

The Economic Integration of Taiwan and China and Its Implications for Cross-strait Relations

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I. Introduction

Both the United States and the People's Republic of China (PRC) were alarmed when the pro-Taiwan independence presidential candidate Chen Shui-bian of the Democratic Progressive Party (DPP) surprisingly won the 18 March 2000 election as president of the Republic of China (ROC), because they feared the delicate situation in the Taiwan Strait would be upset by Chen's provocative measures toward China.¹ But equally surprisingly, in his May 20 inauguration address, Chen sent a message that reassured Taiwan's most important ally, the United States, and its archrival, the PRC. Chen pledged, *inter alia*, that, during his term in office, he would not declare independence as long as the PRC had no intention of using military force against Taiwan.

President Chen has followed this line of his generally conciliatory policy toward China ever since, and the attitude and behavior of the PRC toward Taiwan has been far more self-restrained than in the 1990s. We have seen a more calm and stable Taiwan Strait since President Chen took office.

¹ The terms "Taiwan" and "The Republic of China" here are loosely interchangeable as are the terms "China" and "The People's Republic of China."

A stable Taiwan Strait is exactly what both sides of the strait need. It is also desired by the United States, which has consistently stressed its interest in the stability and security of the Taiwan Strait as well as in a peaceful resolution of the disputes between Taiwan and the PRC. Taiwan needs stability because mainland China's huge markets have provided Taiwanese businesspeople with opportunities to stay competitive in the globalization process. China needs stability because it is conducive to using the economic means to accomplish the "sacred mission" of reuniting Taiwan with the mainland. Besides, as modernization and economic development are at the top of the PRC reform agenda, an economically robust Taiwan would not only enhance its economic development, but would also be a "golden goose" that China would not want to kill. At the same time, China's military buildup and the deployment of 400 missiles along the coast opposite Taiwan as well as China's insistence on the right to use force against Taiwan are strategically designed to act as a last resort to deter Taiwan from becoming a *de jure* independent and sovereign state.

Although intractable obstacles still exist at the level of "high politics" (e.g., the sovereignty issue, one China issue), the "low politics" economic and cultural exchanges between the two have gained a lot of momentum since the late 1980s.²

² For the terms "high" and "low" politics, see Cal Clark, "Does European Integration Provide a Model for Moderating Cross-Strait Relations?" *Asian Affairs*, Winter 2003, Vol. 29, No.4. pp. 195-215

Trade between Taiwan and China has grown so rapidly that as of the year 2002 China has become Taiwan's leading trade partner. The level of Taiwanese investment in mainland China, first in traditional labor-intensive manufacturing industries and then in high-tech semiconductor industries is enormous. This reflects the magnetic effect of the Chinese mainland market, which is characterized by the cheaper cost of land and labor, as well as numerous incentives taken by the government.

The following discussion will first look at the economic integration between Taiwan and China that has occurred over the past sixteen years, and then to see what implications it might have for cross-strait relations. The author also endeavors to look into its policy implications for the Taiwan government.

II. The “High Politics” of Cross-Strait Relations

1. The Political Stalemate between Taiwan and China

The perennial disputes between the ROC and the PRC over the issues of sovereignty and the future of Taiwan, the one China principle, Taiwan’s international status, and other issues constitute the “high politics” of cross-strait relations, while the economic and cultural exchanges are the “low politics,” or people -to-people diplomacy and social communications. The disputes over high politics peaked in the 1995-96 Taiwan Strait crisis, which almost brought the United States to the brink of military conflict with China. Tensions rose again in July 1999, when Taiwan’s then President Lee Teng-hui characterized the linkage between Taipei and Beijing as “special state to state relations” (i.e., the “two-state” theory), which the PRC claimed verged upon Taiwan’s proclaiming its independence from China.

When President Chen Shui-bian remarked in August 2002 that there is a country on each side of the Taiwan Strait (i.e., the “one country on each side” theory), China’s reaction, having learned the lessons of the past, was more constrained.³ However,

³ The PRC’s saber-rattling tactics on the eve of the 1996 presidential election and Premier Zhu Rongji’s threatening rhetoric on the eve of the 2000 presidential election, both of which aimed at intimidating

China distrusts President Chen Shui-bian and suspects him of having a hidden agenda of incrementally pursuing Taiwan independence. This has prompted the PRC to take a “wait and see” attitude towards his conciliatory approach.⁴ Beijing still avoids direct contacts with the DPP government, refuses to renounce the use of force, continues to suppress Taiwan’s international relations, and insists on its definition of “one China” as the precondition for bilateral talks, thus stalemating cross-strait relations.⁵

2. President Chen Shui-bian’s Conciliatory Approach to the PRC

Despite this, the Taiwan Strait has been relatively calm since President Chen took office. Chen has adopted a generally conciliatory approach, the so-called New Middle Line, in dealing with China. In his 20 May 2000 inaugural speech, President Chen stated that the principles of his mainland policy were “goodwill reconciliation, active cooperation, and lasting peace”. He also pledged that, as long as the Beijing authorities did not use military force against Taiwan during his term in office, he would not

Taiwanese voters from electing pro-independence candidates backfired. In both cases the PRC’s least desired candidates, Lee Teng-hui and Chen Shui-bian, were elected.

⁴ Suisheng Zhao, “Coping with the Chen Shui-bian Administration: Beijing’s Wait-and-See Policy and Two-Pronged Strategy,” Prepared for delivery at the conference, “Assessing Chen Shui-bian’s First Year: The Domestic and International Agenda,” George Washington University, Washington, D.C. May 31, 2001

⁵ Suisheng Zhao, “Economic Interdependence and Political Divergence”, in Zhao, Suisheng, ed., *“Across the Taiwan Strait: Mainland China, Taiwan, and the 1995-1996 Crisis,”* 1999, pp.21-49

declare independence, change the name of the nation, push for the inclusion of the so-called state-to-state description in the constitution, nor promote a referendum on the question of independence or unification.⁶

Furthermore, Chen has no intention of abolishing the Guidelines for National Unification or the National Unification Council.⁷ In his 2001 New Year's message, he further proposed 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 permanent peace and political integration."⁸ Chen repeated this call in his 2002 New Year's message by saying that "if the Chinese mainland can renounce military intimidation and respect the people's free will, the two sides can begin with integration in the cultural, economic, and trade fields, before

⁶ Taiwan-China Relations, Online at www.gio.gov.tw/taiwan-website/5-gp/brief/unification.htm

⁷ In March 1991, the ROC government promulgated the Guidelines for National Unification, which were first discussed by and gained consensus in the National Unification Council, with the goal of establishing a democratic, free, and equitably prosperous China. They are based on the following principles: a) both Taiwan and the mainland areas are all parts of Chinese territory; b) China's unification should aim at promoting Chinese culture, safeguarding human dignity and fundamental human rights, the practice of democracy and the rule of law; c) the timing and manner of China's unification should first respect the rights and interests of the people in the Taiwan area, and protect their security and welfare. It should be achieved in gradual phases under the principles of reason, peace, parity, and reciprocity.

⁸ President Chen's Cross-century Remarks, 1 January 2001, <http://www.mac.gov.tw/english/index1-e.htm>

further seeking a new framework for permanent peace and political integration.”⁹

3. Other Factors That Contribute to a Calmer Taiwan Strait

Chen's party, the pro-independence DDP, has also modified its rhetoric and platform on Taiwan independence, which had appeared to be the reason for the party's defeat in the 1998 elections. According to polls over the last fifteen years, between 70 and 80 percent of Taiwan's 23 million people consistently favor the status quo; those who favor either immediate reunification or independence are on the outlying side of the spectrum, with each side having less than 10 percent of support. The critical reaction of the Bush administration to President Chen's "one country on each side" theory in August 2002, and the subsequent reiteration of non-support for Taiwan's independence by President Bush has reassured the PRC leadership that the United States will adhere to its "one China" policy.¹⁰ As long as the ROC government can be dissuaded from declaring independence, the PRC feels that time may be on its side, and it is confident that it can concentrate on its economic modernization and a strategy of reunifying Taiwan through an all-out pursuit of economic ties.

⁹ President Chen's New Year Message, 1 January 2002, <http://www.mac.gov.tw/english/index1-e.htm>

¹⁰ U.S. President George W. Bush reportedly told former Chinese President Jiang Zemin and the current President Hu Jintao to that effect, respectively, in the meetings at the Crawford Ranch in October 2002 and on the sidelines of the G8 summit on 1 June 2003 at Evian, France.

The U.S. government support for Taiwan has played a pivotal role in keeping the Taiwan Strait peaceful and stable. Under the Taiwan Relations Act, the U.S. law which governs the unofficial relations between Taiwan and the United States, the U.S. government has committed itself to safeguarding Taiwan's security and maintaining a peaceful Taiwan Strait. In April 2001 President Bush made it clear that the United States would come to Taiwan's defense if China mounted an unprovoked attack on the island. U.S. arms sales to Taiwan also deter Beijing. The United States has offered Taiwan a variety of systems that meet Taiwan's real needs, and these would make the outcome of a PRC attack much more unsure. They also enhance the will of Taiwan's public to resist coercion.¹¹

¹¹ Richard C. Bush III, "American Ambiguity on Taiwan's Sovereignty Increases the Island's Safety," *Insight Magazine*, 4 December 2002.

III. The Growth of Cross-strait Economic Relations

1. Beijing's Peaceful Unification Offense

Deng Xiaoping's ascension to leadership following Mao's death in 1976 cleared the way for a PRC policy toward Taiwan that, until the crisis of 1995, was mainly conciliatory and rarely involved public threats or military posturing. Xu Xiangqian, who was the PRC minister of defense at the time, announced in January 1979 that the People's Liberation Army (PLA) would stop shelling Quemoy and Matsu as a friendly gesture to Taiwan and in recognition of China's normalization of relations with the United States.¹²

At the same time, the National People's Congress (NPC) released a "Message to Compatriots on Taiwan," promoting a peaceful process of unification and the establishment of trade, transportation, and mail links across the Strait. On 30 September 1981, in his nine-point proposal for peaceful reunification, Ye Jianying, the vice chairman of the NPC Standing Committee, specifically proposed opening the three links and called for "four exchanges" (i.e., academic, cultural, economic, and

¹² Denny Roy, *"Taiwan,, A Political History"* Cornell University Press, 2003, p.147

athletic) as the first step to “gradually eliminate antagonism between the two sides and increase mutual understanding.” To lure Taiwan business, Beijing offered various special tax shelters and other attractive terms for Taiwan investment on the mainland.¹³

2. Taipei’s Response

At first, Taipei insisted on its “three no’s” policy (no contact, no negotiation, no compromise) out of caution, but in 1986 it rapidly began to ease many restrictions on contact with the mainland. It began relaxing restrictions on trade, investment, and travel to the mainland in 1987, it liberalized indirect imports of mainland goods into Taiwan in June 1989, and in October 1990, indirect investment and technical cooperation were liberalized, allowing Taiwan businessmen to register their investment on an approval list with the government.

However, as soon as the ban on visiting the mainland was lifted, Taipei admitted that the government was no longer able to control indirect trade with the mainland, so in 1990 it permitted indirect investment on the mainland. In early 1995, in response to the eight-point proposal made by Jiang Zemin on high-level negotiations to end hostilities

¹³ Suisheng Zhao, “Economic Interdependence and Political Divergence”, in Zhao, Suisheng, ed., *“Across the Taiwan Strait: Mainland China, Taiwan, and the 1995-1996 Crisis,”* 1999, pp.21-49

across the strait, Taipei officially announced that cross-strait relations would henceforth hinge on economics and trade.¹⁴

3. Cross-strait Economic Interactions Since the Late 1980s

Social and economic interactions between Taiwan and mainland China took off in the late 1980s. Before then, there were almost no direct contacts between the citizens of the two countries. Taiwan then announced in late 1987 that citizens would be allowed to visit relatives on the mainland for humanitarian purposes. Once the door was opened, visitors and trade poured across the strait “like waters rushing through a breached dam.”¹⁵ Within about a year, 200,000 islanders had traveled to China; by the end of 1989 the number had neared 1 million.¹⁶ According to the Mainland Affairs Council (MAC), by October 2002 over 27 million visits by Taiwanese citizens to mainland China have been tallied. In the year 2002 alone, the figure was more than 3 million.¹⁷

At the same time, by the 1980s Taiwan’s prosperity had driven up wages to the point that it was losing competitiveness in its labor-intensive production sector. With the

¹⁴ Ibid.

¹⁵ Denny Roy, “Taiwan, A Political History,” Cornell University Press, 2003, p.150

¹⁶ Ibid.

¹⁷ Online at <http://www.mac.gov.tw/english/english/foreign/28.gif>

opening of the mainland, many Taiwan businesspeople saw it as a prime location for new factory sites as it had unlimited low-cost labor, the language and cultural ties are very strong, and pragmatic provincial leaders offered substantial incentives for investment in export industries. In the meantime, China in the late 1980s embarked on a “coastal development strategy” aimed at attracting the light and labor-intensive industries that were being priced out of Hong Kong and Taiwan. It also began to emulate the export-led industrialization of the East Asian capitalist nations.¹⁸

This confluence of fundamental economic change in Taiwan and the new Chinese economic strategy produced tremendous growth in cross-strait economic interactions.¹⁹ Taiwan’s exports to China grew nearly six times between 1987 and 1991 (from \$1.2 billion to \$6.9 billion),²⁰ and they more than doubled again between 1992 and 1996 (to \$19.1 billion), despite much political turbulence, including the Tiananmen massacre of 1989 and the Taiwan Strait crisis of 1995-96.

Taiwan’s exports to China remained steady at \$21.2 billion from 1997 to 1999, despite the Asian financial crisis of 1997-98 and Lee Teng-hui’s 1999 declaration of “two-state theory.” Nor did the 2000 presidential election of Chen Shui-bian change this growth

¹⁸ Cal Clark, “Does European Integration Provide a Model for Moderating Cross -Strait Relations?” *Asian Affairs*, Winter 2003, Vol. 29, No.4. pp. 195-215

¹⁹ Ibid.

²⁰ All the figures hereafter referred to in this paper are all in US Dollars.

trend. In 2000, Taiwan's exports to China were estimated at \$26.1 billion, while the bilateral trade volume jumped to \$32.3 billion. In 2002 these figures increased to \$33.05 and \$41 billion respectively.²¹

Statistics from China's Ministry of Commerce suggest that in the first quarter of 2003 cross-strait trade volume increased by 39 percent to reach \$12.12 billion.²² According to Taiwan's Board of Foreign Trade (BOFT), from January to March 2003 the cross-strait trade volume was \$10.06 billion, a 33.2 percent increase over the same period in 2002, which was 16.4 percent of Taiwan's total trade volume. The value of Taiwan's exports to China in the same period was \$7.8 billion, a 29.9 percent increase from 2002, while its imports from China were valued at \$2.26 billion, a 45.6 percent increase, for a total \$5.53 billion trade surplus with China.²³

Since 1995, China has become the single most important source for Taiwan's foreign trade surplus: in 2002, its trade surplus with China was \$25.3 billion, while its total trade surplus that year was \$18.05 billion. In fact, Taiwan's balance of trade would be in deep deficit if it were not for its huge trade surplus with China. Table 1 provides an

²¹ Based on the statistics of Taiwan's Bureau of Foreign Trade.

²² Online at <http://www1.chinadaily.com.cn/news/2003-05-29/116889.html>

²³ Online at <http://udn.com/NEWS/WORLD/WOR8/1351386.shtml>

estimate of cross-strait indirect trade between 1986 and 2002.

Table 1: Taiwan's Trade with China

Year	Exports		Imports	
	Value (in US\$ billions)	% of Taiwan's total exports	Value (in US\$ billions)	% of Taiwan's total imports
1987	1.02	2.3	0.3	0.8
1988	2.2	3.7	0.5	1.0
1989	3.3	5.0	0.6	1.1
1990	4.4	6.5	0.8	1.4
1991	7.5	9.8	1.1	1.8
1992	10.6	13.0	1.1	1.6
1993	14.0	16.5	1.1	1.4
1994	16.0	17.2	1.9	2.2
1995	19.4	17.4	3.1	3.0
1996	20.7	17.9	3.1	3.0
1997	22.5	18.4	3.9	3.4
1999	21.2	17.5	4.5	4.4
2000	25.0	20.2	6.2	4.4
2001	26.5	23.0	5.8	---
2002	33.0	25.3	7.9	7.1

Sources: Chu-yuan Cheng, "Economic Relations across the Taiwan Straits: Mutual Dependence and Conflicts," in Winston L. Yang and Deborah A. Brown, eds., *Across the Taiwan Strait: Exchanges, Conflicts, and Negotiations* (New York: Center for Asian Studies, St. John's University, 1999); and Board of Foreign Trade, Ministry of Economic Affairs.

Taiwan's trade with the mainland is for the most part investment driven, because

Taiwanese investors in the mainland mainly depend on the island for their supplies of

machinery equipment, spare parts, and certain raw materials. It is estimated, according to Taiwan's BOFT, that 54 percent of the materials and 75 percent of the machinery and equipment needed by Taiwanese businesses in China are imported from Taiwan.

This growth of investment from Taiwan to the mainland is particularly impressive, as prior to 1987 there was virtually none. But in the wake of the end of Taiwan's decades-long martial law in July 1987, followed by the relaxation of foreign exchange controls, some adventurous businessmen began to invest in the coastal cities on the mainland, especially in the city of Xiamen, located directly across the Taiwan Strait.

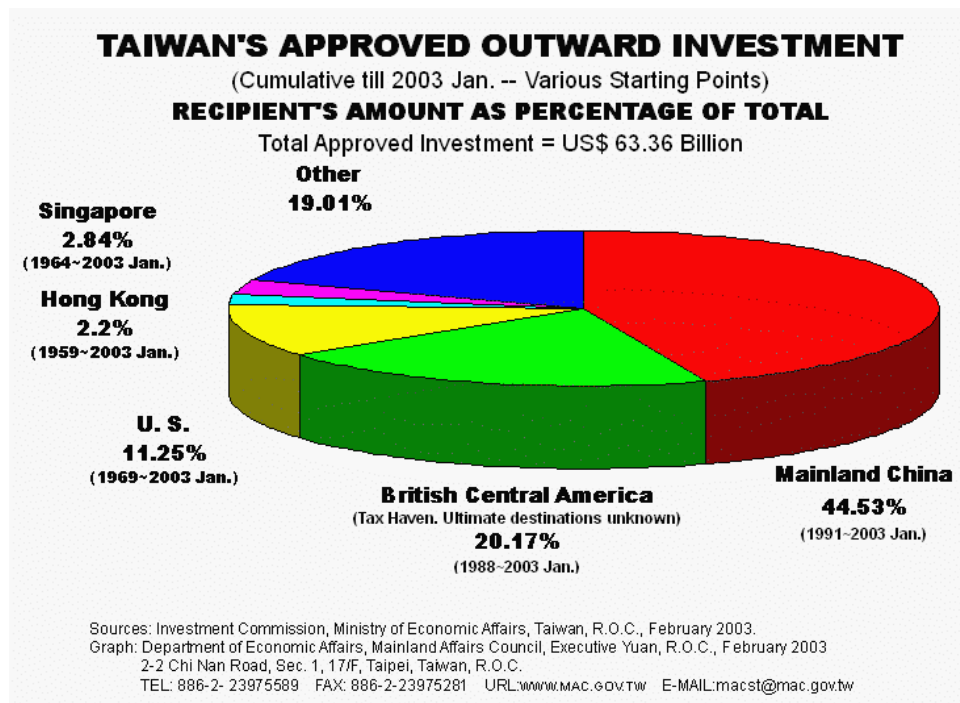
The initial level of investment was very moderate; however, this sped up after 1990, when new capital poured into the real estate in the coastal cities of eastern China.

According to official Taiwan statistics, between 1991 and 1995, 11,254 investment applications to the mainland, with a total value of \$56.45 billion, were approved, while Beijing's statistics show 31,780 Taiwan investment applications for a total value of \$114.27 billion.²⁴ According to Taiwan's Mainland Affairs Council (MAC), the mainland became the most important outlet for Taiwan's overseas investment,

²⁴ The discrepancies of Taiwan and Beijing's statistics result from the indirect trade and investment between Taiwan and the mainland. Since most Taiwanese businessmen made their investment on the mainland through Hong Kong or another third country, their records of investment are generally excluded from the official Taiwan statistics, while they are included in Beijing's statistics.

accounting for 44.53 percent of the island's total investment abroad from 1991 to January 2003, far exceeding Taiwan's second country of investment, the United States (11.25 percent from 1969 to January 2003, see Table 2).

Table 2: Taiwan's Investment in Mainland China



The nature of this foreign investment became more long term as well. Taiwan investors moved from joint ventures to solely owned enterprises and began to build their own factories in China. The structure of these ventures was also upgraded from simple assembly to “upstream” heavy and more capital-intensive or high-tech production. By the mid-to-late 1990s, the mix of Taiwan investment in China began to shift from predominantly small business in labor -intensive exports to much larger businesses seeking to penetrate the Chinese market in heavy industry (e.g., Formosa Plastics) and

consumer goods (e.g., President Enterprises). There was also a geographical spread of Taiwan investment, from an initial concentration in Fujian and Guangdong provinces, to Shanghai, to almost all regions in China.

By 2002, this economic integration began to generate another round of economic interactions between Taiwan and China. Cross-strait trade jumped that year by 36.9 percent, from \$29.9 billion to \$41 billion, and investment surged even more dramatically, by up to \$20 billion in 2000-02, reaching an estimated cumulative level of \$80-100 billion.²⁵ These strong economic ties also augment informal people-to-people diplomacy and have created substantial Taiwan communities in many mainland cities. There are now an estimated 400,000 to 700,000 Taiwan nationals living and working on the mainland, concentrated in the high technology and high economic growth areas of Shanghai and Shenzhen.²⁶

4. The Information Technology Migration to the Mainland

The year 2000 was a benchmark for Taiwan investment in China, which moved from low - and mid-tech into the high-tech sectors. Furthermore, investments in services

²⁵ The cumulative investment statistics varies. For example, non-governmental sources estimate that Taiwan has actually invested well over \$140 billion in the mainland.

²⁶ Some sources say the number of Taiwanese living in Shanghai alone is about 300,000.

showed for the first time that Taiwanese businesses have finally begun to view mainland China as a major export market in itself. For the year 2000, an astonishing 72.8 percent the total \$25.535 billion production value of China's information technology (IT) hardware sector was manufactured by Taiwan-owned production lines.²⁷

According to Taiwan's Ministry of Economic Affairs, by the end of 2000 up to 48 percent of desktop computers exported by Taiwan makers were manufactured in mainland plants, 18 percent were turned out by their plants in Taiwan, while the remaining 34 percent were produced in other parts of the world. In 2000, Taiwanese-operated plants in mainland China assembled 6.5 percent of Taiwan's notebook output, double the 1999 figure. About 56 percent of Taiwan's motherboard makers also had production lines on the mainland, which by the end of 2000 produced over 50 percent of Taiwan's total motherboard shipments. Of Taiwan's computer monitor producers, 58 percent have major production lines in the mainland, while 74 percent of Taiwan's CD-ROM drive makers have moved to mainland China, and 88 percent of scanner manufacturers had moved to the mainland by the end of 2000.²⁸

²⁷ John Thacik, "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*, Strategic Studies Institute, October 2001, pp. 35-62.

²⁸ Ibid.

While Taiwan initially imposed investment restrictions on the semiconductor business, pressure from the business circle caused the government to revise the restrictions on a limited basis. Now Taiwan foundries must build a 12-inch plant in Taiwan for every 8-inch plant they build in China. But semiconductor manufacturers besides Taiwan Semiconductor Manufacturing Corporation (TSMC) and United Microelectronics Corporation (UMC) fear that the government's restrictions will jeopardize their competitiveness, and Taiwanese companies have found their way around these restrictions. For example, UMC reportedly constructed a \$1 billion, 8-inch plant under the name of He Jian Technology through a Virgin Islands holding company.

Even TSMC CEO Morris Chang folded under the pressure of rivals in China. He conceded, "When the Chinese authorities provide incentives like tax breaks as well as sufficient supplies of high-tech personnel and water and electricity, and our competitors start to take advantage of these, we will lose our competitive advantage if we do not follow suit...Taiwanese foundries have to come to China...they have no other choice."²⁹ In February 2003, after several months of tussle between the government and the legislature, TSMC's plan to set up an 8-inch wafer plant was

²⁹ Michael Klaus, "Red Chips: Implications of the Semiconductor Industry's Relocation to China," *Asian Affairs: An American View*, Washington, Winter, 2003, vol. 29, no. 4, pp. 237-253.

finally approved.³⁰

³⁰ *China Times*, 26 February 2003

IV. Taiwan's Economic Dependence on the Mainland

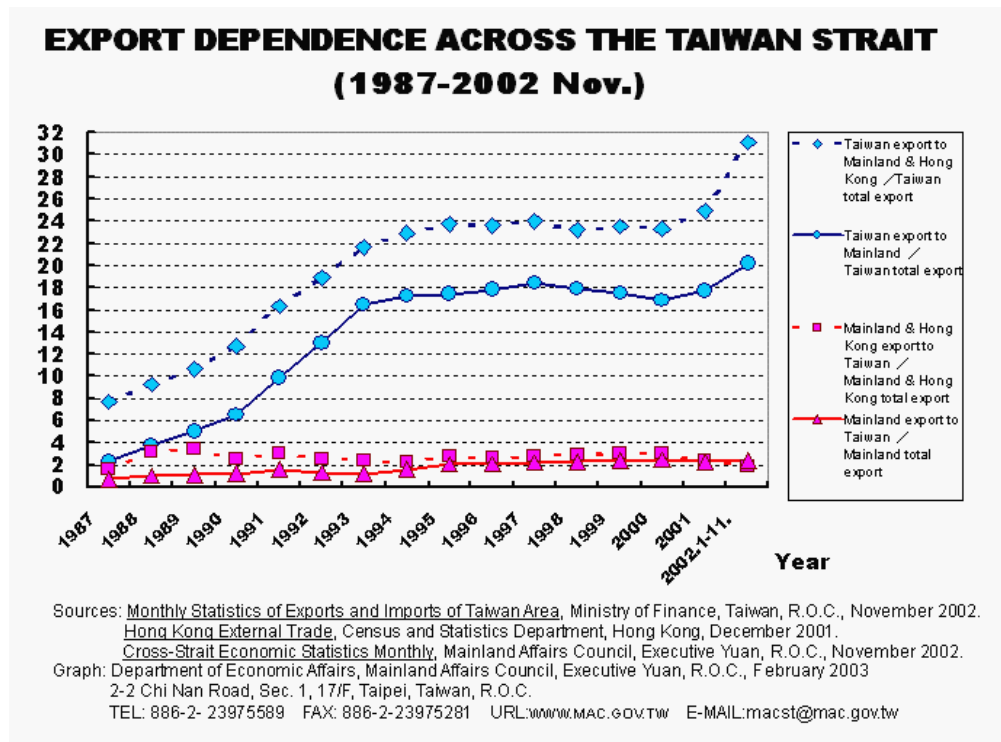
Given these developments, it is not surprising that Taiwan's trade is increasingly dependent on the mainland. In fact since 1992, Taiwan's degree of dependence on the Chinese markets for its exports has exceeded the "warning line" of 10 percent set up in the early 1990s by the Ministry of Economic Affairs. The percentage of Taiwan's exports to the mainland in proportion to its total foreign trade rose dramatically from 9.1 percent in 1991 to 25.3 percent in 2002, with the total value reaching a record high of \$33.06 billion.

Furthermore, the first three months of 2003 have seen a continued growth in export and import volume with China, and Taiwan dependence on China for trade continues to rise. Mr. Chi-peng Huang, director-general of the Taiwan Bureau of Foreign Trade, was quoted on 28 January 2003 as saying that Taiwan's export has tilted too much toward China.³¹ Although the percentage share of Taiwan's imports from China rose from 1.8 percent in 1991 to 7.1 percent in 2002, the import value was only \$7.9 billion, creating a huge trade surplus for Taiwan of \$25.1 billion. But Taiwan's total trade surplus that year was \$18.05 billion, and without its surplus with China, Taiwan would

³¹ Central News Agency, 28 January 2003

have had deficit in its foreign trade. With a bilateral trade value of \$41 billion in 2002, mainland China for the first time replaced the United States as Taiwan's leading trade partner.

Table 3: Export Dependence Across the Taiwan Strait



The governments on both sides of the Taiwan Strait were deeply involved in promoting or regulating economic exchanges. Beijing encouraged the exchange in hopes that increased economic interdependence would bind Taipei's hands in seeking independence and that it would facilitate national reunification. Taipei, however, strove to regulate the pace of economic exchange out of fear that increased economic

interdependence might eventually erode its position in the face of Beijing's reunification campaign.

Beijing's leaders were quite open about the political objectives of its trade and investment policy toward Taiwan. At the 1990 National Work Conference on Taiwan, President Yang Shangkun said, "We should promote political integration through the economy, compel the Taiwan authorities to talk with us by manipulating Taiwan people's opinion, and lead exchanges between the two sides in a direction favorable to the reunification of the motherland." His successor, Jiang Zemin, reiterated this point of view in April 1994 by saying "enhancing cross-Straits economic exchanges and cooperation...will be useful in boosting the development of cross-strait relations and national reunification."³²

Specifically, Beijing's policy is to "circumscribe politics through business benefits, to influence government through public pressure" (*yi shang wei zheng, yi min bi guan*).³³

Taiwanese entrepreneurs who have large investments in the mainland and supported Chen Shui-bian's bid to win the presidential election in March 2000 became the target

³² Suisheng Zhao, "Economic Interdependence and Political Divergence", in Suisheng Zhao, ed., "Across the Taiwan Strait: Mainland China, Taiwan, and the 1995-1996 Crisis," 1999, pp.26-27

³³ Ibid., p. 27

of Chinese news media's attack. The *Financial and Economic Times* published in Beijing warned on 11 April 2000 that Beijing would no longer "sit idly by" and "watch Taiwan businesses make money in China to support Taiwan independence back home."³⁴

Taiwan's businessmen now have too much invested in China to risk it by actively supporting Taiwan independence and they wield enough influence over President Chen to restrain any precipitate and overt move to Taiwan independence. As a matter of fact, a substantial constituency has already been created in Taiwan for the "three links" (trade, transportation and postal links) advocated by Beijing.³⁵

The Taiwan government was very cautious toward economic interaction. It considered it imperative to keep the island's dependence on the mainland at an acceptable level, lest its security be jeopardized by trade and other economic ties.³⁶ In addition, the Taipei leadership was deeply concerned about the steady increase in the size of Taiwanese investments in the mainland and the possibility that overinvestment would

³⁴ John Thacik, "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*, Strategic Studies Institute, October 2001, pp.35-62

³⁵ Ibid.

³⁶ SuishengZhao, "Economic Interdependence and Political Divergence", in SuishengZhao, ed., *Across the Taiwan Strait: Mainland China, Taiwan, and the 1995-1996 Crisis*, 1999, pp.27-28

eventually “hollow out” the island’s economy.³⁷

Taiwan’s leaders were aware that Beijing’s policy was “designed to deepen economic integration of the two entities and to create bargaining chips that can be used when the communist leadership decides to push for unification.”³⁸ In President Chen’s own words, China’s primary goal is to “marginalize” and “downgrade” Taiwan to the status of a local government by isolating Taiwan politically while involving it economically.³⁹

Aware of the dangers, the Taiwan government attempted to limit or shape the size and contours of economic interactions with the mainland. The government still officially prohibits direct trade across the strait, and measures were taken to constrain the investment in mainland in order to keep the investors’ roots in Taiwan. In particular, the Taiwan government has tried to control the relocation of Taiwan enterprises, especially large ones, to the mainland.⁴⁰

³⁷ Ibid.

³⁸ Yu-Shan Wu, “Mainland China’s Economic Policy toward Taiwan: Economic Needs or Unification Scheme?” *Issues and Studies* 30 no. 9, September 1994

³⁹ Harvey Sicherman, “A Conversation with Taiwan’s Chen Shui-bian,” *Orbis*, Vol.47, No.2, Spring 2003

⁴⁰ Suisheng Zhao, “Economic Interdependence and Political Divergence”, in Suisheng Zhao, ed., *Across the Taiwan Strait: Mainland China, Taiwan, and the 1995-1996 Crisis*, 1999, p. 28

As early as 1993 Taiwan had launched a “southward policy,” encouraging Taiwan’s entrepreneurs to invest in Southeast Asia rather than mainland China. But the region proved to be unable to replace the mainland as a target for Taiwan investments.⁴¹ In 1996, a “No haste, be patient” policy was adopted to govern Taiwanese investments on the Chinese mainland. Under this policy, investments on the mainland by the high-tech and infrastructure sectors were restricted, and a \$50 million ceiling was imposed on any single investment in China. The aim of the policy was to encourage businesses to keep their operation centers in Taiwan and to prevent excessive outflow of capital and core technologies.

However, the government was not effective in regulating the pace of cross-strait economic exchanges and in resisting the pressure from its own private sectors to lift the ban on direct trade and direct air and sea links with the mainland. Taiwan investments on the mainland continued to increase, reaching a record high in 2002, as capital- and technology-intensive industries joined the rush.

Realizing that controlling capital flows to the mainland was impossible, the ruling DPP government opted to increase economic integration with the mainland. As Dr. Tsai

⁴¹ Ralph N. Clough, “*Cooperation or Conflict in the Taiwan Strait?*”, Rowman & Littlefield Publishers, Inc., 1999, p56

Ing-wen, Chairwoman of the Mainland Affairs Council said in an address to the Taiwanese Chamber of Commerce of San Francisco in January 2001 that “With the changes in the circumstances and increased needs of the Taiwanese firms, the government is currently reviewing the policy to allow greater flexibility. The overall policy direction will be less restrictive.”⁴²

As cross-strait exchanges continued to increase, on 1 January 2001 Taiwan authorized the “mini-three-links” between its two offshore islands of Quemoy and Matsu and China as a prelude to direct cross-strait links. In response to the recommendations of the Economic Development Advisory Conference which was held in August 2001, President Chen announced an “active opening and effective management” policy that would replace the “No haste, be patient” policy. Under the new policy, such regulations on cross-strait investment as the \$50 million maximum would be relaxed, and the “Three Links” would be opened consistent with the World Trade Organization (WTO) rules.⁴³

⁴² Tsai Ing-wen, “Current Cross-Strait Relationship,” an address delivered to the Taiwanese Chamber of Commerce, San Francisco Bay Area, 21 January 2001

⁴³ Taiwan-China Relations, Online at www.gio.gov.tw/taiwan-website/5-gp/brief/unification.htm

V. The Question of the Three Links

The Taiwanese government under President Chen Shui-bian is at a crossroads as to how and when to establish the three direct links with mainland China. These are essential for Taiwan to develop into an Asia-Pacific regional operational hub and transshipment center, something that was first envisaged about ten years ago by the former economic leaders in Taiwan as a solution for Taiwan's economy in the face of the magnetic effect of mainland China. But because of political concerns, this grand strategy did not win the approval of the former President Lee Teng-hui, who veered toward and co-opted the DPP's China policy through the 1990s.

The PRC evidently believes that the growing social and economic ties across the strait will increasingly pull Taiwan into China's orbit. Consequently, one of Beijing's central initiatives toward the ROC is to call for the establishment of direct transportation, trade, and investment and postal links—the so-called three links—between Taiwan and the mainland. But the PRC has insisted that negotiations on this issue should proceed under the one China principle, which Taiwan will not accept. Only on 16 October 2002 did then Chinese Vice Premier Qian Qichen say that mainland China would call the

links across the Taiwan Strait a “cross-strait route,” rather than a “domestic route.”⁴⁴

Based on Qian’s statement and under the continued pressure from the Taiwanese businesses, Chen Shui-bian’s government seems to have softened its tough position on this issue, but there have been confused messages from policy-makers. For instance, on 1 November 2002, Premier Yu Shyi-kun told the legislature that the opening of direct transportation links with mainland China is the government’s established policy and that it is ready to start negotiations on the issue if Beijing attaches no political strings to it. Yu also agreed that the negotiations could be conducted by private groups, as suggested by the PRC, but should be under the government’s control. He reiterated that the government would not oppose such links, but that their implementation would have to be made with due regard for the equality of both sides and must not erode Taiwan’s security or dignity.⁴⁵

Meanwhile, on the same day, 1 November 2002, MAC Vice Chairman Chen Ming-tong told a news conference that Taiwan would aggressively try to start negotiations with Beijing on the direct links issue in a month, when related laws had

⁴⁴ Maubo Chang, “Transportation links with Mainland is Established Policy: Premier,” Central News Agency, 1 November 2002

⁴⁵ Ibid.

been revised and technical assessments of the impact of opening had been completed.⁴⁶

But on the issue of negotiations through private groups, MAC Chairwoman Tsai Ing-wen, when answering a question posed by an opposition legislator on the very same day again, denied that the government has ever mentioned the “Hong Kong and Macau ” formula (i.e., the same formula used in talks between Taiwan and Hong Kong and Macau on the renewal of bilateral air pacts) as a method for conducting talks on the three links in order to accelerate the opening of the direct cross-strait trade, postal and transportation links.⁴⁷

According to Prof. Joseph Fewsmith of Boston University, who visited Taipei in January 2003, Taiwan’ top policy-makers in fact seem to have agreed to the Hong Kong and Macau formula and an assessment study on the merits and drawbacks of establishing three links would soon be completed and available for release.⁴⁸ Its release, however, has been postponed for unknown reasons.

The question of direct transportation links is the most pressing one, especially for Taiwanese businesspeople (and clearly for the PRC, too). The current flight route from

⁴⁶ Ibid.

⁴⁷ Deborah Kuo, “‘Three Links’ Require Talks: MAC Head,” Central News Agency, 1 November 2002

⁴⁸ Based on a conversation with Prof. Joseph Fewsmith of Boston University on 16 February 2003

Taiwan to China is via Hong Kong or Macau, which is both time consuming and expensive. According to the surveys conducted by MAC from 1997 to 2002, the vast majority of the respondents (ranging from 71.9 percent to 83.2 percent) invariably favored a conditional opening up of direct transportation links with mainland China.⁴⁹

Thanks to the efforts of the KMT legislator Mr. John Chang and some Taiwanese businessmen, on 26 January 2003 a Taiwan airliner picked up passengers at the international airport in Shanghai and returned to the island, breaking a half-century freeze on commercial aviation across the Taiwan Strait. This flight by a China Airlines Boeing 747-400 was the first of sixteen chartered flights to help Taiwanese living in mainland China return home for the Lunar New Year holiday and was billed as an important step toward restoring transportation links across the strait.⁵⁰

The Taiwan government is now considering opening direct cross-strait cargo transport links. At a high-profile economic meeting, President Chen was recently reported to have instructed appropriate government agencies to draw up a plan as soon as possible for facilitating the flow of cargo between the two sides of the strait.⁵¹ Vice President

⁴⁹ Mainland Affairs Council, "Should We Open up Direct Transportation Links with Mainland China?" Online at http://www.mac.gov.tw/english/english/pos/9112/9112e_a.gif

⁵⁰ Joseph Khan, "Taiwan Ends a Half-Century Freeze on Flights to China," The New York Times, 27 January 2003

⁵¹ Kwang-chun Huang, "Cross-Strait Cargo Transport Would Attract Foreign Investment: VP," Central News Agency, Taipei, 28 May 2003

Annette Lu said the opening of cross-strait cargo transportation by chartered planes or ships is in line with the government's policy of making Taiwan into a regional and global hub of operations and logistics.⁵²

Beijing has agreed to consider the proposal. Li Weiye, a spokesman for the Taiwan Affairs Office of the State Council, said the mainland is willing to facilitate any move that benefits business circles on Taiwan, as well as cross-strait economic exchanges.⁵³ If implemented, the chartered freight flight program would signal another landmark move in cross-strait relations, following the successful operation of the first chartered passenger flights between Taiwan and the mainland during 2003's Spring Festival holiday.

In an interview given after visiting Taiwan and China in November 2002 with the delegation led by William Perry, a former U.S. defense secretary, David Lampton, director of Chinese Studies at The Nixon Center and professor of China Studies at the Johns Hopkins School of Advanced International Studies, said the biggest threat to Taiwan's security lies not in the PRC missiles, but in the health of its economy.⁵⁴ He

⁵² Ibid.

⁵³ "Cross - Strait freight charters proposed," China Daily, 29 May 2003

⁵⁴ Central News Agency, 29 November 2002, online at <http://www.taipei.org/teco/cicc/news/chinese/c-11-30-02/c-11-30-02-5.htm>

stated that to maintain its economic edge, Taiwan needs to conduct a division of labor with the mainland and establish the three links as soon as possible. According to him, the delegation's main piece of advice to the Taiwan government was that the three links should be quickly established—but he got the impression that Taipei was not in a hurry to do so. “Taipei realizes that three links are unavoidable. But they think the three links are kind of favor to the PRC. They don't want to give it too soon.”⁵⁵

There are also voices within the Taiwan government that argue in the same vein.

Taiwan's Council for Economic Planning and Development (CEPD) Vice Chairwoman

Ho Mei-yue said in February 2003 that Taiwan should move swiftly to improve its

investment climate in view of mainland China's magnet effect in pulling in foreign

investment.⁵⁶ Citing a study by Germany's Deutsch Bank, Ho argued that opening

direct trade, transport and postal links between Taiwan and the mainland in 2004

would help businesses slash 50 percent in transport fees and 30 percent in financial

transaction charges and that direct links would also help create an additional 2.5

percent economic growth rate for Taiwan during the 2004-08 period.⁵⁷ She also argued

that if Taiwan were to further improve its investment climate, including lowering

⁵⁵ Ibid.

⁵⁶ Central News Agency, 23 February 2003

⁵⁷ Ibid.

transport costs for cross-strait travel and expanding its airlink network, Taiwan would have a stronger appeal than the mainland as an operational hub, for both Taiwan and foreign investors.⁵⁸

In a newly released report, *Leaping Dragon, Trailing Tigers? : Taiwan, Hong Kong and the challenge of mainland China*, the UK-based Economist Intelligence Unit (EIU) asserts that Taiwan should view China 's rise as a major economic power as an opportunity and not a threat, and that the greatest hurdle for Taiwan to overcome in the exploitation of China 's growth is the lack of direct transportation links between the two countries. The report in particular advises that direct links must be opened to keep Taiwan from slow economic death.⁵⁹

⁵⁸ Ibid.

⁵⁹ Bill Heaney, "Fear not China, says EIU," Taipei Times, 30 June 2003, p. 10.

VI. The Implications of Economic Integration for Cross-strait Relations

1. Taiwan Becomes Increasingly Vulnerable and Dependent

In his book *The Taiwan-China Connection: Democracy and Development Across the Taiwan Strait*, Tse-Kang Leng points out that “a state that is heavily involved in the international economy and cannot shift to relative autarky is vulnerable to political leverage exercised by its trade partners.” From Beijing’s economic policy toward Taiwan and statements by its political leaders, it is clear that the Chinese want to attract Taiwanese trade and investment for political as well as economic reasons. Chinese leaders openly use phrases stating their intention to bring about political integration and exert pressure on Taiwan through economic exchange. Economic dependence not only limits Taiwan’s capacity to intervene effectively in economic transactions but also gives China leverage to manipulate its domestic economy for political ends.⁶⁰

Some fear that economic integration and dependence on China for manufacturing “may make unification desirable or at least necessary for Taiwan.”⁶¹ Although China has not yet used its economic leverage to coerce Taiwan, its opportunities to do so are

⁶⁰ Tse-Kang Leng, *The Taiwan-China Connection: Democracy and Development Across the Taiwan Strait*, Westview Press, 1996

⁶¹ Nancy B. Tucker, “If Taiwan Chooses Unification, Should the United States Care?,” *The Washington Quarterly*, Summer 2002.

growing immensely.⁶²

As more Taiwanese live and grow up in places like Shanghai, the possibility exists for many of them to remain citizens of the ROC while they develop a strong sense of identity with the mainland. Observers in Taipei assert that the gradual reduction of a Taiwan identity and the rise of a Chinese identity among the Taiwan populace could generate less support for pro-independence political parties and more support for accommodation with the mainland.⁶³

If Taiwan's economy loses its competitive advantage to mainland China, and if the Chen administration fails to rejuvenate Taiwan's sluggish economy, its decades-long pragmatic diplomacy that relies on its strong economy will be undermined. A tight government defense budget, which has become more evident in recent years as a result of budgetary restrictions, will make it more difficult to purchase the expensive high-tech U.S. weaponry that is essential to its arms race with the PRC. Furthermore, if the current trend of economic exchange continues unabated, and if Taiwan's economy, which has been hard hit by global recession, fails to transform and upgrade its structure,

⁶² Mihael Claus, "Red Chips: Implications of the Semiconductor Industry's Relocation to China," *Asian Affairs: An American View*, Washington, Winter 2003, vol. 29, no. 4, p.248

⁶³ Michael Swaine & James Mulvenon, "*Taiwan's Foreign and Defense Policies: Features and Determinants*," Rand Corp. 2002, p. 110

an economically and militarily weak Taiwan would find it hard to resist the PRC terms for reunification. The PRC could ultimately fulfill its political goal through economic means, without firing a missile.

In an interview with Taiwan's Central News Agency on 19 February 2003, Taiwan Vice President Annette Lu described the tilting of Taiwan's economy toward the mainland as a "tremendous crisis." With the expanding cross-strait economic integration and the exodus of the island's industries to the other side of the strait, Lu claimed that the national identity of the people of Taiwan has become "vague." She urged the people of Taiwan to heighten their vigilance as mainland China "is nibbling Taiwan gradually."⁶⁴

But what can the Taiwan government actually do about it? The regulations imposed on the Taiwanese businesspeople have mostly proved to be ineffective. Perhaps Taiwan must face the reality that the Chinese market holds the future to its economy. In fact, it is hard to see any other choice for Taiwan but further economic cooperation with the mainland. And for all the pessimistic views given above, we have yet to see how the PRC might turn its economic leverage into political leverage against Taiwan. After all,

⁶⁴ Central News Agency, 19 February 2003

economic integration between Taiwan and China has also created some Chinese dependence on Taiwan. In fact, the economies on two sides of the Taiwan Strait have developed a certain degree of symbiosis.

2. Will Economic Integration Lead to Political Integration?

Will there be a “spillover” effect from “low politics” to “high politics”? Will economic integration between Taiwan and China lead in the long run to political integration? President Chen has already suggested this in his 2001 New Year message. But the PRC is doubtful of Taiwan’s motive for seeking political integration and seems only to be interested in reunification. For them, Taiwan under a unified China will be only a local government, with no sovereignty.⁶⁵ So the European Union (EU) model, in which the political integration among its member states is achieved through a long period of economic integration, cannot apply here.

Although Taiwan and China have a unique situation in which both possess very strong cultural ties, the problem is still the sovereignty question. The publics and the governments on both sides of the strait hold mutually incompatible definitions of

⁶⁵ The PRC tries to sell its “one country, two systems” formula or Hong Kong model to Taiwan. The design of that formula is aimed to reduce the ROC to a local government while the PRC holds the central government.

Taiwan's sovereignty.⁶⁶ The PRC has rejected the EU model, saying that if it were followed, it would amount to admitting that Taiwan is a sovereign state.⁶⁷

3. Can Economic Interdependence Reduce China's Incentives To Use Force?

It is plausible to argue that business interests are likely to urge restraint by both Taipei and Beijing. It is also a widely held belief among government officials and academia that trade and investment with the mainland might reduce incentives for the PRC to use force. In his book *The Lexus and the Olive Tree*, Thomas Friedman asserted that the economic ties between mainland China and Taiwan greatly affect the possibility of military conflict between the two sides, since such a development would cause "mutual assured economic destruction."⁶⁸ A report of the U.S.-China Security Review Commission to the U.S. Congress asserted that, as China's dependence on Taiwan is growing, "an increasing number of Chinese businesses are becoming vested in the cross-strait economic relationship, creating a growing force within China for moderating tensions with Taiwan. These economic benefits may become an increasingly important component of Beijing's political calculations should the

⁶⁶ Cal Clark, "Does European Integration Provide a Model for Moderating Cross -Strait Relations?" Asian Affairs, Winter 2003, Vol. 29, No.4. pp. 195-215

⁶⁷ Based on a conversation with MIT Prof. Thomas J. Christensen

⁶⁸ Thomas Friedman, *The Lexus and The Olive Tree: Understanding Globalization*, New York: Farrar, Straus, and Giroux, 1999

economic relationship continue to grow.”⁶⁹

Michael Swaine and James Mulvenon, in their book *Taiwan's Foreign and Defense Policies: Features and Determinants*, point out that some have argued against this seductive logic of economic interdependence (in particular Christensen and Betts in their Winter 2000 *National Interest* article) on the basis of the sensitive and unpredictable issue of Chinese nationalism.⁷⁰

There is little reason to assume that sober economic interest will necessarily override national honor in a crisis. A tough stand by Beijing may be viewed from the inside as essential for regime survival, even if it is not seen by detached observers as being in China's "national interest." In an imbroglio over Taiwan, which capitals will feel the strongest emotional inhibitions against backing down? Beijing and Taipei both have a greater material, moral and historical stake in the outcome than does the United States.⁷¹

The world has witnessed the force of Chinese nationalism in the incidents of the U.S. bombing of the Chinese embassy in Belgrade in 1999 and a U.S. EP-3 reconnaissance plane colliding with a Chinese military fighter over the South China Sea on 1 April 2001. In both incidents, Chinese nationalism played a central role in instigating a

⁶⁹ Ibid.

⁷⁰ Michael Swaine and James Mulvenon, "Taiwan's Foreign and Defense Policies: Features and Determinants," Rand Corp. 2002, p. 108

⁷¹ Richard K. Betts and Thomas J. Christensen, "China: Getting the Questions Right," *The National Interest*, No. 62, Winter 2000/2001, pp. 17-30

strong reaction against the United States among the Chinese public. Furthermore, in the case of cross-strait tension over the issue of Taiwan sovereignty, the PRC would certainly rely on Chinese nationalism to justify its use of force against Taiwan if Taiwan were to declare *de jure* independence. This also seems to be a widely held belief among the western, particularly American, academics.

VII. Conclusion: Policy implications for the Taiwan Government

The market forces of globalization have prevailed over Taiwan government regulations with respect to economic exchanges between Taiwan and China. In the foreseeable future, the same market forces will undoubtedly intensify, rather than dampen the “China fever” that has worried the Taiwan government since the late 1980s. Although trade between the two sides has been asymmetrical in the past and has resulted in Taiwan’s trade dependence on China, a certain degree of interdependence has also developed.

Instead of fearing a “hollowing out” of Taiwan’s economy, Taiwan should take the initiative in seizing the opportunities the Chinese market and investment environment have to offer. In this the Chen administration has taken the right steps, first, by proclaiming a conciliatory approach in dealing with the “high politics” between the two sides, and second, by replacing the ineffective “No haste, be patient” policy with a more pro-business “proactive opening, effective management” policy. The decision to open “mini-three-links” is also a development in the right direction. But time is not on Taiwan’s side, and this half measure may need another push to establish the three direct links.

While it is legitimate for the Taiwan government to have misgivings as to the PRC's explicit political motive behind its push for closer cross-strait trade relations, it is still advisable for the Chen administration to venture a bold step on the question of three links as quickly as possible. By doing so, President Chen may earn widespread acclaim among the business circles both domestically and overseas. The security concerns over direct air links may prove to be only illusory while the benefits of such links for Taiwan's weakening economy could be very real. After all, it has been Taiwan's strong economy that has helped bolster the ability of Taiwan's leaders to resist PRC pressure and a weak economy would certainly make Taiwan's pragmatic diplomacy less tenable. It would likewise undermine the ability of Taiwan's defense forces to modernize themselves.

Yes, Taiwan has evolved into a democracy and sets a good example for the Chinese to emulate on the mainland. But the rivalry between Taiwan and the PRC is also a down-to-earth competition for survival, especially for Taiwan, which has survived and prospered since 1949 because of its success in developing its economy. Facing a potentially strong China, Taiwan cannot afford to lose this competition. It has to maintain a vibrant economy, as well as its much-acclaimed democracy, if it does not want to be absorbed by the PRC.