

U.S. China Commission

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Good afternoon. I am privileged to have this third occasion to share with the Commission my findings and perspective as developed over a continuing, three-year examination of cross-strait trade in the Information Technology sector. I have conducted this research at a general level under the auspices of the Foreign Policy Research Institute in Philadelphia but I have also helped a range of clients understand particular issues of specific interest through work contracted with my consultancy business, GC3 Strategy. My general approach has been to go directly to the CEOs from Taiwan who are invested in, and now managing, operations on the China mainland across a broad range of Information Technology sectors. My aim is a better understanding of the current dynamics and future trends of cross-strait IT trade.

The concerns of this panel are issues I have been examining directly. That such a large number of Taiwan entrepreneurs are active and living in the mainland has major implications for Taiwan's long-term ability to innovate, to train its local work force, and to maintain its competitiveness. The prospectus for this panel mentioned approximately 1 in 23 Taiwan citizens now working full-time in China. As a light-hearted aside, I would point out that this figure appears generally accurate but that a large proportion of those 1 in 23 Taiwan may not actually be on the mainland at any given time, they are semi-perpetually in the air somewhere between Shanghai and Hong Kong or between Hong Kong and Taipei.

The prospectus also mentioned the Shanghai-Suzhou-Nanjing corridor. I have recently concluded a small case study on Suzhou's emergence as the new critical-mass staging-point for IT investment in China. Suzhou's emergence, following an earlier progression of Taiwan IT investment through Dongguan (Guangdong), Shanghai, and then Kunshan (Jiangsu) is noteworthy. Clearly something new is happening when the Mayor of Suzhou visits the headquarters of Macronix outside Taipei to solicit additional Taiwanese IT investment. Or when the Taiwan Computer Association and the Municipality of Suzhou jointly sponsor a new IT world trade show, called "eMex," resulting in the construction of a brand-new 52,000 square meter International Exhibition Hall in Suzhou and catering largely to the Taiwan Computer Association's membership. Or when Suzhou emerges as the world's leading cluster for PC and notebook display screens as well as for TFT-LCD advanced generation TV flat panel displays, at the same time that the Taiwan Government is building this into a \$35 billion USD industry by 2008.

My testimony will deal with three of the specific questions posed by the Commission for this Panel:

- What are the recent trends in Taiwan's growing investment in the PRC and what are the political and economic implications;
- Are Taiwan and China on a path toward resolution or collision
- What, if any, U.S. policy adjustments are necessary in light of recent activities and trends in cross-strait relations

However in light of earlier, more narrowly-circumscribed testimony, I am going to accept the Commission's invitation to 'paint outside the lines' a bit. My previous testimony has always confined itself to dynamics and trends within the IT sector alone. For our purposes today, I would like to keep within the commercial/economic sphere but broaden the perspective of my testimony beyond the IT sector to view it alongside other key sectors of US-Taiwan-China economic activity. We are, I believe, well past the sterile point in earlier policy dialogue when some pundits vigorously insisted that commercial/economic factors were largely irrelevant to the cross-strait security equation. The work of this Commission as well as the work of this Administration make clear that commercial/economic factors are now counted as vital by decision-makers and analysts who count. The need at this point is, first, for broader perspective and deeper context to be applied in analyzing discrete developments in the cross-strait IT arena and, second, for IT dynamics and trends to be 'disaggregated' from other key arenas of cross-strait economic/commercial activity. This broadening of perspective on cross-strait IT issues and this 'unbundling' of IT issues from other key areas of economic engagement can help us sort out better whether Taiwan and China are on a path of resolution or collision and how we should adjust policy to support resolution or to avoid collision.

II

The first issue I have raised is one of perspective and context in the IT sector. To take one example, the migration of chip foundry capability from Taiwan to China. The forces driving chip foundry migration from Taiwan to China have been driven as much by changing market conditions, global venture capital, and developments in the global IT supply chain as they have been by explicit government policy in Taiwan or China. We need to be able to better sort out those behaviors and events which are authentically impelled by global market forces and in our interest not to impede from, on the other hand, behaviors and events which represent a foreign government's effort to manipulate the global market so that it can amass capabilities of a strategic nature. The latter is clearly in our national interest to impede. The trick of course is how to discern in a fast-moving world of rapid technological change where to encourage, where to impede, and where to get out of the way.

When applied to the IC sector, this perspective and framing suggests that (a) some degree of migration of foundry capability from Taiwan to China is natural and even unavoidable as a result of trends in the global market; (b) very few foundries would ultimately be PRC-owned because the global ecology is able to support only 3-5 global players; (c) that the PRC government is unlikely to direct its limited capital resources to betting on foundry winners and losers because the global VC community is already placing its bets with the advantage of having deeper pockets and greater understanding of the global market and (d) that the area where the Chinese government appears to be focusing its resources and efforts (and where the US government would do well to focus its scrutiny) is not so much targeted toward foundry manufacturing as it

is in promoting the IC design capabilities that develop hand-in-hand with expansion of foundry capacity.

By the same token, this perspective and framing can help address the question of the degree and likelihood of potential ‘bleeding’ or ‘seepage’ between the relatively unconstrained sector of globalized IT, on the one hand, and, on the other, those technology areas traditionally subject to explicit and enforced export control. Our understanding of the cross-strait dynamic in areas of software, IC design, networking equipment, and wireless telecoms could benefit from this approach.

The central focus within this broader perspective needs to be on the continuing and accelerating ‘integration’ between Taiwan and China in most sectors of the Information Economy. While there continue to be variations in the relative degree of integration between various sectors (e.g., notebook computers has a high degree; wired and fixed line telecoms has a low degree), the overall fact of cross-strait IT interaction has been an enduring dynamic of accelerating integration which has shown fundamental continuity over decades. At bedrock, it represents the extension – at first gradual, now quickening – of a complex, highly-differentiated global supply chain for IT products. Originally, this supply chain linked primarily Silicon Valley and Hsinchu, Taiwan; over time, it has ramified to include multiple IT innovation clusters in the advanced economies of North America (e.g., Dallas-Fort Worth, Seattle, etc), Europe and Japan as well as important manufacturing clusters in Mexico, SE Asia and elsewhere. The context for, and driver of, this expansion of the global IT supply chain has been the phenomenon of globalization itself.

The feature of the world-wide expansion of the global IT supply chain which is central to this study concerns its historic main artery: the historic ‘trunk-line’ of IT integration originally established between the U.S. and Taiwan. Driven by globalization trends, this ‘trunk line’ in the global IT supply chain has not only expanded dramatically, it has extended its reach from the U.S., through Taiwan, to China in a systematic and even orderly way, driven by cost pressures (‘commoditization’), technology and consumer trends, and various other trends familiar in a rapidly globalizing world.

This broader perspective brings some unexpected findings into focus. One such finding: that the overall trajectory of this trend has shown fundamental continuity over decades, despite changes in the agenda of differing political leadership teams on both sides of the Strait and despite dramatic advances in technology.

Unfortunately, none of the cross-strait IT dynamics are either static or technologically obvious. IT is fast-changing and the cross-strait region is a key nexus in those changes. There are new vectors of growth in established IT sectors, such as e-services, mobile telephony services, and digital media. Similarly, there are over-the-horizon IT applications just arising to service a range of next-wave industries in the bio-life sciences arena. BioInformatics is one such emergent application.

III

The second issue which I would like to raise is to clearly unbundle the IT sector from some other key sectors of cross-strait trade and investment in which we also have vital interests at stake. In other words, now that cross-strait economic and trade activity is recognized as a key element of the cross-strait security equation, what are the most relevant component factors of that economic and trade activity. As a starting point, I would suggest that we focus on at least four broad sectors of economic engagement that tend to play out very differently and each of which is 'driven' by a fundamentally different calculus of business decision-making.

The first such sector has already been discussed: the broad range of IT products tied to a highly-developed and highly-differentiated global supply chain. While these products are not generally subject to stringent regulatory or export control restrictions, they are subject to relentless market-driven pressures of commoditization and price erosion. A better understanding of dynamics in this sector is needed to understand how these technologies and industrial capabilities might be, in effect, 'seeping into' a concerted effort by the Chinese to amass capabilities of a strategic nature.

The second such sector would be the category of military and dual-use technologies. This sector differs from the broad category of IT products just discussed in that it is characterized by highly strategic technology IP, generally commands higher profit margins and is not equally subject to 'commoditization' pressures, and is 'driven' by regulatory and governmental forces rather than by market forces. A primary challenge here is determining how this sector is being affected by 'seepage' effects from the first sector, the broad range of IT products tied to a global supply chain. A secondary challenge is to keep the export control apparatus of Taiwan and other allies aligned and coordinated with ours during constant and rapid technological change.

The third such sector is what I will call "WalMart" commodities – everything from air-conditioners to xylophones. This is of course the sector where the pain of job displacement and the issues of labor and environmental standards are most focused. It is the duty of many of you in this room to sort through these difficult and very painful problems in a way consistent with the established values which the American people have always historically banked on with regard to a free and open economy. My only comment would be to restate what I hope is the obvious: that the commercial dynamics in the "WalMart" sector are entirely different from the dynamics in the IT sector as a whole and different responses are called for.

The fourth major sector to 'disaggregate' would be trade and investment relating to industrial raw materials and other natural commodities. A specific example in the cross-strait arena would be the joint exploration taking place between Taipei and Beijing of energy resources in the Strait of Taiwan. A recent example between the U.S. and China would obviously be CNOOC's failed bid for Unocal. My one observation here is that there is indeed good commercial justification in questioning the validity of CNOOC's shareholder pitch to Unocal. As we are reminded by Yahoo no company in China is free to operate just like a 'regular' global company from the U.S. or Europe or elsewhere. Therefore the argument that Unocal shareholders should look at CNOOC's bid just like any other bid and that no additional time should be taken to allow investors to quantify the political risk premium associated with CNOOC's bid was always hollow.

IV

I would say that there is no single answer to the question of whether the commercial and economic trends I have described above are leading in the direction of cross-strait resolution or collision.

From the ‘unbundled’ perspective I have advocated, I would offer these more limited generalizations:

- In the general IT sector, the net-effect of the extension of the global supply chain from the US through Taiwan to China has been beneficial and generally stabilizing for all concerned.
- In the sector of high technology goods traditionally subject to explicit export control regimes, it remains an open question whether China is currently leveraging its new-found position in the global IT supply chain to amass qualitatively or quantitatively new capabilities of a strategic nature to be directed against either Taiwan or the US. This would potentially be destabilizing but, to date, there are no obvious indications from my perspective that this is widespread or acute. Clearly, however, this question needs to be much better understood.
- In the sector of ‘WalMart’-type consumer goods, I am confident that our political process will sort through these issues as successfully as it has in the past, balancing fairness and opportunity for our citizenry with our long-established values of openness and free trade. While the long-term resolution of this issue – adjusting our economy and worker training to take account of China’s active and resurgent economic engagement -- could potentially affect political attitudes in the U.S. to such an extent that it would start to affect the course of either cross-strait resolution or conflict, I personally see that as quite a remote risk in light of the values, c.
- In the sector of raw materials and natural commodities, new risks are apparent and new thinking required. China’s appetite is voracious, its acquisitions activity of its companies worldwide is actively encouraged by the government and supported, directly and indirectly, by unprecedented for-ex reserves and a still artificially low exchange rate. A globalized economy is an economy dependent on efficient, worldwide distribution of key resources. This means greater benefit but also greater risk of disruption, through natural disaster or terrorism. We have an interest in seeing that China’s entry into these markets is not that of a ‘bull in a china shop.’

To conclude, I have offered only the some quite general prescriptions for better focusing on the cross-strait trade dynamic. In sum, these are (1) to contextualize specific instances of IT tech transfer and localization of industrial capability from the broad perspective of the general IT sector and from the context of historical globalization dynamics which drive it; (2) to disaggregate or unbundled various sectors of cross-strait engagement in order to better understand the dynamics of each on its own merits; and (3) to focus more sharply on the fast-evolving interface between the broad established global supply chain of IT and those specific IT-related technologies subject to traditional export control in order to identify areas of ‘seepage’ that may be contributing to a build-up of Chinese strategic capabilities.

Finally, and more specifically, I would recommend support of Taiwan’s Free Trade Agreement candidacy with the U.S. Government. As the key node for the U.S.- Asian ‘trunk-line’ in global

IT, Taiwan is the only nation in Asia without a significant bilateral trade agreement of any type with any partner. While the economic effects of a US-Taiwan FTA would be relatively modest in strict economic terms (and largely trade-diverting rather than trade-creating), a US-Taiwan FTA would serve as a strong signal to the world that the U.S. Government recognizes and rewards economic performance (and the free values that underlie that performance) as well as rewarding economic potential.