

*February 1, 2016*

## **Trouble in Taiwan**

Taiwan held elections on January 16<sup>th</sup> and the Democratic Progressive Party (DPP) won a resounding victory over the Kuomintang (KMT). This election will likely raise tensions between Taiwan and Mainland China (People's Republic of China, PRC).

In this report, we will begin with a history of Taiwan. Next, we will recap the election results, discussing what the election means for Taiwan's foreign and domestic policies, the PRC's problems with the DPP's victory and the election's potential impact on regional stability. As always, we will conclude with market ramifications.

### **The History of Taiwan**

There is evidence that suggests the Han Chinese began settling in Taiwan in the 11th century, although it appears that hostile indigenous tribes hampered development. It wasn't until 1624 that the Dutch established a commercial base in Taiwan. The Chinese ousted the Dutch in 1662, and the area was ruled by Chinese warlords who were remnants of the collapsing Ming dynasty that was being ousted by the incoming Qing dynasty. One of the Ming loyalists was Captain Zheng Chenggong, who was responsible for removing the Dutch from Taiwan. Zheng<sup>1</sup> successfully began a series of raids on the mainland and built the Kingdom of Tungning, which, at its peak, included parts of the central coast of the mainland, partial control of Shanghai and

several miles inland along the Yangtze River. Although the Ming eventually regained control of Taiwan and ended the Kingdom of Tungning, Zheng's exploits serve as a reminder to modern PRC leaders that Taiwan can be a "launch pad" for invaders and thus they see an independent Taiwan as a significant threat.

China maintained control of Taiwan until 1895, when China was defeated in the First Sino-Japanese War. As part of the peace treaty, China ceded Taiwan to Japan. The Japanese began industrialization of the island, building transportation networks, public infrastructure and public schools. It also embarked on a program of suppression and assimilation of the aboriginal people. It conducted aggressive military actions against tribes that resisted Japanese rule but also allowed groups that cooperated to earn second-class citizenship. At the onset of the Pacific War and World War II, thousands of Taiwanese joined the Japanese military. The Imperial Navy operated a base out of Taiwan. In general, many native Taiwanese have a favorable view of Japan, which is unusual in the region.

Japan's defeat in World War II ended its control of Taiwan. The Nationalist Chinese under General Chiang Kai-shek were given control over the island. The military government run by the Nationalists was corrupt, inefficient and very unpopular with the native Taiwanese. In 1949, after the Nationalists were defeated in the Chinese Civil War, Chiang Kai-shek and his followers fled to Taiwan and established the Republic of China (ROC). As they departed, the Nationalists carried many national treasures and all of China's gold

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<sup>1</sup> Also known as Koxinga.

and foreign currency reserves. Mainland China, controlled by the communists, established the PRC.

Both nations considered themselves the legitimate government of China. The ROC maintained seats in its legislature for the districts on the mainland even though it was impossible to hold elections in those areas. Chiang Kai-shek ruled Taiwan under martial law. The KMT, the political party of the Nationalist Chinese, was the only legal party in Taiwan.

The United States, the primary protector of Taiwan, considered the ROC to be the legitimate government of China until January 1, 1979, when official recognition shifted to the PRC. The ROC lost its status in the United Nations at this time. That same year, the United States passed legislation indicating it would protect Taiwan from mainland Chinese military threats. In 1992, the PRC and the ROC agreed on the “1992 Accord,” which indicated that there was only one legitimate government of China; however, using “strategic ambiguity,”<sup>2</sup> both considered themselves to hold that honor.

By the mid-1980s, Chiang Kai-shek’s successor, his son Chiang Ching-kuo, began to liberalize the government. Martial law was eased in 1984 and abolished in 1987. Political parties were allowed; the DPP was established to represent the interests of the native Taiwanese, which account for 80% of the island’s population. In 1991, the KMT finally forced those legislators that held seats for mainland districts to retire, paving the way for legislative elections. In 1996, the ROC held its first presidential election. Lee Teng-hui of the KMT won.

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<sup>2</sup> Strategic ambiguity is a diplomatic tactic where two parties say exactly the same thing but derive completely different meanings from the words.

In the 2000 election, Chen Shui-bain of the DPP won the presidency on a platform of defending native Taiwanese rights. He persistently pushed for independence from China. The PRC viewed these threats as the equivalent of civil war, since it treats Taiwan as a province of China. The United States was also unhappy with Chen’s policies as they constantly increased tensions in the region. The Chen administration persisted in not allowing direct transportation, mail and trade links. This did not stop Taiwan investment into the PRC, but it made such activity more difficult. Although the DPP controlled the executive branch, the KMT maintained control of the legislature. The legislature prevented proposals designed to trigger confrontations with the PRC. Chen won two terms in office but the DPP failed to hold power in 2008, and the KMT, led by Ma Ying-jeou, prevailed in the presidential election.

Ma Ying-jeou, unlike Chen Shui-bain, worked hard to improve relations with the PRC. Tourism between the two regions increased; in 2008 less than 10% of Taiwan’s tourists came from the PRC. That number is now over 40% and total tourism is 2.75% of GDP, up from less than 1% in 2008. Ma signed 23 different cross-strait economic agreements, virtually all the pacts negotiated in secret. Currently, about 25% of Taiwan’s exports go to the PRC. Last November, he met personally with General Secretary Xi in Singapore, the first time two leaders from the PRC and Taiwan have met since the schism in 1949.

Unfortunately for the KMT, integrating with the PRC’s economy has led to a “hollowing out” of Taiwan’s manufacturing base. Taiwanese firms, like many firms around the world, found it difficult to compete with the PRC’s low cost manufacturing base. The

DPP tends to represent those who have been “losers” in globalization and technological change, whereas the KMT mostly represents the corporate elite who, like establishment elites everywhere, benefit from these factors. Thus, to a great extent, the most recent election reflects the populist sentiment being observed globally.

### **The 2016 Election**

The DPP was led by Tsai Ing-wen, a law professor who studied in the U.S. and Britain. She is a trade expert who negotiated Taiwan’s entry into the WTO. She won a decisive victory, capturing 56.1% of the vote, far outpacing the KMT’s candidate, Eric Chu, who gathered 31.0% of the ballots. James Soong of the People First Party, which caucuses with the KMT, finished third with 12.8% of the vote. Ms. Tsai is the first woman president in Asia who did not come from a political dynasty.

Perhaps even more impressive is that the DPP also won control of the legislature, the first time since 1949 that the KMT hasn’t controlled this body.

Ms. Tsai won by promising generational equality; she won widespread support from younger voters for her positions against the KMT’s PRC-favorable policies and for promises of pension reforms that would not overly burden younger workers. She also campaigned for more international trade deals,<sup>3</sup> while supporting some degree of trade protection from the PRC. Other policy goals include a hike in the minimum wage and more affordable housing. Most of these positions are “standard issue” populist policies. In other words, the DPP didn’t win because it ran on a platform of independence; it won by supporting policies designed to help those who were “left

behind” by globalization and technological change. These policies will likely include a reduction in economic integration with the PRC. Given her control of the legislature, we expect many of these proposals to become law.

### **The Risks from the Election**

Although Ms. Tsai may not want to necessarily antagonize the PRC leadership, we would expect relations to deteriorate. The Xi government would much rather deal with the KMT; although they may have been mortal enemies at one point, they both tend to agree that Taiwan is part of China. The DPP isn’t so sure about that position. DPP leaders have rejected the 1992 Accord, pointing out the strategic ambiguity of the agreement.

Polls suggest that the position of the Taiwanese people is steadily moving toward supporting a future outside of Mainland China. In 1996, only about 20% viewed themselves as “Taiwanese,” about 26% saw themselves as “Chinese” and the rest saw themselves as “Taiwanese/ Chinese.” Now, a full 60% see themselves as Taiwanese and only 4% see themselves as Chinese. Other polls indicate that 80% of Taiwanese are happy with the status quo, which would best be defined as autonomy with limited sovereignty; we suspect they would prefer independence but realistically understand that such a policy would likely lead to military conflict.

Under the Ma government, relations with the PRC were greatly improved. Although the PRC leadership is clearly more comfortable with the KMT in power, it should be noted that Ma mostly dealt with Hu Jintao during his terms in office. Hu was intentionally less confrontational with Taiwan, essentially “playing the long game.” Hu recognized that as China’s

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<sup>3</sup> She has intimated she would like Taiwan to join the TPP and wants a free trade agreement with Japan.

economy grew and its military expanded, it would be natural that the PRC's influence would expand in the region and essentially engulf Taiwan. The KMT wanted to become part of the PRC's economic expansion which led to greater integration of the two economies.

General Secretary Xi faces a much different situation. The PRC economy is slowing rapidly as Xi attempts to restructure the economy toward consumption and away from investment and exports. Xi is in the midst of a massive purge of corruption and political enemies. This process includes a restructuring of the People's Liberation Army (PLA). Whenever a civilian leader is changing the military, there is a risk that the latter pushes back. Thus, tensions between Xi and military leaders could be rising. The PRC has been actively expanding its activities in the South China Sea, building artificial islands and threatening the first island chain of which Taiwan is a member. If provocations rise, the odds of triggering a strong response rise as well. In fact, General Secretary Xi could find that he might need to support the hawks in the PLA with regards to Taiwan to win their support for military restructuring.

As the PRC faces these difficult issues, the U.S. is pivoting its focus to Asia, reducing its footprint in Europe and the Middle East. The PRC sees this as a threat to its interests. Japan is working to be part of this pivot, putting further pressure on the Xi regime.

Simply put, the likelihood of miscalculation is rising. It is unclear whether the U.S. would be willing to defend Taiwan at all costs if a shooting war develops. To some extent, American policy has to use strategic ambiguity toward both the PRC and Taiwan. To the former, it must show that the U.S. is willing to risk a military conflict if the PRC

attacks Taiwan to increase the perceived costs of a war. To the latter, the U.S. must signal that it might not come to Taiwan's aid to prevent it from provocative behavior.

Unfortunately, as conditions change, the potential for misunderstanding rises as well. If the PRC becomes convinced that the U.S. won't respond, it will be tempted to use military force to bring unification. If Taiwan becomes convinced the U.S. cannot be relied upon, it might try to find other allies, such as Japan. This would infuriate the PRC and might trigger a conflict on its own.

At present, the PLA could inflict massive damage on Taiwan. However, we doubt the PLA is capable of conducting an amphibious landing and holding territory in Taiwan. So, for now, Taiwan remains a "frozen conflict," but one that will likely become "warmer" in the coming months.

### **Ramifications**

Although the chances of a military exchange are higher with the DPP in power, we doubt General Secretary Xi is anxious for a military conflict with Taiwan. On the other hand, the PRC will likely use its massive economy to influence Taiwan's behavior. We have already seen a reduction in tourist visits to Taiwan from the PRC. We would expect increasing economic pressure on the Tsai government, especially if the new president follows through on attempts to join the TPP or execute a trade deal with Japan. Forays into cyberwar would not be a shock, either.

As long as tensions remain mostly confined to non-military tactics, we doubt this situation will have a broad impact on risk markets. Obviously, it would negatively affect both Taiwan and PRC financial assets. A shooting war is another matter. Flight to

safety would likely ensue, with gold, Treasuries and the dollar strengthening, while equities would weaken. Commodity prices could also rise as regional powers try

to hoard key resources, fearing supply disruptions.

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