

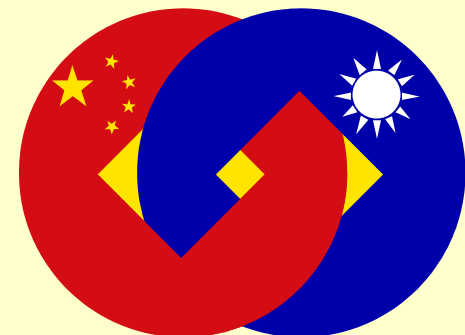
Capital Links

Taiwan: The next big China play

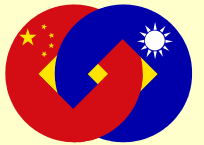
Peter Sutton

Head of Taiwan Research, CLSA Asia Pacific Markets

March 2007



The Capital Links thesis



- ❑ Economic but not political integration of Taiwan with China
- ❑ Transform Taiwan into a corporate service centre for China
- ❑ Drive Taiwan's equity and debt markets
- ❑ China's perspective – national unity postponed
- ❑ Taiwan's perspective – economic gains without political cost
- ❑ Alternative scenarios see variations in speed not direction

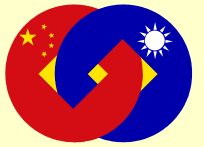
China's hearts & minds campaign



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A new strategy



- ❑ **A shift away from a strategy of seeking rapid – and potentially forced – reunification**
 - Now the PRC is focused on deterring moves by Taiwan towards independence
 - Reunification is a long-term objective without a timetable

- ❑ **A major revision to the PRC's definition of "one China"**
 - Old: 'Taiwan is an inalienable part of China' and the PRC rules it
 - New: 'Both the Mainland and Taiwan belong to China'

- ❑ **The changes 'recognize and respect the reality' on Taiwan**
 - Threats didn't work
 - Most in Taiwan prefer the status quo (*de facto* independence) and Beijing can live with this

New tactics as well



- ❑ **Winning hearts & minds, rather than trying to intimidate**
 - Appealing to key constituencies: businessmen, farmers, students, animal lovers

- ❑ **Recognition, almost**
 - Hu has implicitly acknowledged the existence of the Taipei government

- ❑ **Co-opting the opposition**
 - “Golden handshakes”

- ❑ **Co-opting Washington**
 - ‘The US strongly supports Taiwan democracy . . . But we do not support Taiwan independence’

Beijing's end game



❑ The economic payoff

- Official Taiwan FDI in China went from \$14bn in 1999 to \$50bn now
Unofficially, as much as \$250bn
- Jobs and technology transfer

❑ Prospects for conflict

- The chance of war has never been lower

❑ Great expectations

- PRC scenario I: DPP maintains restrictions, KMT wins in 08 and lifts them
- PRC scenario II: DPP eases restrictions and wins in 08

Taiwan's perspective



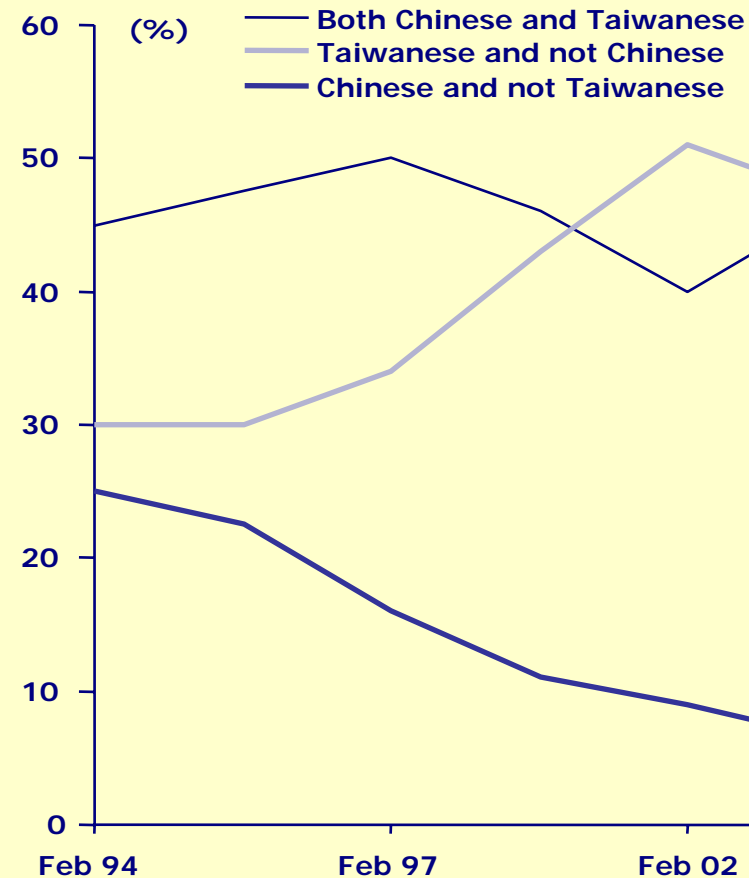
□ Gallup polling results

- Identity politics prevents compromise
- Growing support for greater economic interaction with China
- Growing Taiwanese identity

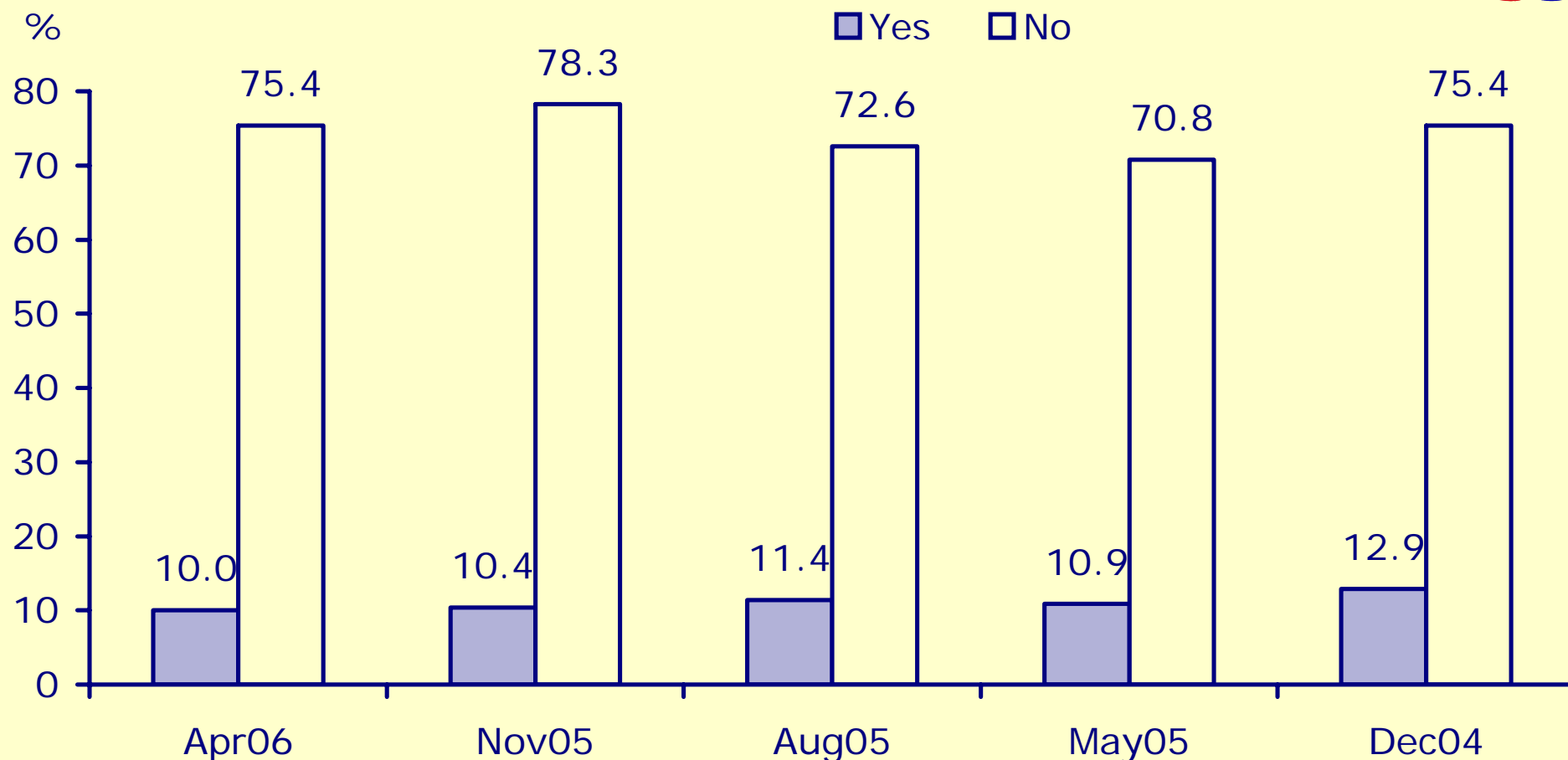
□ Gallup focus-group results

- Resentment drives older people, so political climate hard to change
- Younger people have stronger Taiwanese identity, but a much greater willingness to compromise

What is your identity? Are you:

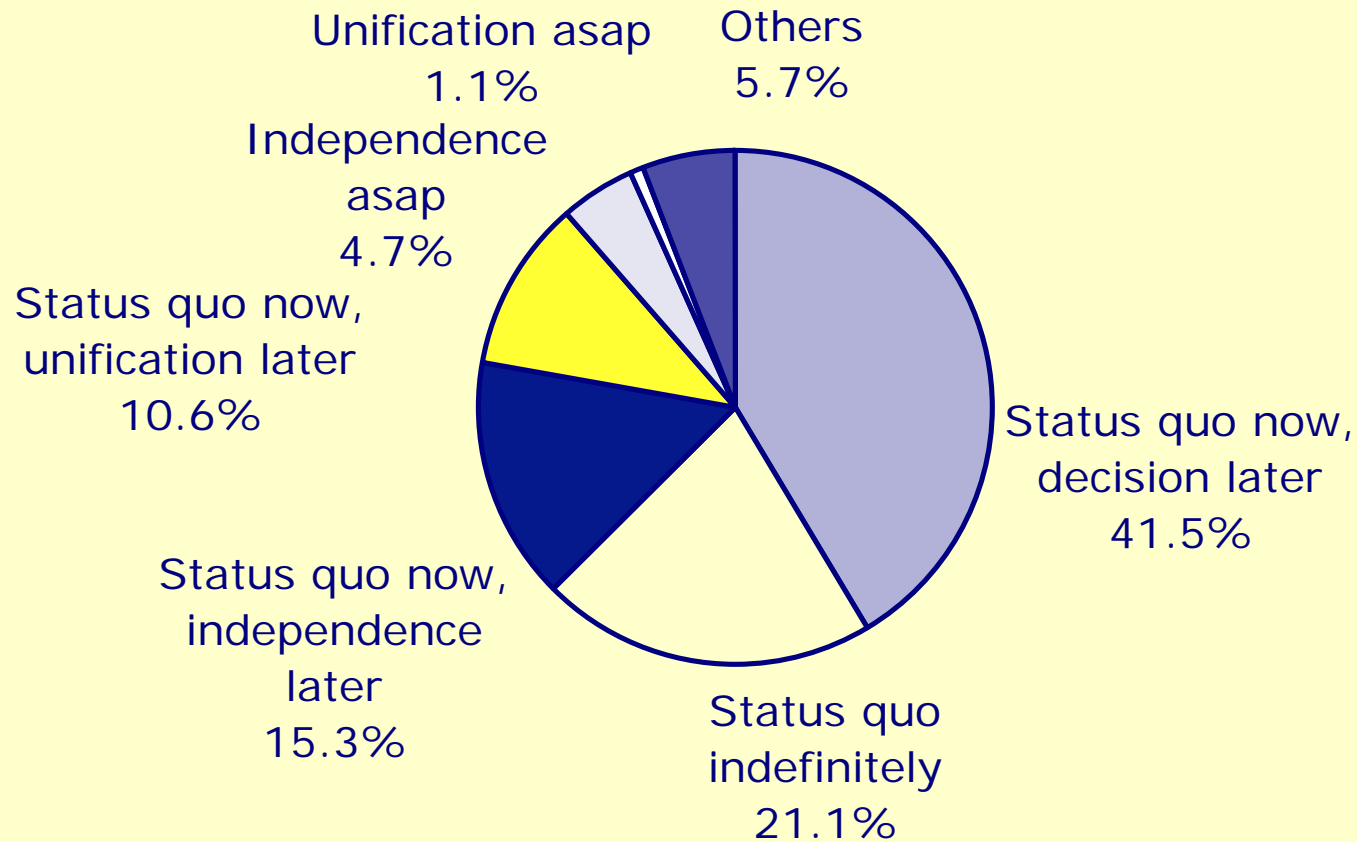
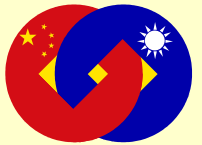


Is the "One Country, Two Systems" Formula Applicable to Solving the Problems Across The Straits?



Note: Latest poll conducted on 31 March -2 April 2006 shows 75.4% of respondents do not support the "One China, Two Systems" formula. Source: Taiwan's Mainland Affairs Council

Taiwan public opinion poll on unification/independence



Note: Latest poll conducted on 31 March-2 April 2006 shows 88.6% of respondents favoured "maintaining the status quo". Source: Taiwan's Mainland Affairs Council

Strong support for closer economic ties



1. Do you support regular cross-strait direct air passenger links between Taiwan and China?

Strongly support	Support	Not support	Strongly not support	Don't know/refusal
(%)	(%)	(%)	(%)	(%)
23.7	39.8	10	5.7	20.9

2. Do you support an open policy to allow Chinese tourists to visit Taiwan?

Strongly support	Support	Not support	Strongly not support	Don't know/refusal
(%)	(%)	(%)	(%)	(%)
21.7	51.1	12	4.9	10.3

3. Are you in favour of the government easing investment restrictions for Taiwanese companies to invest in China?

Strongly in favour	In favour	Not in favour	Strongly not in favour	Don't know/refusal
(%)	(%)	(%)	(%)	(%)
14.9	34.7	24.3	12.5	13.6

4. Some people say Taiwan should become more economically independent from China even if it means lower living standards in Taiwan; other people say Taiwan should increase economic ties with China to improve living standards in Taiwan, which statement do you agree more?

"More economically independent from China"	"Increase economic ties with China"	"Neither of them"	Don't know/refusal
(%)	(%)	(%)	(%)
27.4	57.5	4.2	11

From Gallup MRC Taiwan 31 August – 4 September 2006

Taiwan's restrictions



- ❑ **Direct links - Air passenger, air and sea cargo**
- ❑ **Visas for PRC nationals - Tourist and business**
- ❑ **Investment by Taiwanese and mainland companies**
 - 40% rule
 - List of banned industries
 - No mainland investment in Taiwan
- ❑ **Restrictions on imports from the mainland**

Most critical - direct flights and visas



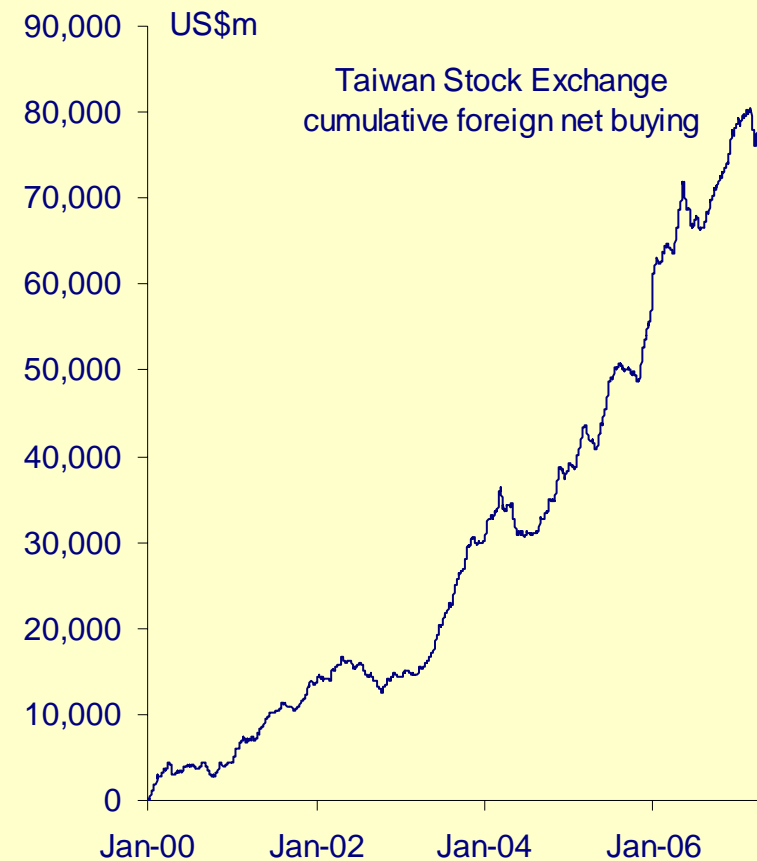
- **Prevent Taipei emerging as a regional centre for**
 - Internal corporate services
 - Specialist financial services
 - Training
 - Education
 - Medical tourism

- **Significant foreign company presence is possible**
 - Air pollution in HK/China now a major life style issue
 - Potential to use Taiwan as a regional hub for certain activities
 - US nationals have lower housing costs and similar taxes

Investment restrictions



- ❑ Foreign portfolio investors have put US\$77bn into Taiwanese equities since 2000
- ❑ Removal of investment restrictions enhances Taiwan's attractiveness to foreign investors
- ❑ These funds are lower cost and passive. They enable Taiwan to drive its own economic destiny
- ❑ The greater Taiwan's relevance to global markets the more control it will have over investment flows
- ❑ Returns in the stockmarket drive consumption in Taiwan

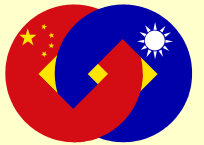


Restrictions on imports



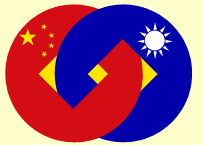
- ❑ Reduce choice and consumption power in Taiwan
- ❑ Divert imports from high cost locations to the benefit of no-one in Taiwan
- ❑ Make it difficult for foreign companies to do business in Taiwan, reducing Taiwan's interaction with the rest of the world
- ❑ The world is globalising around Chinese manufacturing and the costs to Taiwan of trying to avoid this are rising

Managing population growth



- ❑ Dramatic demographic changes are about to drive down economic growth and disrupt the health and education industries
- ❑ In 2000 the fertility rate was 1.68. In 2005-1.12
- ❑ In 2000 the divorce rate was 29%. 2005 is 44%
- ❑ In 2000, 305,000 births. 2005 saw 206,000 births
- ❑ Time for Taiwan to think about managing immigration to sustain service industries

Property and related services



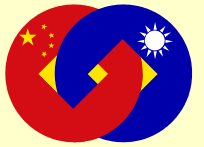
- ❑ Adding 50-100,000 high income people to Taipei will boost construction and consumption
- ❑ Shortage of high quality residential, retail and office property
- ❑ Related services such as training and financial services also require space
- ❑ Expansion in other services industries such education, health, entertainment and hotels

The macro impact of opening up



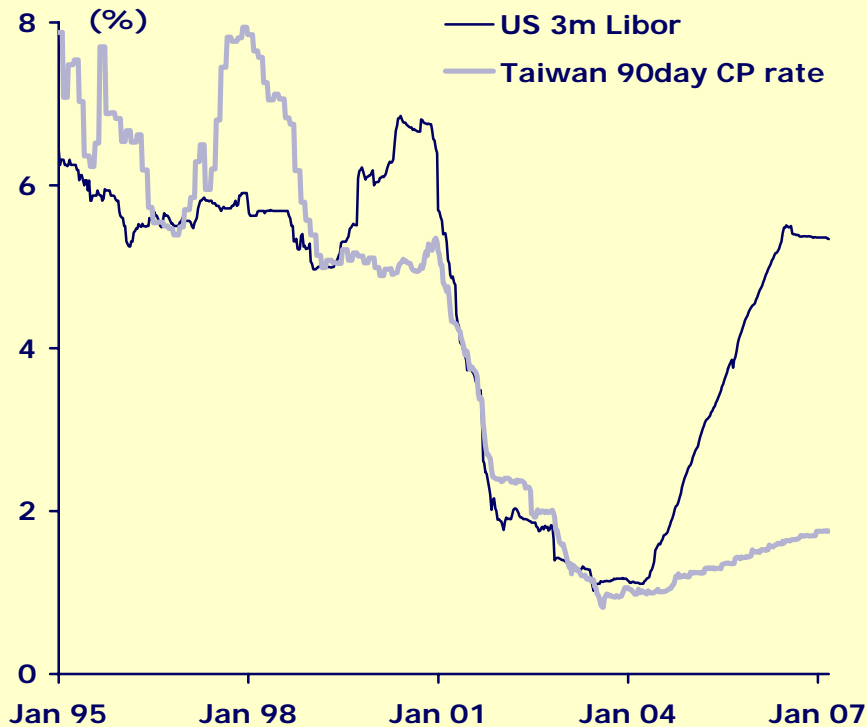
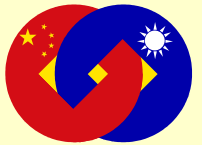
- ❑ Lift the interest-rate structure back to global levels
- ❑ The initial beneficiaries are in Northern Taiwan, with more hollowing out in the South
- ❑ Growth in small businesses, especially in service industries and food manufacturing
- ❑ Taiwanese manufacturers grow their internal services in Taiwan
- ❑ Taipei becomes a regional service centre

The Taiwanese advantage in China



- ❑ Control and retention of employees
- ❑ Over-regulation and government interference
- ❑ Can deploy large numbers of native speakers
- ❑ Thorough research, detailed planning, disciplined execution
- ❑ The Taiwan Affairs Office
- ❑ Foreign investors will pay for their track records

Outlook for bond yields



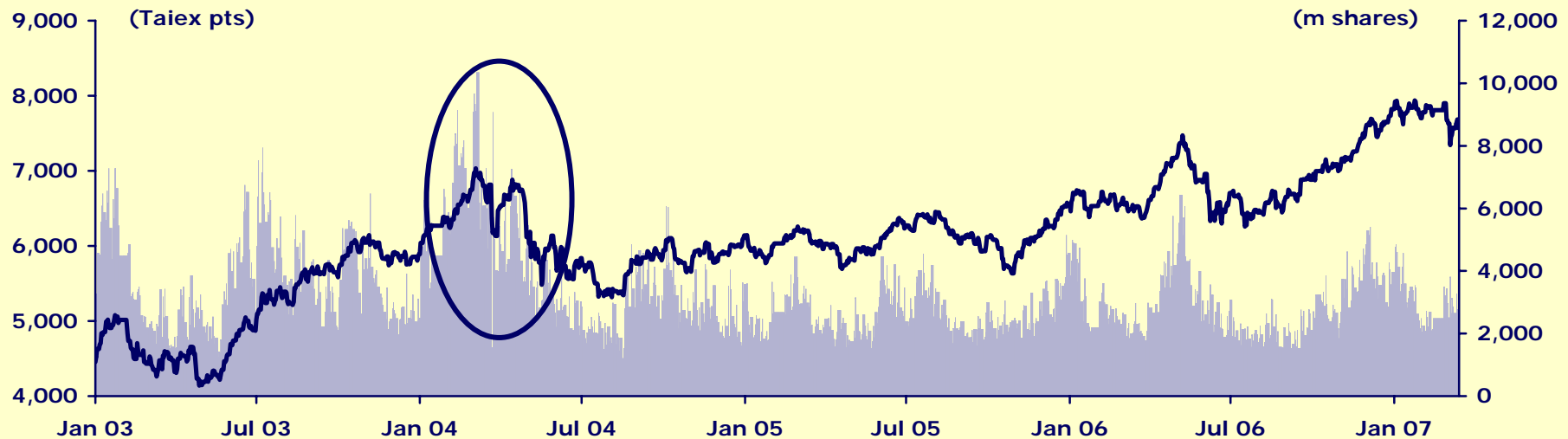
- ❑ Up to 2004, US and Taiwan short rates similar, except in Asian crisis and internet boom
- ❑ Short rates not risen much in Taiwan as there is no wage inflation or pressure on NT\$
- ❑ Long rates have fallen and stayed low due to a massive internal carry trade in Taiwan

Opening up to China will boost yields



- ❑ Inflation expectations are too low - likely 0-1% pa
- ❑ Opening up to China will create wage inflation in Northern Taiwan
- ❑ Outflow of capital to China will also raise real interest rates
- ❑ Any increase in short-term rates will drive up long-term yields as banks, bond funds and post office are borrowing short to invest long
- ❑ Unlike Japan, the pricing of the property and equity markets reflect global bond yield levels not local bond yields
- ❑ Central bank wants a steeper yield curve and will likely try to guide it upwards as we approach
- ❑ Failure to account for liabilities and assets at market value encourages bond funds, insurance companies and post office to have too high a bond weighting

Who is right?



- ❑ Some say easing restrictions leads to less people and activity in Taiwan. Our conclusion is the opposite. This chart tells you what the stock market thinks.
- ❑ In the nine months leading up to the previous election, the market rose 70%
- ❑ Taiwanese property has been strong despite a consumer-banking crisis
- ❑ The property and stock markets think closer economic relations with China are good for Taiwan

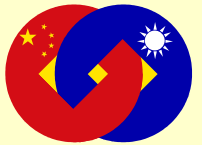
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Our conclusion



Removing the restrictions on contact with China would:

- Enhance Taiwan's economic independence by increasing the amount of decision making made in Taiwan
- Increase Taiwan's relevance to the rest of the world
- Greatly enhance the domestic economy and create a base for the stronger domestic industries to go offshore
- Stem the loss of talented young people offshore
- Increase self-confidence in Taiwan. Economic success gives individuals and countries confidence in who they are

Politics and policy in Taiwan and China is moving in the direction of making this happen