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Dancing with the enemy

Jan 13th 2005

From The Economist print edition



AP

For all the hostility between Taiwan and mainland China, their respective economies are now deeply interdependent, says James Miles (interviewed [here](#)). That should help to keep the peace

"GIVE back our rivers and mountains," says a slogan inside a military base on the tip of Kinmen (also known as Quemoy), a tiny island controlled by Taiwan but shrouded by the same polluted haze that envelops Xiamen, a port city on the communist-controlled Chinese mainland. A soldier on guard says giant loudspeakers inside the base still broadcast music across the 2km (1.2 mile) stretch of water to Xiamen.

The easy-listening fare, selected by Taiwan's "political warfare" troops, is a curious cold-war legacy on this fortress of an island. Taiwan's defence ministry will not say what it is for. But the original purpose of these broadcasts, which began after the inconclusive end of China's civil war in 1949, was to undermine the mainland's faith in communism and help to restore Taiwan's government as that of the whole of China. China had loudspeakers too, but they fell silent in 1991. It is decades since the two sides lobbed artillery shells at each other's broadcasting facilities.

Oddly, China would love it if Taiwan really wanted to regain control of the mainland. But the broadcasting station and the slogans are merely anachronisms. Taiwan's armed forces, led by officers who were either born on the mainland or had fathers who were, have found it hard to keep step with the rapid changes on the island. These days the goal of Taiwan's government is to assert the island's independence from China, ideally—though it dare not say so—a permanent one. But the barrack routine of shouting slogans calling for the reunification of Taiwan with the mainland was abolished only last September.

China knows that Taiwan is slipping ever further away. Since 2000, the island has been led by Chen Shui-bian, its first president from outside the Nationalist Party or Kuomintang (KMT) since the civil war.

The main aim of his Democratic Progressive Party (DPP) is to bring about the island's formal independence from China. Its charter calls for a Republic of Taiwan, not a Republic of China, as the island now confusingly calls itself. Mr Chen himself has vowed not to go this far, but China's leaders do not trust him. They have given warning that a declaration of de jure independence (such as by a change of name) would mean war.

Pessimists—and there are plenty of them in both Beijing and Washington—argue that in the remaining years of Mr Chen's presidency, which runs to 2008, tension between China and Taiwan could escalate, even to the point of armed conflict. Such a war could drag in the United States, Taiwan's main provider of moral and military support. If America decided to intervene, two nuclear powers would be pitted against each other. Japan, from where America would probably launch any bid to defend Taiwan, could find itself sucked in. The whole region could be plunged into turmoil.

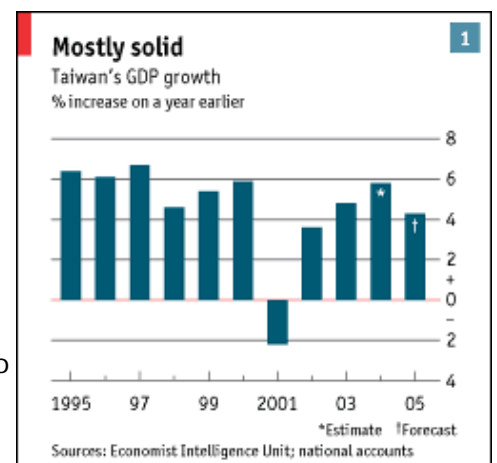
Both China (economically) and Taiwan (politically) are evolving so rapidly that talk of preserving the status quo between them is no longer meaningful. Taiwan's smooth and rapid democratisation has allowed its people to redefine their identity. Increasingly, they no longer think of themselves as Chinese. They are Taiwanese, and mainlanders are foreigners. In China, too, nationalist sentiments are surging as the nation becomes more prosperous and the armed forces far more powerful.

Fear of China helps to keep Taiwan's nationalism in check. In parliamentary elections in December, the KMT and its allies caused a surprise by maintaining their slim majority in the legislature. These parties won support for their less confrontational stance towards China, despite their lack of appeal to many native Taiwanese. But around the region and in America, there are worries that Mr Chen will continue to rile the Chinese, who might one day lose patience and respond with force.

This survey will argue that the chances of conflict are slim. For all the nationalistic exuberance of China, there is no sign of a shift away from the fundamentally pragmatic external policy of the last quarter-century. And Taiwan's leaders, for all their *braggadocio*, are pragmatists too. Not just China, but America, Japan and other big powers are urging them not to go too far. A renamed or redefined republic recognised by the same handful of insignificant states that now recognise Taiwan would gain nothing and probably lose a lot. President Chen may resent America's restraining hand, but he cannot do without it.


There is another remarkable transformation under way that will put just as powerful a brake on any slide towards war: the rapidly growing economic integration and interdependence of Taiwan (the world's 20th biggest economy), China (number seven) and America (number one). Doomsayers in Taiwan, who a few years ago gave warning of a rapid "hollowing out" of their country's economy as manufacturing migrated to China, have been proved manifestly wrong. China, with Taiwan's abundant help but not to the island's detriment, has become the pre-eminent manufacturing base for many of the world's information-technology (IT) products. Even the initially sceptical Mr Chen is beginning to realise that Taiwan can only gain by working with China to remove the remaining barriers to cross-strait flows of people, goods and capital.

In the next few years there will be plenty of pro-independence rhetoric as the debate gets under way on Taiwan's proposed constitutional revisions that Mr Chen has said will be endorsed in 2006 and enacted two years later. But if he is sensible, the main achievement of his eight years in office will be not that he made Taiwan truly independent (which, in almost every respect, it has been for 55 years), but that he helped his country to gain unprecedented prosperity, shoulder to shoulder with China. To get there, he will need to ride the



tide of Taiwanese identity with skill—and some caution.

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Turning Taiwanese

Jan 13th 2005

From The Economist print edition

The islanders are developing a distinct identity

Reuters

TAIWAN'S deep fascination with a televised form of puppet theatre illustrates the complexity of what it means to be Taiwanese. *Budaixi*, as the art form is known, is an omnipresent feature of Taiwan's cultural and political life. The island's biggest *budaixi* production company, PiLi International Multimedia, says it has an annual turnover of \$35m. A million people a week rent the latest PiLi shows on DVD. *Budaixi* puppets feature the wooden expressions and jerky movements of early TV animations, but the characters, costumes and plots draw on ancient Chinese sources, with a heavy dose of martial arts and special effects. The target audience is grown-ups as well as children. Politicians like to portray themselves as *budaixi* heroes.

**Chen says it with budaixi**

Taiwan's 23m residents regard *budaixi* as Taiwanese, yet the genre has its roots on the Chinese mainland. The hand-held puppets were imported more than 200 years ago from Fujian province on the mainland coast facing Taiwan. *Budaixi* is the name for it in standard spoken Chinese, which the KMT forced the Taiwanese to use, but the natives still mostly speak a Fujian dialect. They are the descendants of Fujianese who fled to the island to escape upheavals on the mainland. Some trace their ancestry to the island's original inhabitants, Malayo-Polynesian-speaking peoples akin to those of Indonesia and the Philippines. China incorporated the island into its empire after putting down an insurrection there in the late 17th century.

In 1895, China ceded Taiwan to Japan after being defeated in a war over control of the Korean peninsula. Taiwan still has strong cultural ties with Japan, and many Taiwanese take a fairly positive view of the colonial era. But the Japanese discouraged Taiwanese-ness. During the second world war, they forced *budaixi* troupes to perform in Japanese and adjust their plots to extol the Japanese martial spirit.

The end of Japanese rule in 1945 brought little relief to the puppeteers. *Budaixi* now had to be performed in standard Chinese. In the 1960s, televised *budaixi* was banned for allegedly distracting islanders from their work. By the time Taiwan began moving towards a multi-party democracy in the 1990s, *budaixi* was in danger of dying out, but it became "intertwined" with a movement to revive Taiwanese culture, wrote Wu Sue-mei, a scholar at Carnegie Mellon University.

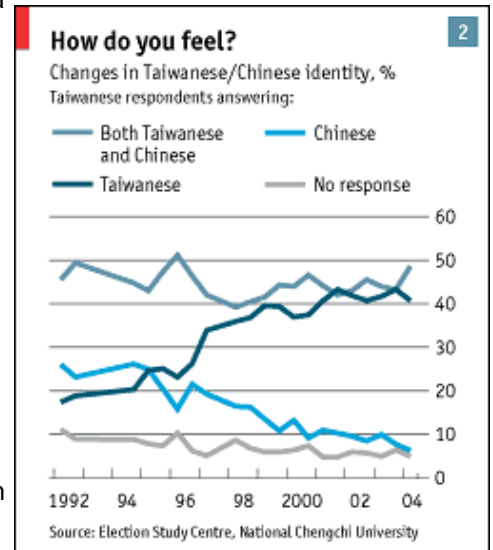
For all its moorings in the culture of the mainland, Taiwan's version is now being touted as something very distinct. For President Chen and his generation, the struggle for democracy on the island and the struggle for a Taiwanese identity amounted to much the same thing. It pitted native Taiwanese against the "mainlanders", the label attached to those who arrived with the KMT in 1949 (and their offspring). Mainlanders make up about 15% of the population and still provide much of the support for the KMT

and its allied splinter parties. But there are not enough of them to return the KMT to power. Democracy is forcing it to turn Taiwanese too.

Surveys conducted by Taiwan's National Chengchi University show a remarkable shift in Taiwanese self-perception over the past 12 years. The number of those identifying themselves as Taiwanese has risen from 17% to 41%, whereas those who see themselves purely as Chinese have dropped from 26% to 6% (see chart 2). This alarms the government in Beijing, which not unreasonably suspects Taiwan's leaders of pursuing a deliberate policy to "de-sinify" the island.

Chinese? Us?

This view is shared by some opposition politicians in Taiwan, and it is true that President Chen is fostering Taiwanese-ness, but he is doing it because it is popular. Admittedly the policy does not encourage support for reunification with China, but nor does it seem to detract from the public's strong support for the preservation of the current ambiguous relationship with China. Polls suggest that less than 10% of Taiwanese want independence "as soon as possible", a figure that has hardly changed in recent years. No doubt China's sabre-rattling plays its part in that.



Yet the new emphasis on Taiwanese identity is making it harder for the DPP to cloak its dealings with the mainland in ambiguity. In 1992, when Taiwan and China began discussions between nominally non-governmental bodies set up by both sides to disguise their official contacts, they agreed on the notion of "one China" but deliberately left open exactly what that meant. China broke off the talks in 1999 after Mr Chen's predecessor, Lee Teng-hui (of the KMT, but born in Taiwan and very pro-Japanese) proclaimed that Taiwan and China were separate states.

Now talk of "one China", with Taiwan as one of its components, has become dangerous for Taiwanese politicians. Ma Ying-jeou, the charismatic KMT mayor of Taipei, who is widely regarded as a potential future leader of his party, says that using the term would be political suicide in Taiwan. China, for its part, would clearly not be happy with Mr Ma's suggestion that Taiwan and China model their relations on that between the two Germanies before their unification. For China, the Taiwan problem is the result of an unfinished civil war. It would find simultaneous recognition of two separate Chinas almost as abhorrent as Taiwan renouncing Chineseness altogether.

Galling though it is for China, Mr Chen's emphasis on Taiwan's identity has helped win him votes. But he can go only so far. In the build-up to December's parliamentary elections, Mr Chen angered China's leaders with his calls for a new constitution for the island, to be approved by a referendum, and for provocative name changes for government offices and state-owned enterprises. Taiwan's nervous voters responded by denying the DPP and its allies the majority in parliament on which they had set their sights.

But China knows that threats of war do not reinforce Taiwan's identification with the mainland. Some officials in Beijing still hope that economic interaction with Taiwan will make people in the island feel more Chinese again, but many now have their doubts. "My Taiwanese friends ask me, what do we get out of reunifying with the mainland? It's a difficult question," concedes Wang Jisi of the Chinese Academy of Social Sciences. "I cannot think of many attractions."

Although China feels a little more relaxed after December's election results, it still fears that Mr Chen will now look for ways of backing down from his promise not to make any constitutional changes that would affect the island's official name or the definition of its sovereign territory. America is also worried. In December 2003, President Bush, with China's prime minister, Wen Jiabao, by his side, dressed down "the leader of Taiwan" for challenging the "status quo". Mr Chen got the message and watered down provocative plans for a referendum on cross-strait issues.


China crowed. "America doesn't want to see Taiwan becoming independent, war breaking out across the strait and America being dragged into the water," says Zhang Mingqing, a Chinese spokesman on Taiwan affairs. "America has the problem of fighting terrorism, the Iraq problem and the North Korean nuclear problem. It does not want a problem with Taiwan."

Since his censure by Mr Bush, Mr Chen has tried to repair relations with America, sending drafts of important public documents on cross-strait issues to Washington in advance. Michael Kao, Taiwan's deputy foreign minister responsible for ties with America, says he has been explaining to the Americans that President Chen is "a pragmatic lawyer, not a political ideologue". Mr Chen, he says, is trying very hard to "hold the line so that political movements in Taiwan would not push him to [declaration of] de jure Taiwan independence".

But Bush administration officials are not entirely convinced. They held extensive discussions with their Taiwanese counterparts on a speech that Mr Chen was to deliver on the occasion of Taiwan's national day on October 10th. The speech was billed by Taiwan as an important overture to China. But to the Americans' surprise, it contained last-minute additions, not cleared in Washington, that challenged the decades-old principle of overlapping sovereignty between the Republic of China and the People's Republic of China. "The sovereignty of the Republic of China is vested with the 23m people of Taiwan. The Republic of China is Taiwan, and Taiwan is the Republic of China," Mr Chen said. And just to make sure everybody got the point, he said that Taiwan was "a country of 36,000 square kilometres", in other words, just the island and a few islets.

Radicals in Mr Chen's party and in its main ally, the Taiwan Solidarity Union, want Taiwan to revise its constitution to clarify its de jure independence, arguing that the island has only a narrow window of opportunity while China is preoccupied with its preparations for the 2008 Olympics. China, the theory goes, would avoid a war in order to ensure the success of the games, which it wants to mark the country's emergence as a great power.

Without a legislative majority or evidence of strong public support for a referendum, Mr Chen could not achieve this even if he wanted to. Personally he seems to prefer a gradualist approach, stopping short of the final, formal change. In his first term of office he enraged China by adding the word "Taiwan" to Republic of China passports. He has recently suggested a change of tactic in the island's dogged but futile attempt to join the United Nations: it is now asking for admittance as Taiwan, not the Republic of China. This has caused anxiety in Washington, where officials resent his goading of China and feel he does not understand the risks he is taking.



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The dragon next door

Jan 13th 2005

From The Economist print edition

War with China may not be likely, but if it happened it would be devastating

"AT THE beginning of this new century, nowhere is the danger for Americans as great as in the Taiwan Strait, where the potential for a war with China, a nuclear-armed great power, could erupt out of miscalculation, misunderstanding or accident." So argues Nancy Bernkopf Tucker, an American scholar, in an edited volume, "Dangerous Strait", due to be published shortly. Other threats may be more certain, such as conflict in the Middle East, terrorism or clashes with rogue or failed states, yet "none but a collision with China would be as massive and devastating," Ms Tucker suggests.

Since 1995, China has been engaged in a rapid military build-up on the coast facing Taiwan, triggered by the then President Lee's visit to his alma mater, Cornell University. China was incensed by America's willingness to give a Taiwanese president a public platform on American soil. It saw the event as confirmation that Taiwan's democratisation was strengthening international support for Taiwan's separateness. Military pressure, it felt, was needed as a warning to Taiwan and the Americans about the dangers of going too far.

In 1995 and 1996 China staged large-scale military manoeuvres in the Taiwan Strait, including the firing of unarmed missiles close to Taiwan's two main ports. America responded with its biggest naval deployment in the region since the Vietnam war, sending two aircraft-carrier battle groups to the area. China has fired no more missiles since, but has positioned large numbers of truck-mounted short-range ballistic missiles (SRBMs) along the coast. It has also increased deployments of longer-range missiles that could target American bases in Japan or on the Pacific island of Guam, about 1,500 miles from Taiwan. And it is working to develop land-attack cruise missiles, which could be fired across the 160km (100 mile) strait and penetrate even the most sophisticated anti-missile defences that Taiwan is acquiring from America.

China has also been buying an array of Russian weaponry, from SU-27 and SU-30 fighter jets to quiet Kilo-class submarines and Sovremenny-class destroyers. These ships are equipped with Sunburn anti-ship missiles, the ones America's navy "fears most", says Peter Brookes, a former senior defence official in the Bush administration. Russian-supplied anti-aircraft batteries on the coast can lock on to Taiwanese aircraft as soon as they take off from the island. The technical superiority of Taiwan's weaponry could well be overtaken by China's within a few years.

Kurt Campbell, the Pentagon's senior official responsible for the region at the time of the crisis in 1995-96, says the biggest cautionary tale was how difficult America found it to communicate with the Taiwanese and to understand their capabilities and intentions. This did not bode well should the two sides find themselves fighting together against China. So the Clinton administration decided to step up contacts with the Taiwanese armed forces, including mutual visits and training of Taiwanese officers.

In 2001, after George Bush became president, the Republican administration strengthened these ties. Mr Bush also offered to sell Taiwan a huge package of advanced weaponry and help it buy diesel

submarines. As Michael Swaine, an American academic, notes in "Dangerous Strait", reports suggest that there are now more American military programmes in progress with Taiwan than with any other major American ally. And America has been adding to its submarines and bombers stationed on Guam.

But Taiwan itself is curiously ambivalent about China's growing military prowess. The purchase of new weapons from America has become bogged down in fierce political debate on the island, with many arguing that they are too expensive, will take too long to acquire and integrate into the Taiwanese military, or will simply fuel an arms race with the mainland. American requests that Taiwan do more to protect vital structures such as command-and-control centres and airfields have met similar foot-dragging. Taiwan's defence spending as a share of GDP has been declining for several years, to around 2.4% in 2003, below South Korea's (2.8%) and well below China's (see chart 3). In 2005 it is set to rise to 2.5%.



Look at it our way

The problem, according to James Mulvenon of the Centre for Intelligence Research and Analysis, an American consultancy, is that there is a "fundamental perceptual difference" between Taiwanese officials and American ones about the nature of the Chinese threat. The Americans brief their Taiwan counterparts on Chinese military capabilities, he says, but are "flummoxed" by their unwillingness to accept that "the threat is imminent".

The Americans are also worried that these days the Taiwanese talk a lot more about acquiring offensive capabilities of their own. The prime minister, Yu Shyi-kun, last September famously threatened missile strikes against the mainland should China attack Taiwan. "If you hit us with 100 missiles, we'll fight you back with 50 missiles," he said. "If you hit Taipei or Kaohsiung, we'll strike Shanghai." To the many Taiwanese who balk at spending \$18 billion on America's proposed arms package, offensive weapons seem a more cost-effective way of deterring an attack.

Taiwan has been working for several years to develop supersonic cruise missiles that could hit mainland targets. Since President Chen took office, it has installed less advanced subsonic anti-ship missiles on outlying islands that could also hit the mainland. These moves worry some in the Pentagon, who think that in the event of conflict a Taiwanese attack on the mainland could escalate out of control. Naturally, they also anger China.

There are concerns, too, that Taiwan might secretly acquire nuclear weapons. President Chen has ruled this out. But Taiwan has tried in the past to make such weapons behind America's back. As recently as the late 1980s, the Americans put a halt to a suspected nuclear-weapons programme in Taiwan. Some commentators there say it should be revived. China has said it might attack if Taiwan goes nuclear. "If I had to nominate an area that was ripe for a strategic surprise in the next three or four years, I would probably place China-Taiwan at the top of the list, above North Korea," says Mr Campbell.

Policymakers in Washington are right to worry about the risks, but the chances are that Chinese leaders would think more than twice about mobilising their arsenal. Politically, any military action against Taiwan could well prove riskier for China than doing nothing. "The risk of failure weighs pretty heavily on a lot of the senior leadership [in China]," says a Pentagon official. A war that failed to achieve Taiwan's submission would be a powerful blow to the party's credibility. And it is hard to see how, even if China were to subdue Taiwan's armed forces, it could be confident of a lasting political solution that would rule out any return to independence.

A war would come at a terrible economic price, not only for Taiwan but for China too. And one thing Chinese officials seem to agree on is that the party's grip on power depends on a vibrant economy.

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Onshoring

Jan 13th 2005

From The Economist print edition

Taiwan is shifting much of its manufacturing to the mainland

IN THE smoke-and-mirrors statistics for foreign investment in China, Hong Kong appears as the biggest investor, followed, oddly, by the Virgin Islands. Trailing in sixth place, behind Japan, South Korea and America, is Taiwan. But if investments were traced back to their true origins, Taiwan might well turn out to be the largest.

The capital flow from Taiwan to China is turning the mainland into a global leader in information-technology (IT) equipment, albeit one that still relies mainly on imports for the more advanced components. In 2002, China overtook Japan and Taiwan to become the world's second-largest IT hardware producer after America. The steep upward curve of China's IT exports is almost exactly matched by its imports of IT components from Taiwan. China is now the world's biggest IT hardware exporter to America. Yet more than 60% of these exports are made in China by Taiwanese companies.

China's latest list of its top 200 export companies is headed by subsidiaries of Taiwanese IT firms: Hon Hai Precision Industry (whose exports from China in 2003 were worth \$6.4 billion), Quanta (\$5.3 billion) and Asustek (\$3.2 billion). Altogether Taiwan has 28 entries on the list, all of them high-tech companies. Far from being undermined by competition from China, Taiwanese IT businesses are benefiting from their production on the mainland, increasing their global market share across a broad range of products, says Nicholas Lardy of the Institute for International Economics in Washington.

Thanks to a huge trade surplus with mainland China, Taiwan has built up the world's third-biggest holding of foreign-currency reserves: a record \$239 billion at end-November 2004. Taiwan is second only to Japan as a source of Chinese imports. And for Taiwan, China is the biggest export market. Taiwanese companies employ some 10m people on the mainland. For China, worried as it is about growing unemployment, this is an enormous contribution to stability. In just a few years, a strong economic symbiosis has developed across the Taiwan Strait.

Take the city of Dongguan in Guangdong province (which borders on Hong Kong). The municipality is a vast sprawl of factories, many of them Taiwanese, stretching mile after mile through what were tiny villages a few years ago. Dongguan is awash with Taiwanese money, much of which has been there for a decade or so. Dongguan was an obvious choice for the first wave of Taiwanese investors who flocked to the mainland after the Taiwan government began to ease investment restrictions in the early 1990s. It is close to Hong Kong, which together with nearby Macao offers the only direct flights from Chinese cities to Taiwan.

To start with, Dongguan was a magnet for low technology, labour-intensive industries. But since the late 1990s, Taiwanese investment in the mainland has moved rapidly up the technological ladder. Dongguan is still booming, but the investment hotspot has shifted north to the Yangzi River valley, particularly in the area around Shanghai, an area with good access to skilled workers and potentially better placed for China's domestic market. The town of Kunshan, an hour's drive from Shanghai, has become almost a

replica of Taiwan's high-tech industrial zones. Some 300,000 Taiwanese businessmen and their dependants now live in the greater Shanghai area, causing property prices to soar.

Taiwan is rife with stories of kidnappings, robberies and murders of Taiwanese businessmen on the mainland. There is also speculation about how many really make money; Tsai Ing-wen, a former head of Taiwan's mainland-affairs office under President Chen, estimates that only half of them do. Even so, more than 70,000 Taiwanese firms have set up on the mainland, notwithstanding political tensions, Taiwan's restrictions on some investment and the absence of direct flights. "This is a time of global competition," says Preston Chen, chairman of the Ho Tung Group, which has invested over \$100m on the mainland. "If you don't go [to China], others will, and the first to suffer will be you."



In Dongguan, some Taiwanese businessmen in low-value-added industries are getting restless as the stampede of Taiwanese capital shifts to the north. Some have begun to move elsewhere, including neighbouring Vietnam. "If you come back in ten years it's hard to say whether you'll find any Taiwanese business here," says Juei Chen Wong, the boss of a Taiwanese electric-wire factory in Dongguan.

He is exaggerating: more likely, other Taiwanese businesses less dependent on cheap labour will move in. For labour-intensive manufacturers geared to the export market, China may be losing some of its shine. But the new wave of Taiwanese investment is looking for skilled labour, and is setting its sights not only on markets abroad but also on a fast-growing group of affluent consumers in China itself. This investment is helping to transform China's trade, now fuelled increasingly by higher-value-added production. In 2003, China exported some \$130 billion-worth of electronic and IT products, up 41% on the previous year. Such products accounted for nearly one-third of total exports. Chinese officials say that output of IT products will triple by 2010.

To achieve this, China needs Taiwanese businesses, even if they support independence. In May 2004, the Communist Party's mouthpiece, the *People's Daily* newspaper, accused Hsu Wen-lung, the founder of Taiwan's Chi Mei Group, which has a large chemical plant on the mainland, of using his profits for pro-independence causes. But China has not taken any direct action against the company. "There are a very small number whom we do not welcome," says Mr Zhang, the Chinese government spokesman. "But as long as they uphold the law, we let them invest. We have not said we will expel them."

So near and yet so far


At government level, the two sides still bicker over what they call the "three direct links": communication, trade and transportation, which have been disrupted since the end of the civil war. But barriers have been quietly dismantled. Mail is channelled through Hong Kong; direct telephone calls have been possible since the 1980s; cross-strait cargo shipping can be routed through a third area, but can go directly if not carrying local freight.

The absence of direct flights except to Hong Kong and Macao is the biggest nuisance, though it really is no more than that. If you set off an hour before dawn from downtown Taipei, you can reach most of the big cities on the mainland by the afternoon. But direct flights would certainly help. Getting to Shanghai currently takes six or seven hours. Flying direct would take 90 minutes.

The Taiwan government estimates that direct air and sea links would reduce shipping costs by 15-30%. Sea transport would be twice as quick, and air travellers would save \$390m a year. But direct flights are fraught with symbolism, so both sides are determined to extract maximum political advantage from any move they make.

For Taiwan, direct flights are part of a bigger question: how much economic integration with the mainland it should allow. Should it stop trying to curb investment in certain technologies; open its doors wider to trade with the mainland; and allow mainlanders to work, invest and holiday in Taiwan? The economic arguments are compellingly in favour, particularly in information technology.

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Come and see my minefields

Jan 13th 2005

From The Economist print edition

A tourist attraction with a difference

KINMEN, a small island nestled against the Chinese coast but belonging to Taiwan and occupied by 10,000 Taiwanese troops, badly wants visitors. Since the end of the civil war in 1949, its economy has depended on the military garrison. Islanders rushed to build hotels when Taiwan first allowed tourists (though not from China) to visit 12 years ago. But Taiwanese visitors are not much enamoured with an island ringed by minefields. The hotels are struggling and the property market has slumped.

In an effort to give its outlying islands a boost and show some goodwill to China, Taiwan in 2001 opened the “mini three links” between the islands and the mainland. It was not running much of a risk. Taiwan proper would remain aloof, and the Kinmen islanders would get some revenue. But things did not work out as planned. The visitors did arrive, because the new direct ferry service saved many Taiwanese businessmen hours of travelling time. But they hardly glanced at the little island as they shuttled to and fro.

Life on Kinmen has continued in its traditional sleepy way. The 60,000 islanders grumble ever more loudly as the garrison's ranks begin to thin. Apart from servicing the troops, they have little to do. There is hardly any manufacturing other than liquor production and a factory that converts old bits of military ordinance into knives for tourists. The local government has done its best to liven the place up, recently sponsoring avant-garde artists to exhibit their works in disused military bunkers. But something is still missing: the mainland tourists.

China's initial response to the opening of the “mini three links” was lukewarm: sending tourists was seen as too much of a gift to President Chen. But late last year the mainland authorities announced that tourists could come, at least from Fujian province. The first group arrived on December 7th, though Taiwan is limiting numbers to 600 a day for now.

The island could be a huge attraction for mainlanders, 1,000 of whom already board boats every day simply to sail close and gawp at one of the giant slogans put up many years ago by Taiwanese troops: “Unite China with the Three Principles of the People”—the philosophy espoused by Sun Yat-sen and adopted by the KMT. If they set foot on Kinmen, however, they are in danger from poorly marked minefields if they stray off the roads, as your correspondent discovered after walking through one by mistake.

Since 2002, mainland tourists have been allowed to visit Taiwan proper, but Taiwan allows them in only if they arrive via a third country for which they have a visa. This restricts the flow to all but the very richest of mainlanders. Taiwan wants to develop its tourist industry, but is worried that opening Taiwan

Magnum Photos

**Welcome to Kinmen**

proper to mainland tourists will encourage illegal immigration and provide an easy way in for mainland secret agents. But Kinmen's top official, Lee Juh-feng, has no time for such excuses. "In future we hope the majority of tourists (in Kinmen) will be from the mainland, not from Taiwan," he says.

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Moving on

Jan 13th 2005

From The Economist print edition

Manufacturing is out, knowledge-based industries are in

AT THE start of this decade, three-quarters of the world's notebook computers were made in Taiwan. Now the last of the production lines—except for a few top-of-the-range models—are preparing to move to China. "Taiwan is no longer a manufacturing paradise," says K.Y. Lee, the chairman and chief executive of BenQ Corporation, a Taiwanese maker of consumer electronics and mobile phones.

How can the island adapt? Many of its companies have prospered in the same way as BenQ, by making IT products for other companies which sell them under their own brands—a process known as original design manufacturing (ODM) or original equipment manufacturing (OEM), depending on the amount of creative work involved. But China is fast getting into the ODM business too. At the same time, consolidation among the brand-name IT producers has reduced the number of potential customers for the ODM manufacturers and intensified competition. "We think the company cannot rely on this sort of business in the long term," says Mr Lee. "We must find a way out."

In Taiwan, this requires a radical change in thinking. Although Taiwanese companies make a large proportion of the world's IT hardware, whether in Taiwan or on the mainland, few of the consumers who buy the products would recognise their names. What they see is the labels of other firms, often American, Japanese or South Korean. The island's IT manufacturers, whose output accounts for 15% of Taiwan's GDP, have concentrated on making goods as efficiently as possible rather than on branding and marketing. The top 100 global brands list drawn up by Interbrand, a consultancy, does not contain a single Taiwanese firm.

A few years ago, many in Taiwan feared that the exodus to the mainland of the island's anonymous industries would leave Taiwan with swelling ranks of unemployed workers. Their worries were intensified by the bursting of the IT bubble. In 2001, Taiwan's economy contracted by 2.2%, the first whole year of negative growth in half a century. Unemployment surged from 2.9% in 1999 to 5.2% in 2002.

But now Taiwan's economy is regaining strength. GDP growth in 2004 was around 5.9%, buoyed by strong private investment, and this year is expected to be 4-5%. The banking system, awash with bad loans three or four years ago, is looking far healthier. The non-performing loan ratio has fallen from 8.3% in 2001 to around 3.5%. Unemployment fell to below 4.5% last year. Despondency is giving way to visions of Taiwan as a centre of research and development (R&D), "knowledge-based" industries based on the exploitation of ideas, logistics and financial services, and globally recognised brands.

BenQ is among the first of Taiwan's big ODM firms (its turnover in 2003 was \$3.2 billion) to try building

Reuters

**Anything to build a brand**

a brand. Since 2001, when it was spun off from its parent, Acer, BenQ has expanded its branded operations from around a quarter of its business to 35-40%. Acer, the world's fifth-biggest producer of personal computers, has made notable gains in developing its brand too. Acer notebook computers are now among the top sellers in Europe.

For BenQ, the transition involves risks, not least that buyers of their ODM equipment might turn to other suppliers because the new brand might compete with the ODM product. As Taiwan's biggest manufacturer of mobile phones, it is trying to build up its own brand, but continues to sell mobile phones to Motorola, which has nearly half of Taiwan's market.

Mr Lee says his company has managed to steer clear of potential conflicts by making its branded models clearly different from those supplied to ODM customers. Profit margins on branded business are three or four percentage points higher than on ODM output, he says. BenQ spends far more on R&D than traditional ODM manufacturers: around 3% of its revenue, against an average of around 1%.

For large, well-established companies such as BenQ and Acer, developing their own brands may be feasible. But the backbone of Taiwan's industry consists of small and medium-sized enterprises that are looking for short-term profits. In their race to drive down costs, R&D is an unaffordable luxury. So Taiwan's government has long seen it as its business to help steer industry in new directions. Two years ago it unveiled a development plan known as "Challenge 2008", which emphasised the need to build brands and concentrate on cutting-edge technologies. It called for an increase in total R&D spending from just over 2% of GDP to 3% within six years. This would bring Taiwan up to the current level of the United States and Japan. The government would do its bit by providing low-interest loans and launching new transport infrastructure projects.

The industries Taiwan hopes to boost are intriguingly known as the "two trillions and the twin stars". The two trillions refer to the semiconductor and the thin-film transistor liquid crystal display (TFT LCD) flat-screen industries, annual output of which is supposed to more than double by 2006, to more than 1 trillion Taiwanese dollars (\$30 billion) each. The twin stars refer to digital content (such as digital games and computer animation) and biotechnology, which are expected to grow at similar rates.

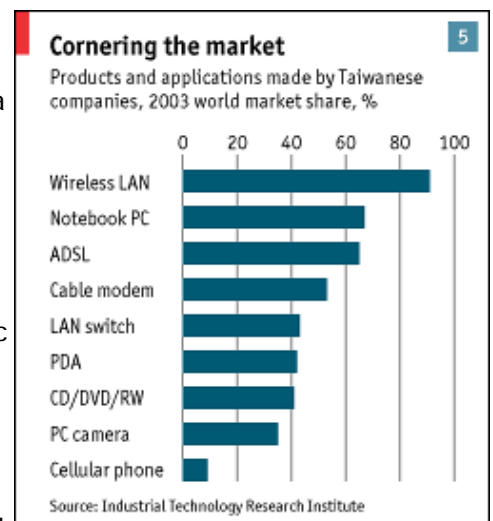
Taiwanese industry is well on its way to accomplishing some of these goals. The flat-screen industry has grown rapidly, thanks to the nimbleness of Taiwanese business rather than government support. Taiwan now matches the market share of rival South Korea and could well surpass it in the coming year.

Going, going

Taiwanese officials know they have little hope of keeping their most treasured industries entirely on the island. China's growing domestic market for IT products is pushing Taiwanese companies to move closer to their consumers. In the TFT LCD business, manufacturers have been pressing the government to allow them to move the (labour-intensive) production of the small screens used in mobile phones to the mainland. Joseph Wu, the head of Taiwan's Mainland Affairs Council, says that after initial hesitation, restrictions on small screens are now likely to be eased.

For all the push to the mainland, businesses still prefer to keep their latest technologies and cutting-edge R&D in Taiwan. Intellectual property rights (IPR) protection on the island has improved considerably in recent years, not least thanks to pressure from America. Although owners of intellectual properties still complain, Taiwan is certainly a far safer place for them than the mainland.

But for Taiwan to fulfil its dreams, it will need to open wider to China. It is already suffering a growing shortage of the highly skilled workers needed for its new industries. A freer flow of workers, facilitated by direct flights, would turn an already dynamic economic relationship "red hot", says Richard Vuylsteke, director of the American Chamber of Commerce in Taipei. Among other things, it would



encourage multinational investors to see Taiwan as a back door to doing business in China, a role that the island has long aspired to play. "If Taiwan continues to view the mainland through the prism of economic threat, it is in danger of isolating itself and getting cut out of tomorrow's deals," said America's chief representative on the island, Douglas Paal, in a 2002 speech.

Restrictions on cross-strait investment hamper Taiwan's efforts to build up its service industries. They block Taiwanese banks, for example, from doing any more than set up representative offices on the mainland or remitting money to Taiwanese firms or individuals in China. In the semiconductor industry, they hobble investment in chip-fabrication plants using 8-inch wafer technology, even though China itself is setting up production lines using the latest 12-inch technology.

Both China and Taiwan are members of the World Trade Organisation (WTO), but Taiwan still bars imports of a wide range of mainland goods, from agricultural products to cars. Chinese investment in Taiwan is all but banned (though there are ways round that). Protectionist sentiment on the island is strong. "Even though [Taiwan is] a market economy, when we face such a hostile and strong neighbour, we need to take some precautions," says Mr Wu of the Mainland Affairs Council.

The KMT has promised a very different approach to cross-strait ties. The party's chairman, Lien Chan, says he wants a free-trade agreement and eventually a full-fledged common market with the mainland. A free-trade agreement would allay Taiwanese worries about exclusion from a mooted free-trade area embracing the 10-member Association of South-East Asian Nations (ASEAN), China, Japan and South Korea. Mr Lardy of the Institute for International Economics says that if such a regional arrangement went ahead, the island would lose out in a big way. The problem is how to get China to talk.

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My fab is bigger than yours

Jan 13th 2005

From The Economist print edition

A cross-strait chip-making competition

THE citizenship of Semiconductor Manufacturing International Corporation (SMIC) is hard to establish. Registered in the Cayman Islands, the company has its headquarters in Shanghai; its chairman and CEO is Taiwanese; the majority of its investment (he thinks) comes from America; its biggest shareholder is Chinese; and it is listed in both America and Hong Kong. But the main point is that to China it is Chinese, and to Taiwan it is simply menacing.

In the semiconductor industry, identity has an importance that transcends the value of silicon chips. Taiwan is immensely proud of its global leadership in the sector. Not many people outside the business may have heard of the Taiwanese giants, Taiwan Semiconductor Manufacturing (TSMC) and United Microelectronics (UMC), but these two (definitely Taiwanese) companies between them account for around 70% of the world's foundry production (a foundry is a semiconductor manufacturer that produces chips for other brands). They symbolise Taiwan's transformation from a maker of cheap plastic toys 25 years ago to a manufacturer of leading technologies. They even have a strategic dimension. In his 2001 book, "Silicon Shield", Craig Addison, a Hong Kong-based consultant, argues that Taiwan's role in the IT industry has become crucial to the global economy, so America would defend the island against attack.

Enter SMIC (usually pronounced "smick"), founded in 2000 by Richard Chang after he sold his Taiwanese company, Worldwide Semiconductor Manufacturing, to TSMC. Shanghai Industrial Holdings, a Hong Kong-listed company controlled by the Shanghai government, became SMIC's biggest single shareholder. SMIC's listings in 2004 in Hong Kong and New York raised more than \$1 billion. The company is about to become the world's third-biggest foundry.

But what worried Taiwan most was the opening in September 2004 of SMIC's state-of-the-art fabrication plant (or fab, in the industry parlance) using 12-inch wafer technology. Taiwanese companies are still barred by their government from investing in 12-inch fabs on the mainland, and can invest in 8-inch fabs (the next step down) there only if they already have a 12-inch fab in Taiwan and ship their old 8-inch equipment to the mainland. SMIC was able to buy 12-inch equipment from private western firms, with a promise not to produce chips for Chinese military use.

Taiwanese officials are now belatedly discussing an end to the ban on 12-inch fab investment. Ho Mei-yueh, the economics minister, says there is no need to restrict technologies that China already has, but it is very important that Taiwan stay two generations of technology ahead of China.

The mood in Taiwan is still bitter. TSMC has filed a lawsuit against SMIC, accusing it of stealing the Taiwanese company's intellectual property, which SMIC denies. Mr Chang, meanwhile, magnanimously welcomes his competitors. He sees a vast potential market in China. "People ask, 'Richard, are you crazy? Are you inviting in the competition?' [But I say] when the pie is big enough, the competition is very friendly," he explains.

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Separate ways

Jan 13th 2005

From The Economist print edition

But the two neighbours must play it softly



Let fortune smile

THE curators of China's national museum in Beijing are wondering what to do with a three-metre high cylindrical copper container donated by a famous state-owned distillery in 2001. Inside it are 34 bottles of Chinese grain liquor, each representing one of what China regards as its regions—including Taiwan. The 2.3-tonne object is inscribed with the words: "Precious celebratory bottles for the unification of the motherland". The museum originally put it on display in the main hall, but it got in the way and last year was moved out into a courtyard off limits to the public. With a big refurbishment now under way, officials seem rather embarrassed by it.

Chinese and American leaders would probably like to see the Taiwan problem similarly put to one side. But the Taiwanese leaders' growing impatience for recognition is forcing China and America to respond. In the past, America has always shunned the role of mediator between China and Taiwan. But now it is getting anxious to move things along.

"We are interested in hearing from the two sides if they think there's a role for [America] that would be acceptable to both sides. And increasingly both come to us and suggest that perhaps there is a role," says a senior State Department official. If both sides wanted America to facilitate a dialogue, "it is something we would give consideration to," he says. But "they haven't quite come up with a blueprint for what might work for everybody."

That is putting it mildly. Since the late 1990s, there has been no official contact of any kind between China and Taiwan. China cannot bring itself even to talk about talks with Mr Chen. When a Taiwanese academic chosen to represent the island at a summit of Asia-Pacific leaders last November actually shook hands and had a brief chat with China's president, Hu Jintao, there was a frisson of excitement in

Taiwan. But it soon fizzled out. In December China threatened to pass a new law against secession to keep Taiwan in check.

Some American academics think there might be scope for an interim agreement. This would involve Taiwan pledging not to declare *de jure* independence and China promising not to attack Taiwan for a specified period, say 20-30 years. During this period they would work on things like arrangements for cross-strait transport and building trust between their respective armed forces. Taiwan would be given more freedom to join international bodies.

A suggestion along these lines was put forward in early 2004 by a former senior official in President Clinton's National Security Council, Kenneth Lieberthal, and another China expert, David Lampton. Officials in China and Taiwan listened politely, but they remain just as far from the negotiating table. China still insists that any talks be held on the basis that there is only one China, of which Taiwan is a part. President Chen says that to accept this would be tantamount to surrender. His only hint of compromise has been to say that he would be prepared to resume talks on the same basis as the two sides' sporadic discussions in the 1990s, which in China's view did involve an understanding on "one China". But President Chen seems so utterly opposed to China's own idea of one China that his big neighbour does not trust him.

The Americans say there is not much they can do. According to a story told in Washington, when a senior State Department official suggested in 1999 that China adopt a "one country, three systems" policy to deal with Taiwan, Chinese diplomats thought that was not a bad idea—except that it had come from an American. Both sides, but especially China, would be deeply suspicious of any plan pushed by America.

It is widely accepted that an interim agreement putting aside questions of sovereignty would be a good thing. But China would need considerable political courage to stop insisting (even temporarily) that Taiwan accept it is part of China (even if loosely defined). The new leaders in Beijing are showing no signs of such courage. If China were to shelve the issue, it could not be sure that it would ever be able to revive it.

More likely in the years ahead is a kind of detente by default, with agreements on smaller, more concrete, issues gradually helping to build up mutual confidence. Taiwan says it wants to build a bridge between Kinmen and the mainland. If it can persuade China to agree, such a joint project would be of enormous symbolic importance.

Borrowing the term South Korea uses for its effort to lure North Korea out of its shell, President Chen said in November that he would adopt a "sunshine policy" toward the mainland. He thinks that an agreement could be reached on chartered flights for cargo, as well as for passengers for the lunar new year celebrations. This would be a good start. Bonnie Glaser of the Centre for Strategic and International Studies in Washington says achieving agreement on the three links first would buy time and help create stability in the cross-strait relationship.

If only China felt the need. Its biggest incentive might be the international kudos that China would gain for restoring stability. If the Olympic Games in Beijing in 2008 were held against a background of rapprochement across the strait, that would greatly assist China's efforts to project itself as a responsible world power. China could wriggle out of the straitjacket of its own rhetoric by accepting that even a move to formal independence by the island would make no difference if no major country recognised it—and the likelihood is that none would. But the Communist Party still seems to feel that the damage this would inflict on its domestic credibility would outweigh the benefits.

Close enough

Ultimately, China will have to come to terms with Taiwan's permanent separation. The most it can ever realistically hope for—even if a liberal democracy were to take root on the mainland—is an arrangement along the lines of the European Union that preserves separate sovereignties. Taiwan would not want to get any closer.

There is a glimmer of hope that China is beginning to understand Taiwan's determination not to be unified. Its "one country, two systems" idea, which in effect puts Taiwan in the same category as Hong Kong, is no longer pushed quite as aggressively as before. One of China's most authoritative pronouncements on Taiwan policy in recent years, issued on May 17th 2004, did not mention "one country, two systems" and only touched on reunification. It concentrated on the dangers of formal separation rather than railing against Taiwan's de facto independence.

But China's President Hu Jintao, who took over as chief of the armed forces in September 2004, would see no domestic benefit in appearing weak on issues of national sovereignty. Nor is there much prospect of change in Taiwan as long as a generation still embittered by the KMT's repressive rule remains in power. "For the decade ahead, we need to keep the lid on the pressure cooker," says an American official. Fortunately, such a policy will be strongly underpinned by mutual economic advantage.

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