

## Letter n°61

### Should financial markets worry about an invasion of Taiwan?

*"Nationalism carries war as the cloud carries the storm"* Jean Jaurès.

- **Geographically**, Taiwan, 36,000 km<sup>2</sup>, occupies a key position in the South China Sea. The capture of Taiwan could give China's nuclear submarines access to the Pacific Ocean, increase the vulnerability of Japan and the Philippines, and threaten the United States.
- **Politically**, the island became a democracy in the late 80s and is ranked first among Asian democracies in the extent of the rights granted. This development shows that democracy combined with economic performance is possible for the Chinese people.
- **Economically**, with a GDP of \$750 billion, Taiwan is the 21<sup>st</sup> largest economy even though its GDP is twenty times smaller than that of China.
- **From a geopolitical point of view**, China's attitude towards Hong Kong has played a major role in shaping international opinion in favour of Taiwan.
- **From the Chinese point of view**, in 2021, 1/5 of global growth was due to China but far behind the 3 decades of 1980-2010 with an average annual GDP growth of 10%. GDP per capita is still only \$17,000 compared to \$65,000 in the United States, and the transition from a middle-income to high-income country looks difficult.

As we can see with these few points, Taiwan is an unbearable political challenge for China, a strategic issue, a renegade province. Faced with this situation, the Chinese authorities are giving free rein to nationalist rhetoric, both in Tibet and in Taiwan, and, in the words of Jaurès quoted above, the markets are worried and the question for China is how far to go to reclaim Taiwan without damage.

To understand the subject, we will successively analyse the Chinese temptation and the risks it presents.

#### **The Temptation:**

7 points provide insight into the reasons for the Chinese temptation to take control of Taiwan.

- ***A reclaim of Taiwan? But can we use this term?***

The original population of Taiwan, which was the majority until the 18<sup>th</sup> century, was comparable to that of the Philippines or Indonesia. Chinese immigration began when the Dutch wanted to use a more docile workforce than the natives.

The island of Taiwan formally entered the Chinese Empire in 1683 under the Manchu Qing Dynasty, and over the next two centuries, Chinese peasants were sent from its overpopulated provinces. Until then, the Chinese population was a minority. Imperial China exercised only limited and sporadic authority.

After the Manchu defeat of Japan and the Treaty of Shimonoseki in 1895, the island was left. Tokyo wanted to make the island a model colony with modern infrastructure and an educated population. Thus, in 1935, the island had 5,000 km of railways compared to 15,000 km in China, an electricity production equivalent to that of China and an efficient banking system.

In 1945, following the Japanese defeat, Taiwan was ceded to China but Taiwan was never part of the People's Republic of China. Chiang Kai-Shek occupied the island in 1949 with 2 million Chinese civil servants and military, all of whom were anti-communist. With the Taiwanese elites speaking little or no Mandarin, communication was difficult and revolts were all the more numerous as Taiwan was more developed than China.

Chiang Kai-Shek rejected communism for Taiwan but was impressed by the methods of the Bolsheviks in the USSR. Chiang Kai-Shek's repression during the establishment of the Kuomintang was harsh and caused more than 20,000 deaths.

Martial law was introduced. It remained in force until 1987 and resulted in strong repression, a fight against "communist bandits", control of the press and militarisation of society. Chiang Kai-Shek remained President of the Republic until 1972. His son replaced him, but although he was the former head of the secret police and responsible for the "white terror", he was also the architect of democratisation where Taiwan had its first democratically elected President in 1996.

Today, Taiwan is in a hybrid situation. The country is hardly recognised as a state by more than by 14 states, China wants to apply the principle of one state-two systems and regain sovereignty over the island.

- ***Taiwan's military inferiority:***

Taiwan spends about 2 to 2.5% of its GDP on defence, but this is only \$15 billion in 2022, a far cry from the \$230 billion China spends, which is far below the US budget of \$770 billion. Thus, militarily, both in terms of manpower and equipment, China has a considerable advantage over Taiwan. Taiwan does not have an aircraft carrier, China has two; Taiwan does not have a nuclear-powered submarine, China has two. Similarly, Taiwan has far fewer fighter jets, missiles or destroyers than China but has chosen to acquire small arms such as portable missiles.

At the same time, China does not have all the necessary equipment (e.g., amphibious boat in particular) for the mass human landing necessary for the takeover of Taiwan. Taiwan is smaller than Ukraine, almost half as populated but it is richer, more insular and more difficult to invade because of its mountainous terrain. China is economically and demographically more powerful than Russia, but it does not have the same nuclear arsenal.

As a first step, China, instead of invading the island of Taiwan, could seek to seize islands belonging to Taiwan, the Matsu and Kinmen Islands, the closest to mainland China, and the Pratas Islands, located more than 200 km from Taiwan.

In such a case, the United States could not abandon Taiwan without losing credit with the allied countries in the region such as Australia, New Zealand, Japan... To help Taiwan protect itself better, in 2022, the US administration approved arms sales to Taiwan on four occasions.

- ***The political interweaving of China and Taiwan:***

From the beginning, in 1949 when Chiang Kai-Shek arrived, the idea of one China prevailed for both Mao and Chiang, and today, the figure of Chiang is rehabilitated in China because, thinking of reclaiming the mainland, he adhered to the idea of one China, even when Beijing took Taipei's place at the UN in 1971.

In 2005, a Chinese law authorised the use of force if Taiwan declared independence and peaceful means of reunification were exhausted. In the heart of Taiwan, China has always relied on the Kuomintang, the nationalist party, to preach peaceful reunification.

But in 2014, at the time of a Kuomintang government, the "Sunflower Movement" in Taiwan rallied tens of thousands of students against a rapprochement with China and was supported by a majority of the population. The crackdown on the "Umbrella Movement" in Hong Kong, the counterpart to the Taiwanese Sunflower Movement, alerted Taiwanese and international public opinion and since then the spotlight has increasingly been on the difference between the Chinese regime and democracy in Taiwan.

While more than 95% of the Taiwanese population is of Han origin, the "mainlanders" now represent only 15% of the island. Only 5% of Taiwanese consider themselves as Chinese compared to a quarter in 1994 and only 7% are in favour of reunification.

The first political alternation between nationalists and independents took place in 2000. The independents are pragmatic and are developing Taiwanese investments in mainland China.

In Taiwan, Tsai Ing-Wen, a single woman, was elected and re-elected in 2020. It is doing everything it can to strengthen the defence of human rights and the freedom of press, as measured by Reporters Without Borders, places Taiwan at the level of major Western democracies, far ahead of Japan and other Asian countries.

- ***The economic interweaving of China and Taiwan:***

Officially, Taiwan's investments in mainland China were only allowed in 1988 but Taiwanese investors were substantially responsible for the Chinese take-off under Deng and helped make China the factory of the world.

In the 2000s, Taiwan was by far the largest foreign investor in China. In 2010, an economic cooperation agreement with preferential tariffs was implemented. At the time, the Kuomintang was in power in Taiwan, there were 1 to 2 million Taiwanese, the Tai Shang, and thousands of Taiwanese SMEs based in China. The preferred provinces have always been Fujian, Jiangsu, Guangdong and Zhejiang.

Initially, the Taiwanese invested in light industries, textiles and plastics. More recently, they have invested in electronics and optics. For example, Apple buys components in China from the subsidiary of Foxconn, a large Taiwanese company.

China absorbs 44% of Taiwanese exports and more than 20% of Taiwanese imports come from China. But China is dependent on Taiwan because 86% of Chinese imports are electrical or electronic products or high-precision products and the Chinese are working to poach Taiwanese executives to develop the semiconductor industry.

Since 2016, the return to power of the pro-independence DPP has pushed Taiwanese companies to diversify foreign investment to Asian countries other than China such as the Philippines, Singapore, Thailand and Vietnam.

Taiwan is also caught up in Sino-US tensions. In semiconductors, TSMC controls 53% of the world's semiconductor market and is the only one to produce miniaturised microprocessors. Cooperation is developing between Taiwan, the United States, the EU and Japan.

Under pressure from Apple, Foxconn, the world's leading Taiwanese company in the assembly of electronic components, is relocating a factory from China to Vietnam and plans to invest \$1.5 billion. Finally, following the Chinese actions of recent days, the Taiwanese authorities are asking Foxconn to abandon the idea of an \$800 million investment to become the second largest shareholder in the Chinese semiconductor company, Tsinghua Unigroup. The subject is not closed because Foxconn, with 75% of its production in China, has strong ties with this country.

Electronic components account for nearly 40% of Taiwan's exports, which is of interest to many countries. China produces only 7% of the world's semiconductors and is only 15% self-sufficient. In 2021, China's purchases of chips amounted to \$430 billion and China's trade deficit on these components reached nearly \$280 billion.

- ***Taiwan's economic attractiveness:***

In 2021, GDP growth exceeded 6%. The country, according to the World Bank, is ranked 15/190 for its business climate while China appears only in 31<sup>st</sup> place. The manufacturing sector is strong and accounts for more than 30% of GDP. The sectors of choice are information technology, telecoms, steel and increasingly, biotechnology, green energy and cybersecurity.

To take semiconductors alone, according to Trendforce, in the first quarter of 2022 Taiwan accounted for 64% of production (including 53% TSMC), South Korea 18%, China 9%, and the United States 6%. The United States would like to create Chip4, an alliance of the US, Taiwan, South Korea and Japan, for the supply of semiconductors. Taiwan and Japan are motivated, South Korea is more hesitant at the moment because it fears Chinese retaliation.

More fundamentally, democracy, patent protection and the legal system are assets of Taiwan that China is deprived of.

- ***The emancipation of Taiwan:***

Taiwan has been a member of the WTO (World Trade Organisation) since 2002 and the ADB (Asian Development Bank) and has economic cooperation agreements with many countries. In 2022, only 14 states, often poor, recognise Taiwan. These include the Marshall Islands, Nauru and two other islands in the South Pacific, Guatemala and Paraguay, the former Swaziland... This number, under pressure from China, has fallen sharply in recent years.

Nevertheless, Taiwan is represented in nearly 60 countries and in the European Union by "trade offices" or "economic and cultural representative office". These de facto representatives generally have diplomatic status and the heads of mission have ambassadorial status. Thus, despite Chinese pressure, Taiwan's democracy is gaining support.

- ***China is failing to meet its 5.5% growth target for 2022:***

China has to overcome 4 challenges: a property crisis, high youth unemployment, deteriorating debt ratios and, more fundamentally, an ageing and declining population. As in all countries facing economic difficulties, the temptation to look outward is increasing.

The first problem is the outstanding mortgage debt. It is estimated at \$6.8 trillion and many developers are virtually bankrupt. According to Capital Economics, the empty homes could house 340 million people. The real estate sector, which in some years accounted for nearly 10% of GDP, is thus in a long-term slump. In June, real estate sales were half the 2021 level in the country's top hundred cities. The value of inhabited real estate is estimated at \$24.1 trillion, a high figure that could fall. Household wealth is weakened because more than 70% of their savings are invested in real estate. According to the World Bank, 96% of urban households own at least one home compared to 65% in the United States. Local government support for the real estate sector is hampered by \$4.5 trillion in debt. Similarly, many banks are experiencing liquidity problems.

The second problem is that youth unemployment affects 1/5 of 16-24-year olds and even graduates are unemployed. Already in 2021, the South China Morning Post highlighted a decrease in business start-ups, 1.3 million compared to 6.1 million in 2020 and 13.7 million in 2019, and noted an increase in bankruptcy filings of small businesses.

The third problem is the country's overall debt. It represents 2.8 times GDP. While public debt is quite low, Chinese corporate debt is equivalent to 1.6 times China's GDP, double the percentage of US corporate debt, and household debt, more than 130% of gross disposable income, is much higher than US debt, 75% of gross disposable income. As a result of indebtedness, investments in the Silk Road have decreased sharply to \$59 billion in 2021, half the amount in 2019, as many countries are struggling to repay.

The fourth and most fundamental problem is demography. The number of children per woman, which had fallen to 1.3x in 2020, far from the 2.1x needed to maintain the population, fell further in 2021 as births fell to 10.6 million in 2021, the lowest figure since 1949 compared to 14.6 million in 2019. The labour force is shrinking, ageing is rapid, the median age, 40, is now higher than in the United States, and India's population will surpass China's by 2025.

**The Risks:**

To better discern the risks presented by a Chinese intervention, let's look at 4 points:

- ***The cost of a blockade:***

An economic blockade of the island by China would be difficult to achieve and would penalise the Chinese economy because in the South China Sea, where a third of the world's maritime trade transits, 90% of regional traffic is to or from China.

The current live-fire operations are partly a bravado offered to the Chinese population dissatisfied with the management of Covid, high unemployment and the real estate crisis.

Democracies are paying attention to these operations.

After the United States, Japan is breaking out of its ambiguity towards Taiwan and has asserted that Japan's security is linked to peace in the Taiwan Strait. Japan, after having five Chinese ballistic missiles land in its exclusive economic zones, is worried, especially for the island of Yonaguni located a hundred kilometres from Taiwan and Tokyo, yesterday under Abe and today with Kishida, is increasing its military spending and will continue to host the major American bases in Okinawa.

In Europe, the European Parliament in 2021 has spoken out in favour of developing relations in all areas with Taiwan and has repeatedly criticised China's pressures.

With the Southeast Asian countries, Taiwan is developing relations with the ASEAN countries. Taiwan signed free trade agreements with Singapore, Malaysia and Vietnam in 2013. And with Singapore, a defence and security agreement was reaffirmed in 2021. Malaysia and Indonesia are also among Taiwan's partners.

In Africa, Taiwan, long side-lined by Chinese pressure, is taking advantage of the disappointments caused by the Silk Road to make a comeback.

- ***Political and economic ties between Taiwan and the United States:***

Since 1979, ties between the United States and Taiwan have been strengthened with the signing of the Taiwan Relations Act, the TRA, which provides for the United States to supply the necessary defence assets. This commitment has since been reaffirmed on several occasions. While the TRA does not provide for automatic intervention, there is little doubt the US will stand firm in the event of a war between Taiwan and China. Donald Trump promised 66 F-16 to Taiwan, Joe Biden reaffirmed US opposition to the challenge of the status quo on Taiwan, and arms sales have increased. The situation is therefore different from that of Ukraine, which does not benefit from an assistance agreement with the United States.

In semiconductors, digital and renewable energy, the economic ties between the United States and Taiwan cannot be underestimated. Two-thirds of TSMC's revenue is with US companies and the bulk of the most miniaturised chips are produced by TSMC. It is impossible to imagine the Americans letting China get its hands on TSMC after a takeover of Taiwan. The United States cannot deprive itself of Taiwan's semiconductors because the \$50 billion investment plan on American territory has just been voted through.

- ***The cost of possible sanctions in the event of an attack:***

As a major trading power, China would have much to lose from economic sanctions. An invasion resulting in the destruction of Taiwan's semiconductor factories or other advanced technologies would affect China and other developed countries. To better assess the economic risks for China, let us consider three aspects:

Today, the only engine of Chinese growth is exports. In 2021, with a GDP of \$16.8 trillion, Chinese exports reached \$3.35 trillion, the equivalent of German GDP. The trade surplus recorded a record value of \$675 billion, including \$400 billion with the United States and nearly \$200 billion with other Western countries, a windfall it will avoid depriving itself of. In March 2021, at its peak, Chinese exports accounted for 15% of global exports compared to 8% for the United States and 8% for Germany. For the month of July this year alone, Chinese exports, \$332 billion, are up 18% year-on-year. Regardless of ties with the United States, exports to the EU amount to \$36 billion/month and the trade balance in 2020 between China and the EU was in favour of the Chinese at \$180 billion. So, we might as well not be deprived of it, especially

in the run-up to the Communist Party Congress in October of this year. Russia is not an alternative because sales to Russia in 2021 were not even two months of sales to the EU.

Secondly, China benefits from foreign investment in its territory, which could disappear in the event of a conflict. In 2021, according to UNCTAD statistics, China received \$180 billion.

Finally, China has many technology companies listed in New York, which are better valued than on the Chinese market and better able to carry out capital transactions.

- ***The cost of a US/China split:***

The two economies are closely linked economically. Despite the trade war unleashed by Donald Trump in 2018, Chinese exports, since then, have increased by 1 trillion. About 18% of China's exports go to the United States. In the first half of 2022, the US trade deficit with China reached a record high of \$200 billion.

China is far from self-sufficiency and the "China 2025" technology independence plan is not finalised.

So, let's bet that China will not take the risk of an invasion.

***Conclusion: "I do not think we will see another major war in our lifetime. Today, war is sterile," Churchill's speech in 1931.***

Such a speech from the mouth of a man of Churchill's quality, a few years before the outbreak of the Second World War, shows the vanity of foresight and allows us to understand the anxiety of the stock markets each time there is renewed tension with Russia or with China. Let's remember 3 points to finish:

- ***Extent of Chinese fears:***

In Taiwan, since 1996, the President and Vice President have been elected every 4 years by universal suffrage. Their term of office is renewable only once. The regime guarantees freedom of expression, freedom of education, freedom of religion, the right of popular initiative and referendum. This right of referendum prohibits any government decision in favour of reunification that is not desired by the population.

The success of democracy in Taiwan contradicts the discourse on the incompatibility between China and Western values. Like Ukraine for Russia, Taiwan offers China an example of democracy whose leaders fear contagion. In 2024, when elections are due, the current president will not be able to stand again. We will observe the positioning of the two major parties: will the current party in power go so far as to proclaim independence? And, what line will the Kuomintang, historically favourable to China but has not won an election since 2008, adopt?

- ***Extent of the Chinese reaction:***

In recent years, China has worried the world as much by its demonstrations of strength as by its manifestations of weakness, as much by its economic initiative of the Silk Road or its military operations off the coast of Taiwan as by the risk of bankruptcy of real estate developers and the slowdown of its growth.

In recent days, Beijing's outraged reaction to Nancy Pelosi's visit is matched only by the country's powerlessness to react. The recent Chinese exercises around Taiwan show an ability to ensure a blockade of the island but nothing about the capacity to land Chinese troops, and they only serve to further unite the Taiwanese against Chinese influence.

If China goes on the offensive, we do not know what form it will take – cyberattack, trade blockade, occupation of small islands belonging to Taiwan, landing in Taiwan. But one way or another, the Americans would intervene in defence. And, all of this has an impact on the stock markets.

- **Extent of China's political differences with democracies:**

In recent years, China has been asserting itself all over the world and increasing pressures: for example, in 2010 against salmon imports from Norway after Liu Xiaobo was awarded the Nobel Peace Prize, in 2020 against Australia when the country requested an international investigation into the causes of the COVID-19 virus, in 2020 when China tried to block the sale of weapons systems by France to modernise frigates sold to Taiwan in the mid-1990s, in 2021 against Lithuania which had opened a "Taiwan Representative Office" instead of calling it "Chinese Taipei".

After the full takeover of Hong Kong, the "one country, two systems" model posted to Taiwan since 1979 no longer has credibility. Nevertheless, attacking Taiwan presents a major cost to China, an uncertain economic benefit if the island is destroyed, a risk of recession, a negative impact in terms of its image, and will exacerbate the regime's economic difficulties. Therefore, one should keep in mind the words of Sun Tzu: **"There is no instance of a nation benefitting from prolonged warfare."**

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