2004.

⁴³ In addition to interviews with political observers, several working-class citizens were quick to mention this fear to the author during his visit to Taiwan in June 2004.

⁴⁴ Interview with a Taiwan political scientist and specialist on businesspeople in politics, Taipei, June 2004.

proposals, such as negotiating with China under the “one China” principle, directing less vitriol toward those Taishang who simply support economic changes, such as loosening investment restrictions. In this regard, Taishang can still exercise great influence on policies that many in Taiwan fear will further “hollow out” or “marginalize” their economy. But still, by painting a picture of businesspeople motivated more by profit than by Taiwan’s broader “national interest,” skeptics of closer engagement with the mainland have helped erode and narrow the political power of Beijing’s most important potential conduit of influence on Taiwan.

Fleeing Pressure from Two Sides: Learning to “Fly Below the Radar”

Beijing cannot hope to effectively manipulate the Taishang as a conduit of influence unless it can monitor their political activities and determine whether or not they are, in fact, promoting Beijing’s interests in Taipei. But most of the experts interviewed for this study agree that most Taishang have struggled to lower their political profile in recent years. Facing pressure on one side from Beijing to oppose Chen Shui-bian and independence and on the other side from Taiwan politicians who impugn their loyalty, a growing number of Taiwan businesspeople have responded by scrupulously avoiding the political limelight. Mainland-invested Taiwan businesspeople increasingly feel that they must keep a low political profile so as not to offend either the mainland or the current Taiwan government. Several interview sources—both mainland and Taiwan sources—enthusiastically embraced the characterization that the Taishang have become very good at “flying below the radar”—keeping their political views secret not only from the Chinese government but also from most of the political world in Taiwan.⁴⁵ In the words of one former senior official with cross-strait responsibilities, “They are good at camouflage.”⁴⁶ A senior business executive argued that this lowered profile was not just the result of recent events:

The pain of the Taiwan private sector . . . is an old pain going back to the first days of cross-strait business. Businesspeople do not want to offend *either* side . . . they have become good at flying below the radar.

This executive waxed about the capacity of Taiwan businesspeople to operate secretly and cleverly, improvising in an often-unpredictable political environment. As a result, the source was frankly dismissive of mainland threats against the Taishang:

How much credibility do you want to give [mainland officials]? How can they determine the “color” [political attitudes] of businessmen? How will they exercise this policy and enforce it? I don’t really see how they can do this. [It] may even

⁴⁵ Interview with a senior Western financial journalist, Beijing, May 2004.

⁴⁶ Interview with a former senior GMD official, June 2004.

cause an internal rift in the mainland's Taiwan policy . . . Would they [Beijing] use politics to kill the golden goose?

This viewpoint was echoed on the mainland, where many experts agreed that China is losing its ability to determine the true political views and activities of mainland-based investors. Several mainland analysts described the Taishang as “two-faced”—perfectly willing to tell Chinese officials that they support reunification with China and oppose Chen Shui-bian, only to return home to give Chen both their money and their vote. Of more than a dozen mainland experts who were asked if they had confidence that China could tell which Taishang were truthfully supporting their policies and which were not, every one answered in the negative.

Some experts argued that the character of Taiwan's mainland-invested businesses makes it more difficult for them to exercise influence over policy in Taipei. The large number of Taishang who invest secretly and illegally in the mainland cannot engage in public political activities to defend their interests. One specialist argued that most mainland-invested firms are no longer single-family businesses but rather large complex corporations. Many of the first-generation “superstars” of Taiwan's corporate world—such as Wang Yung-ching, Stan Shih, and Hsu Wenlung—are stepping down from their leadership posts. This is due in part to age and in part as a response to mainland pressure. The political views and activities of an individual CEO have less impact on a company than in the past, making it harder for Beijing to monitor a company's activities.

Assessing the Taishang's Opposition to Chen

China's strategy of relying upon the Taishang to help remove Chen Shui-bian from office assumed that the vast majority of Taishang and their families would support the pan-Blue campaign and return home to vote in large numbers. Unfortunately, the lack of specific polling data on the Taishang makes it difficult to assess their involvement with any precision.

On balance, the experts consulted for this study agree that a majority of Taishang who returned home did back Lien Chan and pan-Blue with their votes and their money. Many sources agreed with one senior Western financial journalist, who argued that most Taiwan businesspeople above a certain economic level just do not like Chen Shui-bian very much. “To them, Chen has a completely different world view—he really doesn't consider business to be a priority . . . though [he is] not really an ideologue, his priorities are political.”

At the same time, many experts argue that Beijing probably overestimated both the strength and unity of the Taishang's opposition to Chen Shui-bian. In the final months before the election, some pan-Blue organizers and mainland officials announced grossly unrealistic estimates of the number of Taishang who would make the costly and inconvenient voyage to Taiwan to vote. Estimates ranging from 200,000 to 300,000 were

widely claimed in the media. A former senior GMD official argued that the number of available Hong Kong–Taiwan airline seats in the days running up to the election does not come close to approaching these figures.⁴⁷ Two public opinion experts estimate that a figure of 30,000 to 50,000 Taishang returning home is much more likely, even though mainland Taiwan Affairs Offices were ordered to find all means to facilitate Taishang travel back to Taiwan. Another political scientist, citing government customs sources, estimates that 120,000 people of all social categories—not just Taishang—returned home to vote.⁴⁸

Several experts also argue that Beijing overestimated the unity of the Taishang's opposition to Chen Shui-bian, although no hard data on this point appear to be available. Respected public opinion specialists report that, in the 2004 race, no polls were performed that specifically surveyed the Taishang voting, although some political experts extensively interviewed these groups.⁴⁹ Based on these less formal assessments, several experts argue that the widely held impression that businesspeople were overwhelmingly pro–pan-Blue is somewhat overstated.⁵⁰ The GMD office in charge of dealing with Taishang reportedly estimated that before the 2004 election 70 percent of all Taishang were pro–pan-Blue, and that 80 percent of those businesspeople who returned to Taiwan to vote would support pan-Blue.⁵¹ A senior Western financial journalist estimated that business support for pan-Blue was very probably a majority, though not necessarily in numbers as overwhelming as the 80/20 split that pan-Blue forecast before the election. A former senior GMD official noted that the usual rule his party has used is that business voted for pan-Blue by a more modest six-to-four margin. But this official reported that he is “not so sure” of this estimate and believes the GMD's advantage among businesspeople might have been even less.⁵² Another Taiwan expert, drawing on extensive interviews with businesspeople and political party leaders, agrees that most Taishang supported pan-Blue, but that DPP support was somewhat stronger than usually estimated. Echoing the comments of many others, this source argued that because many businesspeople try to keep their political views to themselves while on the mainland, the level of DPP support is somewhat understated.⁵³

⁴⁷ Interview with a former senior GMD official, June 2004.

⁴⁸ Interview with a Taiwan political scientist and specialist on businesspeople in politics, Taipei, June 2004.

⁴⁹ Interviews with senior Taiwan political scientists and public opinion specialists, Taipei, 2004.

⁵⁰ Interviews with senior Taiwan political scientists and public opinion specialists, Taipei, 2004.

⁵¹ Interview with a senior Western financial journalist, Taipei, June 2004.

⁵² Interview with a former senior GMD official, June 2004.

⁵³ This specialist cited estimates that he and his researchers obtained from Taiwan business-association leaders that about 70 percent of Taiwan businesspeople from Shanghai supported pan-Blue. However, he pointed out that pan-Blue support among Taishang overall was probably lower, because the Shanghai business community includes a much higher percentage of ethnic mainlanders—who are usually more disposed to the GMD—than

Polling data on voter occupations and candidate preferences in the 2004 election also suggest that the business vote was less widely divided than is usually assumed. Exit polls performed by the television station TVBS specifically surveyed voters by their occupations. In the category that most closely captures the business vote—self-employed businesspeople (*ziying shang*)—the Chen Shui-bian/Lien Chan voting gap was negligible (51 percent for Chen Shui-bian, 49 percent for Lien Chan). Several other categories of voters—most notably soldiers, government employees, and educators—supported Lien Chan much more decisively. Again, however, this is a very indirect measure, since the Taishang were unlikely to have constituted a large percentage of all voters in the “self-employed businessperson” category.⁵⁴

Beijing Rethinks Economic Leverage, Spring 2004

In Beijing, Chen Shui-bian's reelection touched off a bitter internal debate over how much political leverage Beijing is getting from its economic ties with Taiwan. Internal meetings of policy analysts called after the election saw tough recriminations. Several hard-line civilian and military analysts—Professor Luo Yuan of the Academy of Military Science was one cited by numerous sources—criticized those who had placed excessive faith in the long-term prospects for integration. Luo argued that China must “cast away its illusions” about the effectiveness of several forces to eventually deliver Taiwan to China, including the “illusion” that economics and the Taishang would be effective political levers.⁵⁵ Zhu Chenghu, Deputy Director of the Institute for Strategic Studies of the National Defense University, was quoted as telling the *China Daily* that “although the economic and personnel exchanges between the two sides of the Taiwan Straits are important for increasing links, they could not prevent ‘Taiwan independence’ . . . military action is necessary for reunification.”⁵⁶ One respected foreign policy expert dismissed even more bluntly the Taishang and their ability to rein in Chen Shui-bian: “Businessmen? They're nothing! They have no power.”⁵⁷ Articles in

most other mainland investment venues. Interview with a Taiwan political scientist and specialist on businesspeople in politics, Taipei, June 2004.

⁵⁴ “2004 Nian Zongtong Daxuan TVBS Toupiaosuo Chukou Mindiao [Exit Poll] Jieguo Baogao” (“Report on the Results of the TVBS 2004 Presidential Election Polling Place Exit Survey”), TVBS Poll Center, March 20, 2004.

⁵⁵ Interviews with a Chinese foreign policy experts, Beijing and the United States, May–June 2004. Luo Yuan is quoted using hard-line language and speaking of “throwing away illusions” in Goh Sui Noi, “Beijing Urged to Get Tougher with Taiwan,” *South China Morning Post*, June 3, 2004.

⁵⁶ “Defence Urged to Toe the Line of Economy,” *China Daily*, July 26, 2004.

⁵⁷ Interview with Chinese foreign-policy expert, United States, June 2004. For similar Chinese analyses from this period pointing to the declining effectiveness of economic influence, see Andrew Thompson and Zhu Feng, “When All Else Fails: Beijing's Conservative Stance of Taiwan,” *The China Brief*, Vol. 4, No. 14, July 8, 2004; Shi Yinhong, “Beijing's Lack of Sufficient Deterrence to Taiwan Leaves a Major Danger,” *Ta Kung Pao* (Hong Kong), June 23, 2004, p. A19; Chow Chung-yan and Josephine Ma, “Beijing ‘to Rethink Its Cross-Strait Strategy,’” *South China Morning Post*, March 22, 2004, p. 1.

the official central press underscored the seeming failure of rapidly growing economic ties to yield closer political integration.⁵⁸ Other officials countered by defending the power of economic integration, but they conceded that economic leverage is a gradual, long-term force, not an effective short-term one.⁵⁹ Clearly, however, Chen Shui-bian's reelection and the disappointing role played by the Taishang had put these officials on the defensive.

Several sources in Beijing also reported—based admittedly on secondhand sources—that party-leadership power struggles were complicating policy toward Taiwan. By the summer of 2004, Beijing was increasingly consumed with jockeying over whether or not Party Military Commission Chief Jiang Zemin should hand over his last post to President Hu Jintao. There was very little public evidence to indicate that Hu and Jiang disagreed over the substance of China's policy toward Taiwan. But many analysts argue that leadership tensions put pressure on the allies of both men to not appear too soft on Taiwan. This pressure probably contributed to several acts of harassment against Taishang after the election.⁶⁰

Back on the Attack: The Hsu Wenlong Case, May 2004

After Chen Shui-bian's May 20 second inaugural address, which angered mainland officials, Beijing focused some of its reactions on Taiwan businesspeople.⁶¹ Frustrations boiled over several days later when Taiwan Affairs Office spokesman Zhang Mingqing told reporters at a press conference that China did not welcome "separatist" Taiwan investors who made money in China and then used it to support "independence" back home.⁶²

On Monday, May 31, Beijing again turned on Chi Mei's outspoken founder Hsu Wenlung. In a page-one commentary, the overseas edition of the Communist Party's official *People's Daily* attacked Hsu by name, labeling him a "Green Taiwan investor" and a "shameless . . . anti-China bigot" who preferred speaking Taiwanese or Japanese to speaking Mandarin. In rhetorical terms, the article represented a major escalation over the public attacks of 2000. Beijing's attack helped spark a short-term stock market panic and a slide in the stock of the Chi Mei TFT/LCD manufacturing subsidiary,

⁵⁸ "Political Ice Dents Economic Ties," *China Daily*, August 16, 2004; "Three Links Still a Far Cry," *China Daily*, September 17, 2004.

⁵⁹ Interview with a senior Western economic journalist, Beijing, May 2004. Similar views are echoed in the following editorials: "Despise What He Says, Regulate What He Does," *Wen Wei Po* (Hong Kong), May 22, 2004; and "A Rational Approach to Cross-Strait Relations: Commentary," *People's Daily* (Beijing), July 9, 2004.

⁶⁰ Interviews with Western journalists and diplomats and Chinese foreign-policy experts, Beijing, May–June 2004.

⁶¹ In addition to the attack on Hsu Wenlung noted in the next paragraph, China also reportedly delayed the granting of visas to some Taiwanese trying to visit the mainland and boycotted the Computex 2004 computer conference in Taipei.

⁶² Wang Jianmin, 2004.

which was planning to open a factory in Shanghai or Ningbo.⁶³ But a Chi Mei spokesman immediately claimed the company had no plans to pull out of the mainland.⁶⁴

Chinese foreign policy experts argued that the new attack reflected Beijing's growing frustration with pro-DPP businesspeople who refused to be "educated" and would respond only to threats. Another Chinese expert agreed with this characterization, but added that, in the wake of the recent election and Chen Shui-bian's victory, some of Beijing's leaders simply felt that they were under great pressure to do something—anything—about the Taiwan problem. Several experts noted that Hsu Wenlong's attitude toward Beijing—always harsh—had made him an obvious candidate.

Days after the *People's Daily* attack on Hsu, a Taiwan analyst for the Beijing Academy of Social Sciences further broadened the pressure, publishing a detailed proposal for Chinese economic sanctions against the island. Writing on a government Web site, Wang Jianmin argued that China could frighten foreign investors into withdrawing their capital from the island by destabilizing Taiwan's currency and financial markets. Wang also suggested a targeted shutdown of strategic commodities—citing Taiwan's dependence on mainland sandstone for concrete—and could even resort to a major economic blockade (*jingji fengsuo*), which, Wang argued, would quickly cause "economic chaos." The next day, however, the PRC government's Taiwan Affairs Office distanced itself from Wang's article and its harsh proposals.⁶⁵

Although clearly intended as a shot across the bow of all pro-DPP businesspeople, several analysts questioned whether these threats would have the broad intimidating effect that Beijing intended. They argued that the very features that made Hsu Wenlung an irresistible target also set him apart from most other Taiwan businesspeople. On cross-strait controversies, Hsu has not avoided the limelight, nor has he kept his political leanings much of a secret. Hsu was, as one Western journalist phrased, "a convenient chicken to scare the monkeys."⁶⁶

Just as in 2000, Beijing's willingness to follow through on its threats was open to question. *People's Daily* never indicated what actions, legal or otherwise, Beijing planned to take against Chi Mei and other "green" companies. Some local PRC Taiwan Affairs Office officials, speaking privately, claimed that they would not be as tolerant of "green" investors as in the past, and officials in Fujian were reportedly being ordered to "investigate the political stance" of new Taiwan investors before approving projects.⁶⁷ Several analysts interviewed for this study have claimed that Beijing is now much freer to retaliate against Taiwan investors than it was during the Asian recession

⁶³ "China Attacks Chi Mei Over 'Ideology,'" *Taipei Times*, June 1, 2004, p. 1.

⁶⁴ "Luse Taishang, Zhonggong dianming Hsu Wenlong" ("Green Taiwanese Businessman—The Chinese Communists Label Hsu Wenlung"), *Jingji Ribao* (Taipei), June 1, 2004, p. 3.

⁶⁵ Wang Jianmin, 2004.

⁶⁶ Interview with a senior Western financial journalist, Taipei, June 2004.

⁶⁷ Wang Jianmin, 2004.

of 2000, because now it is awash in FDI and can be pickier about the Taiwan investors it admits.

But other local Taiwan Affairs Offices moved quickly to narrow the focus of Beijing's attacks. Beijing and Jiangsu Taiwan Affairs Office officials publicly stressed that there had been no change in the mainland's welcoming attitude toward average Taiwan investors, and the threats applied only to those whose "political stances were excessively obvious" (*zhengzhi lichang guo yu xianming*)—a rather small number, in reality.⁶⁸ A senior foreign policy advisor reported that many local Taiwan Affairs Offices privately told their Taiwan investors that the threats applied only to businesspeople whose attitudes were "particularly hard" or "public" and not to the "vast majority of patriotic Taiwan businesspeople."⁶⁹

Some sources even indicated that, just as in 2000, Beijing was willing to back down when faced with the prospect of losing a major Taiwan investor. A Western financial journalist reported that Chi Mei and Hsu Wenlung initially responded to the *People's Daily* threats by taking further steps to appease Beijing, further distancing Hsu from his company. But according to this source, when Beijing expressed skepticism that Hsu was really moving out of Chi Mei, Hsu and Chi counterattacked with threats of pulling their investments from China and moving elsewhere in Asia. Facing complaints from local governments who feared Chi Mei's withdrawal, Beijing reportedly backed down.⁷⁰

Business observers felt that China's attack on Hsu and other "green" businesspeople was ultimately counterproductive. "Why," asked one business analyst, "should China attack its best ally in Taiwan—the only part of Taiwan society that still takes a relatively good view of China?" Officials at Taiwan's MAC echoed the sentiment, charging that such threats by Beijing would simply drive Taiwan investors away from the mainland.⁷¹

The Taishang community is hardly reassured by these events, however. Sources very familiar with the Taishang argue that most businesspeople felt deep revulsion at Beijing's bullying of Chi Mei and denounced it as counterproductive and undermining Taishang support for Beijing. Still, many fear that China's economic position vis-à-vis Taiwan had become so strong that it could, in the words of a journalist familiar with the situation, "just drive Taiwan down economically into the abyss" if it chooses, and, thus, Taiwan's government "needs to talk to the Chinese government more sensibly."⁷²

⁶⁸ Wang Jianmin, 2004.

⁶⁹ Interview with a senior Beijing foreign-policy expert, June 2004.

⁷⁰ Interviews with Western financial journalists residing in Beijing, October 2004.

⁷¹ Interviews with Taiwan government officials and Western financial journalists residing in Beijing, May–June 2004.

⁷² Interview with a senior Western financial correspondent, Taipei, June 2004.

By the fall of 2004, however, some of the first signs of Beijing's new, more engaging policy toward Taiwan were becoming apparent, and Beijing was once again taking steps to reassure Taiwan investors and woo them away from Chen Shui-bian's government. In the immediate aftermath of a major Communist Party meeting in September 2004, Beijing published policy documents subtly adjusting the emphasis in its Taiwan policy, reaffirmed efforts to build economic ties across the strait, and reassured Taiwan businesspeople that they would not be targeted.⁷³ In October, Beijing dispatched Jia Qinglin—a member of the Communist Party's ruling Politburo Standing Committee—to meet with Taishang in Fujian province. Jia promised those at the meeting to better protect their interests and sweeten the investment climate.⁷⁴

Although Beijing was reassured by the pan-Green alliance's failure to win control of the Legislative Yuan in the December 2004 elections, Chen's loss did not reaffirm Beijing's hopes for the Taishang. Throughout the fall election campaign, most Taiwan businesspeople continued to keep a low profile.⁷⁵ Mainland reports and commentary after the election gave the "credit" for Chen's loss to the "wisdom" of the Taiwan people, U.S. diplomatic pressure, and its own tough policies against Taiwan independence—every factor except cross-strait economic linkages.⁷⁶

From the outset of 2005, Beijing combined a highly coercive diplomatic stance toward Taiwan—highlighted by the promulgation of the Anti-Secession Law (ASL) in March—with an economic engagement policy that was increasingly sophisticated and less coercive than the 2003–2004 policy. In January, even as debate over the ASL's impending passage was heating up, Beijing finally responded to Taipei's repeated requests to reprise its 2003 negotiations for Lunar New Year's charter flights.⁷⁷ For

⁷³ According to a PRC-owned Hong Kong newspaper, "In an earlier period of time, Taiwan businessmen on the mainland were troubled by the issue of 'pro-green Taiwan businessmen.' Officials of the mainland's Taiwan Affairs Office recently moved to clear the doubts and [to] comfort Taiwan businessmen. The State Council's Taiwan Affairs Office also sent its deputy directors Wang Zhaixi and Li Bingcai to explain the mainland's positive Taiwan policy to Taiwan businessmen to eliminate their doubts on the policy. The authoritative person pointed out that in [the] future the mainland will not speak generally of 'pro-green Taiwan businessmen' and 'pro-green artists.' In fact, it is very difficult to define 'pro-green Taiwan businessmen.' State Council Taiwan Affairs Office spokesman Zhang Mingqing publicly said, 'We do not welcome people who make their money on the mainland and return to Taiwan to support 'Taiwan independence'' (Che Zhiguo, "Beijing's Authoritative Person Analyzes Fine-Tuning of Policy on Taiwan," *Ta Kung Pao* [Hong Kong], September 25, 2004).

⁷⁴ Leu Siew Ying, "Top Leaders Try to Calm Taiwanese Investors," *South China Morning Post*, October 22, 2004.

⁷⁵ Interviews with Taiwan political scientists and experts on businesspeople in politics, Taipei, November 2004.

⁷⁶ On Beijing's interpretation of the elections, see "Separatist Plan Goes Nowhere," *China Daily*, December 13, 2004, p. 1; Joseph Kahn, "China's Saber Rattling: Paying Off?" *New York Times*, December 13, 2004a, p. 6; Joseph Kahn, "China's Army May Respond If Taiwan Fully Secedes," *New York Times*, December 18, 2004b, p. 8.

⁷⁷ Hille, 2005.

its part, the Chen government was eager to find a way of restoring good ties with the business community, which deeply desired the flights. The result of the talks in Macao was a landmark agreement to permit six air carriers to operate a total of 48 direct, nonstop Lunar New Year flights between the Taiwan cities of Taipei and Kaohsiung and the mainland cities of Shanghai, Guangzhou, and Beijing. As in past charter-flight negotiations, however, a pivotal point of contention concerned whether the two sides' negotiators would be considered "official" or "private." Taipei chose to play up the quasi-official aspects of the talks, stressing that the MAC had directly authorized the private TAA to negotiate for it, and that the Director General of its Civil Aviation Administration attended the meeting as a TAA board member. Beijing emphasized the nonparticipation of Taiwan's official mainland affairs bodies (the MAC and the SEF) as well as the nonofficial character of the TAA and its representative, the China Civil Aviation Association. The CAA Director-General's attendance was scrupulously ignored. There was widespread speculation that this new "Macao model" of talks that seemed to allow both sides to claim victory might be used in future negotiations.⁷⁸ In late February 2005, Beijing followed this agreement with an offer to expand mainland market access for Taiwan agricultural goods and a proposal to aid more Taiwan students in studying at mainland universities—all initiatives that were clearly designed to drive a wedge between the Chen government and key constituencies. Beijing has largely avoided the public threats and mass detentions of Taishang that had backfired in 2003–2004, though it is impossible to say whether this shift toward a more sophisticated strategy is a permanent one.

To be sure, Beijing's less-harsh economic diplomacy helped put Chen Shui-bian on his back foot, and, throughout the summer, Chen struggled awkwardly to find new methods and justifications to slow the expanding economic relationship. But a large number of mainland analysts speaking in late 2005 were still hesitant to give the bulk of the credit to Beijing's economic levers for helping place Chen in a more passive position. Instead, these analysts stressed the impact of successive DPP losses in the December 2004 legislative elections and December 2005 local government elections, DPP corruption scandals, and U.S. criticism of President Chen's policy statements in 2004–2005, plus Beijing's stern message communicated in the ASL. Even these diplomatic victories, however, have not greatly eased the fears of these mainland experts. Many still see Chen and the DPP leadership as "irrationally" committed to establishing independence, and they fully expect Chen to attempt other "desperate" pro-independence gambits as the end of his term in 2008 approaches. In the estimation of these analysts, the deterrent and coercive power of even the burgeoning cross-strait

⁷⁸ Wang Hsiao-wen, "Agreement Reached on Direct Flights," *Taipei Times*, January 16, 2005, p. 1; "Mainland, Taiwan, Clinch Deal on Direct Flights," *China Daily*, January 15, 2005; Pan and Culpan, 2005.

economic relationship and the political influence of the Taishang had very definite limits when it came to containing Chen.⁷⁹

Beijing's Counterproductive Strategy Toward the Taishang

Beijing's inconsistent strategy has frequently undermined its goals of establishing the Taishang as a powerful conduit of influence for Beijing's policy preferences in Taipei. China's sporadic threats against "green" businesspeople have driven most to operate "under the radar" while opening up others to red-hatting by DPP officials anxious to undermine their credibility. For the most part, Beijing's follow-through on threats against Taishang has not been strong—largely limited to short-term harassment—while many reports indicate that Chinese officials have been susceptible to counter-threats from some major businesses. Even the timing of its April 2000 and May 2004 attacks—right after Beijing's interests suffered a major electoral defeat in Taiwan—strongly suggests that they were not motivated by a careful strategy designed to use the Taishang for their political interests. In both cases, the Taishang's chance to influence the election had already passed. Instead, Beijing might have been responding more to domestic political pressure—venting its frustration, trying to restore its credibility, and perhaps trying to disarm domestic critics.

To be sure, as Chapter Three demonstrated, the Taishang have been powerful lobbyists for further opening cross-strait economic relations. But, to date, Beijing has been frustrated in its hopes that Taiwan business interests would propel an electoral defeat for Chen Shui-bian, or successfully promote its most fundamental political goals, most notably bringing Taiwan to the negotiating table under some form of the "one China" principle.

The Impact of Economic Pressure on Mainland Chinese Politics

The impact of a Chinese attempt at economic coercion on China's own domestic politics is also likely to have a major influence on the effectiveness of coercion. Serious economic sanctions against Taiwan would also cause considerable pain for the mainland—pain that would not be born equally by all Chinese. Thus, even though mainland China may be highly motivated to use economic pressure against Taiwan given the issues at stake, Beijing would nevertheless have to consider carefully the large economic and political costs it would suffer from such sanctions.

China's costs from sanctions would include substantial lost foreign investment, lost exports to third parties, and probably increased unemployment at a time when China already faces mounting unrest from unemployed workers and pensioners. More-

⁷⁹ Interviews with Chinese international security experts, Washington, D.C.; Shanghai; Beijing; and Shenyang, November–December 2005.

over, since the economic relationship with Taiwan is concentrated in a few sectors and regions, the economic damage would also be disproportionately born by a few key sectors of the high-tech economy and by a few regions of the country, many of which are disproportionately represented within the Communist Party leadership (e.g., its economic “engine” provinces, such as Jiangsu, Fujian, Guangdong, and especially Shanghai). Thus, Beijing may well not be deterred from using these economic weapons to achieve powerful strategic goals—but the costs will be steep, and some Chinese will bear a far higher burden of sanctions than will others.

Accordingly, China may also face significant domestic political problems of “unity” or “coalition management” in employing sanctions against Taiwan. Among the most common reasons that international sanctions fail is that countries in the sanctions coalition cannot maintain their discipline, and they undermine the regime of sanctions; the problems caused by the high payoffs from cheating, “free riding,” or “defecting” from sanctions coalitions are well known. Even though China is a single country and would likely carry out its sanctions against Taiwan without international coalition partners, it could still very easily encounter similar problems of coordination and discipline that could undermine its sanctions—i.e., the problem may simply be domestic rather than international. Given Taiwan’s wealth, there would still be high payoffs for Chinese domestic economic actors who can secretly break ranks and violate trade, investment, and other sanctions against Taiwan. Some regions of China already benefit greatly from their economic links with Taiwan, and those regions would undoubtedly be loath to give up those benefits. Many localities or companies might seek a variety of ways to skirt the sanctions. In this regard, China’s demonstrated record in trying to crack down on local corruption, indiscipline, and smuggling has been far from encouraging. Ever since China’s economic opening to the outside world, it has faced major problems of smuggling—usually aided, abetted, or even organized by the very military, police, and customs forces who were assigned to prevent such actions. Even the prospects of military smuggling subverting a full-scale embargo, blockade, or shipping cutoff cannot be discounted. Such prospects may even figure into Taiwan’s strategy for dealing with economic pressure. Taipei may decide well in advance of any sanctions to begin cultivating units within Chinese local governments, the PLA and the PLA Navy, or business interests in Hong Kong in an effort to lure them into breaking ranks in the event of a blockade. Such actions could be even more effective if Taiwan can persuasively make the case to these potential defectors that they are bearing more than their fair share of the costs of pressuring Taiwan while other leaders and groups in China suffer little.

Finally, even though Taiwan may suffer a greater economic impact as a result of a major disruption in cross-strait relations, it is quite possible that China might suffer greater political dislocation. China continues to suffer rising social unrest, widespread corruption, and destabilizing leadership transition struggles, and it lacks effective, institutionalized means for dealing with popular anger. Recent official Chinese police

statistics indicate that when China suffered major downturns in its economy during the past decade (from 1997 to 1999, for example), the rate of increase in protest accelerated dramatically.⁸⁰ Taiwan, by contrast, is a reasonably well-consolidated young democracy. In the past 15 years, the island has successfully endured several cycles of competitive presidential and legislative elections, safely navigated a peaceful electoral transition from the old ruling party to the former opposition, and even endured the disruption of the highly controversial 2004 presidential election that was marred by allegations surrounding the assassination attempt on President Chen Shui-bian. Before Beijing could undertake a truly large-scale campaign of economic pressure against Taiwan, it would have to undertake some very uncertain calculations about the political risks involved and its citizens' response to the economic dislocation such a campaign would likely create.

⁸⁰ On the rise of unrest in China during the late 1990s, see Murray Scot Tanner, "China Rethinks Unrest," *Washington Quarterly*, Vol. 27, No. 3, Summer 2004a, pp. 137–156.

China's Economic Leverage: A Powerful Weapon, but Tricky to Use

Taiwan's Rising "Asymmetric Interdependence" with Mainland China

The explosive growth of the China-Taiwan economic relationship since the 1980s has created a powerful and wide-ranging relationship of "asymmetric interdependence" between the two sides. Each side relies upon the other for important contributions to its economy, and each would suffer great economic pain and dislocation in the event of a major disruption in that relationship. But as Taipei's leaders have long feared, Taiwan is dependent upon the mainland market for a far higher percentage and a far broader range of its economic activities than the mainland is dependent upon Taiwan. Taiwan's economic reliance on mainland China is unquestionably—and justifiably—a major source of concern in Taiwan and in the United States.

Most experts on economic diplomacy agree, however, that the level of economic deprivation an initiating country (e.g., mainland China) can inflict rarely, by itself, determines the effectiveness of economic coercion. Political factors—in particular domestic politics within the initiating and target countries—usually have a greater impact on the initiator's ability to convert economic influence into political leverage. For countries initiating economic pressure, the challenge is finding effective "conduits of influence" within the target country through which they can convert their economic influence into effective political leverage. Thus, China's growing capacity to inflict economic pain upon Taiwan has not automatically provided Beijing with the powerful political leverage that many Chinese analysts and leaders have long anticipated, least of all on crucial political issues related to sovereignty and reunification.

But Beijing's difficulties in exploiting its economic influence as political leverage—and Taipei's continuing fear that Beijing will eventually succeed—may ultimately prove to be a "good news/bad news" story for U.S. interests in dissuading either side from unilaterally or coercively upsetting the status quo. This monograph has put forward evidence that, in the wake of the 2004 Taiwan presidential campaign, Beijing began to doubt the ultimate efficacy of economic leverage. Still, Beijing's far greater political and diplomatic success as a result of Hu Jintao's new Taiwan policy and the "charm offensive," which began in the spring of 2005 with offers to ease agricultural imports from Taiwan, suggested the Chinese leadership was recovering its long-term

optimism. But in his New Year's Day 2006 speech, President Chen renewed his criticism of Taiwan's excessive economic dependence upon the mainland and called for changing the government's policy of "Active Opening, Effective Management" to one of "Effective Opening, Active Management." Chen soon followed with his defiant February 28 closure of the National Unification Council and his rescission of the National Unification Guidelines, underscoring Beijing's difficulties in exploiting the economic relationship. During those times when Beijing's faith in economic leverage has waned, the result has been assertions among Chinese analysts and leaders that more-nakedly coercive measures might ultimately be necessary to prevent Taiwan's formal independence. At a minimum, periods when economic levers have not served Beijing effectively have left it feeling uncomfortably dependent upon the United States for cooperation in preventing changes to the cross-strait status quo. Moreover, in recent years economic diplomacy has tended to serve Beijing best when it was used far less coercively and with greater restraint. But Beijing has often shown itself politically unable to sustain such self-restraint, especially when confronted with what it would consider "envelope-pushing" behavior from Taipei.

In Taipei, conversely, advocates of a more formally independent Taiwan have continued to voice fears that Beijing's rapid economic growth will eventually provide it with overwhelming and irresistible political leverage over the island. Faced with this fearful long-term prospect, many in Taiwan have asserted their belief that the time to push for constitutional reforms and other measures that will formalize independence is sooner rather than later. If the contrasting views of the political value of Beijing's economic leverage drive both Beijing and Taipei to fear that "time is not on their side" in realizing their cross-strait goals, the result could be greatly heightened tension that would tax U.S. diplomacy.

Taiwan's Struggle Between Growth and Excessive Dependence

Over the past 25 years, successive governments in Taipei have struggled to strike a balance in their cross-strait economic policies. Both governmental and business leaders strongly desire to draw on mainland China's rapid growth as a vehicle for rescuing Taiwan's increasingly challenged international competitive position. At the same time, both the Lee Teng-hui and Chen Shui-bian administrations have sought to limit Taiwan's economic dependency for fear it would provide Beijing with dangerous political leverage. Politically, advocates of liberalizing cross-strait trade and investment relations—in particular Taiwan's influential mainland-invested business community (the Taishang)—have won the lion's share of these battles over the past 25 years. Presidents Lee and Chen, however, have periodically shown real willingness to resist such pressure and can point to some significant successes in limiting Taiwan's dependence—most notably in slowing the pace of high-tech investment on the mainland and maintaining a significant technological "gap" or "lag" between what Taiwan firms produce on the

island and what they produce across the strait. Taipei's efforts to get Taishang to move their investments to less-threatening Asian venues have been far less successful.

As a result of these trends, over the past 20 years, Taiwan's reliance on mainland China's economy has gone from negligible to very substantial. Economic experts who have examined the relationship warn that if China were able to close down key parts of this relationship, Taiwan would be vulnerable to a major recession and other severe forms of economic dislocation. Taiwan's vulnerability is quite broad: It relies upon China as the number-one market for its exports, the number-one venue for its foreign investment, and the number-one production base for many of its most profitable exports—especially its IT exports. The cross-strait economic relationship also carries terrific “weight” within Taiwan's overall economy, with exports to the mainland now accounting for well over one-tenth of Taiwan's entire GNP, and FDI in the mainland accounting for more than half of all Taiwan FDI. The hundreds of thousands of Taiwanese businesspeople now working on the mainland are also vulnerable to pressure and harassment from mainland authorities. In addition, China has shown that it can disrupt key sectors of Taiwan's economy, including its stock markets and information networks. The breadth of this relationship provides China with the potential to inflict very severe economic disruption on Taiwan if it chooses to exploit these various levers.

It should be noted, however, that certain aspects of Taiwan's vulnerability to economic pain from Beijing—although very serious—appear somewhat less substantial when examined in comparison with other countries that have been the object of major economic coercion campaigns. Using a measure of trade dependency employed in the most widely respected study of international economic sanctions,¹ Taiwan's level of trade dependence on the mainland is only moderately high. Taiwan's trade dependence is still significantly lower than the average dependence of those countries that were economically coerced into making major policy concessions during the past century—although it continues to rise.

Taiwan's Vulnerability to Specific Coercion Scenarios

The economic analysis in Chapters Three and Four strongly suggests that Taiwan's economy is more vulnerable to some forms of economic pressure than to others. Its susceptibility to particular forms of coercion is a function of the specific economic forms or structure of the cross-strait relationship.

Mainland Sanctions Against Taiwan's Imports. Taiwan would suffer very substantial economic dislocation from a hypothetical large-scale mainland shutdown of imports from the island, although such an import ban would be very difficult for Beijing to enforce. As noted above, mainland China is now Taiwan's number-one trade partner, and Taiwan exports to the PRC account for a very large share of Taiwan's total

¹ Hufbauer, Schott, and Elliott, 1985.

GNP—at least 11–17 percent through the end of 2003. The principal driver of this export relationship has been cross-strait investment and intra-firm trade—increasingly, Taiwan IT firms shipping parts and goods to their mainland subsidiaries. Mainland China is now the number-one target of Taiwan FDI—China very likely receives well over half of Taiwan’s total FDI, although the margin of uncertainty in this data is so great that the actual percentage could well be far higher. Moreover, Taiwan’s cross-strait investment and export profile has shifted greatly in 15 years—from strategically less-important low-priced manufactured goods (shoes, toys, textiles, and such) to electronics and IT manufacturing and gradually toward research, design, and development. Between 50 and 90 percent of many of the most profitable IT products of Taiwan firms—including desktop and notebook computers, LCD monitors, motherboards, and CD-ROMs—now have their final assembly in mainland factories. It is difficult to dispute the conclusion of a 2002 Deutsche Bank study that reported, “If, for any reason, cross-strait trade comes to a sudden halt, the impact on final demand in Taiwan could be worse than any of the previous regional or global recessions.”²

But large-scale mainland sanctions on imports from Taiwan would be very difficult for Beijing to enforce without a highly effective and disciplined blockade of exports from the island—in other words, an act of war that would risk U.S. military intervention. Owing to Taiwan’s long-standing ban on direct shipping/transport links, the overwhelming majority of Taiwan’s exports to the mainland already traverse a third territory (including Hong Kong, Japan, South Korea, and Macao), which would greatly complicate Beijing’s difficulties in monitoring any sanctions. Chinese efforts to enforce such sanctions on third countries (e.g., South Korea or Japan) would certainly heighten international opposition to such sanctions. Smuggling problems among China’s military and law enforcement officials—already extremely severe—would also be exacerbated by sanctions on Taiwan imports, particularly if Taiwan made a concerted effort to corrupt the large number of the enforcers who would be needed to effect such an embargo. Sanctions would also be undermined if regional and sectoral Chinese business interests—which would be very badly hurt by sanctions—felt that they were unfairly bearing the entire burden of sanctions for the rest of the country. In addition to the lost income from sales of products made with imported Taiwan parts, these firms also would very likely resent the harm that broken export contracts with third countries would cause to their international reputations as reliable suppliers.

Mainland Sanctions Against Taiwan’s Investments. The enormous percentage of Taiwan’s total FDI that is directed to the mainland (more than 50 percent) implies that a hypothetical large-scale Chinese seizure of Taiwan investment assets could also cause considerable damage to major Taiwan firms. But the structure of Taiwan’s mainland investments (the high levels of intra-firm trade) plus the already widespread use of Hong Kong and Caribbean intermediaries by both Taiwan and mainland investors to

² Ma, Zhu, and Kwok, 2002.

cover their investments raise serious questions about the mainland's ability to monitor and enforce any large-scale asset seizure. For effective monitoring, Beijing would also have to rely upon the active cooperation of tens of thousands of local economic officials whose localities would suffer major recessions and unemployment from the shutdown of Taiwan-invested industries—cooperation that may not be forthcoming.

A crucial question would concern the ability of Taiwan firms affected by such asset seizures to survive the short-term damage and to try to revive themselves over the medium and long term. As noted in Chapter Four, many of these firms' most valuable and fungible assets—their intellectual, executive, and managerial talent; many of their most skilled production workers; many key production facilities; their design, research, and development facilities; their best intellectual property; and many of their marketing facilities—would remain on Taiwan outside of mainland China's hands. For Taiwan, the battle would be to help these firms survive in the short term and locate new offshore investment venues elsewhere in Southeast and South Asia—a plan Beijing could be expected to oppose vigorously through its diplomatic influence.

Mainland Sanctions Against Exports to Taiwan. The information derived from this study suggests that Taiwan would be far less vulnerable to a cutoff of imports from the mainland. From the earliest days of cross-strait trade, Taiwan has persistently run a large surplus with the mainland—the result of a deliberate policy choice by the mainland. Taiwan is not dependent upon the mainland for a large portion of its imports, or for its most important, inelastic short-term import—petroleum. It does, however, rely on the PRC for a large portion of its coal supplies and building materials. Moreover, recent reports of mainland efforts to establish mineral and commodity supply relationships with key African, Middle Eastern, and Latin American suppliers may in part represent an effort to dominate Taiwan's supply sources, and these activities merit closer monitoring. But Taiwan security experts interviewed for this project have expressed far less concern over this scenario than over many other scenarios. And they argue that absent a highly effective and sustained PRC blockade of the island, new sources of these imports could be found long before the island suffered major economic damage. Most fundamentally, Taiwan's imports from the mainland are hardly important enough to force Taiwan to consider major political concessions to the PRC.

Economic Disruption, Damage, and Sabotage. By contrast, Chinese officials increasingly recognize that they can threaten Taiwan's economy by targeting its key markets (stocks and bonds, foreign exchange) and information networks for deliberate disruption. Many Taiwan experts regard such disruption as a major vulnerability for Taiwan's economy. Regarding the stock market, Taiwan officials still have at their disposal powerful administrative systems, extensive experience, and enormous financial resources to mitigate the short-term deliberate disruption China has repeatedly inflicted upon the exchange over the past decade. For Taiwan, a major future dilemma concerns the island's efforts to liberalize the market to attract much needed additional foreign capital while trying to avoid opening itself up to greater disruption by the

PRC. As experts have long pointed out, China's greatest threat to Taiwan's markets remains its capacity to erode the vibrancy of markets and undermine investor confidence through sustained, long-term pressure. Several Taiwan experts and officials interviewed for this study expressed real concern about their vulnerability to PRC disruption and clearly regard it as one of the more efficient means available to Beijing for disrupting and undermining Taiwan's economic vibrancy.

Selective Harassment or Intimidation of Taiwan Businesspeople. As Chapter Five illustrated, Beijing has employed this tool repeatedly since 2000. Most of the experts and officials interviewed for this project felt that selective harassment of mainland-invested Taishang remained one of Beijing's most accessible options for exercising its economic leverage—notwithstanding the difficulty Beijing has had in converting this weapon into political influence against Taipei. With very rare exceptions, most notably Hsu Wenlong of Chi Mei, Beijing has not been willing to use this tactic in a sustained manner against major Taiwan investors. There have also been repeated reports that Beijing has sometimes backed down in the face of threats from these major investors to pull out of mainland China entirely. Local Chinese officials, moreover, have frequently provided Taishang with private reassurances that their businesses will remain secure. Finally, high-profile pressure from Beijing undermines the political influence of these Taishang in Taiwan, making them susceptible to “red-hatting” and other attacks on their patriotic motives by DPP and TSU officials. The ease with which such threats can be made—especially against relatively “small fish” investors—almost guarantees that Beijing will continue such harassment. But so long as the majority of Taiwan businesspeople continue trying to fly below the radar—declining to take a public stand on behalf of policies that Beijing supports—Beijing will likely face declining effectiveness in exploiting this weapon to achieve significant political concessions from Taipei.

Mainland Economic Vulnerabilities

As stated above, the cross-strait economic relationship is one of asymmetric interdependence rather than simple one-way dependence of Taiwan on the mainland. Within the PRC, several economically influential industrial sectors and geographic regions—in particular, the mainland's IT sector and coastal provinces such as Guangdong, Fujian, Jiangsu, and, most importantly, Shanghai—rely very heavily upon capital, managerial expertise, technology, parts, and intellectual property from Taiwan. China very likely depends upon Taiwan for at least one-tenth of its FDI—believed by many economists to be one of the two most crucial sources of capital for its recent growth. Regions such as Jiangsu/Shanghai, moreover, very likely receive well over a quarter of their FDI from Taiwan. There is also sound economic reason to believe that the goods and services that Taiwan provides to China account for far greater value added to the Chinese economy than China's goods and services add to Taiwan's economy. Thus, the relative

amount of economic pain and dislocation that China would suffer if it disrupted economic relations with Taiwan is very likely much higher than would be suggested by a simple calculation of the value of these goods and services as a percentage of China's total GDP.

Certainly, the fact that China would inflict significant economic pain on itself if it used these economic levers against Taiwan does not guarantee that Beijing would lack the will to do so if it truly feared Taiwan's imminent, permanent formal separation from China. Still, Beijing would have to consider the painful regional and sectoral economic losses it would suffer as result of a major campaign of economic coercion. In addition, the fact that these losses would be borne disproportionately by a few key Chinese regions and economic sectors could very easily undermine the willingness of these localities and industries to enforce Beijing's sanctions. Finally, the rapid rise in popular unrest in China over the past decade—in particular during the economic downturn years of the late 1990s—means that China's *political vulnerability* to a major disruption in cross-strait relations may, in the end, be greater than Taiwan's.

Beijing's Challenges: Converting Economic Influence into Political Leverage

China has encountered its greatest frustration in its efforts to identify and manipulate effective “conduits of political influence”—that is, Taiwan leaders, groups, and classes with a stake in promoting policies that Beijing also favors—through whom to exploit its economic influence. As Chapter Five detailed, Beijing has tried to use economic leverage to transform Taiwan's mass political opinion, change the political center of gravity among Taiwan's political elite, and forge the Taiwan business community into a reliable and influential lobbying group for Beijing's interests.

But the growth of cross-strait economic ties has been accompanied by a further erosion of the already low mass support in Taiwan for reunification or Beijing's “one country, two systems” proposal. Presidents Lee Teng-hui and Chen Shui-bian and their supporters have also enjoyed considerable success in promoting a shift away from support for reunification among Taiwan's political elite. Despite his less publicly hostile stance toward Beijing, even the new leader of the GMD, Ma Ying-jeou, has repeatedly stipulated that reunification would be undesirable before China has democratized. Taiwan's mainland-invested business community has enjoyed considerable success in getting the government to further open cross-strait economic relations, and over time this certainly could enhance China's economic leverage over Taiwan. But, on the political issues that are most crucial to Beijing, the Taishang have not, to date, emerged as an effective, unified, or highly public lobby pushing Taipei to make political concessions. The Taishang have been uncomfortably sandwiched between Beijing's periodic ham-handed threats and the DPP/TSU's public attacks on the loyalty of many Taishang. As a result, most Taishang have chosen to lower their political profile rather than lobby openly for political candidates and policies that help serve Beijing's interests.

For Beijing to derive greater political benefit from the Taishang community as a “conduit of political influence,” it must make itself continue its recent, less heavy-handed strategy, which does not play into the hands of the Taishang’s domestic critics. Such a change in strategy may require a level of self-restraint that Beijing finds difficult to show in the face of what it regards as Chen Shui-bian’s consistently irksome behavior. Conversely, Beijing may inadvertently benefit if Chen Shui-bian overplays his hand on cross-strait policy so badly that he strengthens the capacity and willingness of many Taishang leaders to resurface as trusted public voices for compromise with Beijing.

Potential Risks for U.S. Interests: Beijing’s Frustrations and Taipei’s Fears

This monograph has spotlighted both Taiwan’s growing vulnerability to economic pain from the mainland and the difficulties that Beijing has encountered in trying to convert that economic influence into effective political leverage, particularly on the sovereignty issues of most concern to Beijing. At first glance, Beijing’s frustrations in trying to exploit economic pressure against Taiwan might appear to be unalloyed good news from the standpoint of the United States’ long-standing interest in preventing either party in the Taiwan Strait from unilaterally and coercively altering the status quo in the area.

When Beijing has been able to employ economic leverage intelligently, effectively, and with restraint, the result has often been a decrease in cross-strait tensions. But when Beijing has felt frustrated at its difficulties in translating cross-strait economic relations into political influence, it has sometimes come to fear that “time is not on its side” in trying to reunify with Taiwan. As Chapter Five illustrated, in the wake of President Chen’s reelection, many in Beijing openly expressed growing frustration that cross-strait economic relations have failed to provide the political results for which Beijing had hoped. Some mainland experts report that in the summer and fall of 2004 this frustration was undermining the political position of experts who had long argued that the rapidly expanding economic relationship represented Beijing’s best nonmilitary tool for preventing Taiwan’s permanent separation from the mainland and encouraging the two sides’ eventual reunification. By 2005, China’s offers of increased agricultural access for Taiwan farm products, lower tuition for Taiwan students studying on the mainland, and a willingness to negotiate direct flights to Taiwan during holiday periods all suggested a restored faith in economic leverage. But official Chinese reports expressing elation at President Chen’s recent political setbacks have primarily attributed the DPP’s poor showing to the alleged “wisdom” of Taiwan voters and pressure on Chen by the United States and Beijing. They have given far less credit, however, to the restraining pressures created by cross-strait economic relations or the political activism of mainland-invested Taiwan businesspeople.

Conversely, Taipei's perceptions of the future political impact of its economic ties with the mainland may also heighten the risk that it would try to unilaterally change the status quo—although, ironically, this may happen for very different reasons. As indicated by the comments of President Chen, Vice President Lu, and other members of the DPP/TSU coalition, many pro-independence leaders simply do not share one of the fundamental conclusions of this monograph—that Beijing is encountering significant difficulties in converting its economic influence into political leverage against Taiwan. Several Taiwan analysts and officials interviewed for this study voiced serious concerns that the booming cross-strait economic relationship will inevitably provide Beijing with decisive political leverage over Taipei. This fear has always been implicit in their attacks on the political activities of the Taishang. In other words, these Taiwan officials and analysts worry, just like many of their counterparts in Beijing, that time is not on their side, but for reasons that are very different from those that motivate Beijing's fears. U.S. analysts will always have to monitor the degree to which such views are widespread among Taiwan's leadership. When they are, they risk heightening the belief among pro-independence leaders that the time to push for more formal assertions of independence (for example, through constitutional reforms that redefine the identity of the state) is “now or never.”

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