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**PRESIDENT'S REPORT:
THE US-TAIWAN BUSINESS COUNCIL & U.S.-TAIWAN RELATIONS - 2007
December 6, 2007**

The US-Taiwan Business Council had another strong year in 2007. We have seen solid economic growth in the US-Taiwan-China relationship, along with some interesting mergers and acquisitions activity - particularly in the technology, banking and finance sectors. In addition, the continued turbulent relationship between Taiwan and the United States and a non-existent relationship between Taiwan and China has left much work for the Council as it seeks to play its role as a robust voice for U.S. industry in Taiwan.

In January of 2007, we could point to only one thing in US-Taiwan relations as a significant net positive - the economic relationship, where bilateral economic ties and the Trade and Industry Investment Agreement (TIFA) process was moving forward. In contrast, the political/military relationship remained in deep distress. There had been little movement on funding President Bush's April 2001 arms package - it was still languishing in the Legislative Yuan (LY) - and we saw continued friction with President Chen and his Taiwan identity politics. President Bush's colleagues throughout government publicly and privately voiced deep frustration over the lack of a national consensus on basic defense and security imperatives, as well as on President Chen's apparent unwillingness to take U.S. regional concerns into consideration when promoting Taiwan's aspirations for greater global relevance.

What a difference a year can make.

The Economic Relationship Goes From Strength To Strength

The leadership of Ambassador Karan Bhatia (who regrettably has stepped down from his post as number 2 at the United States Trade Representatives' office), coupled with the hard work of Tim Stratford and Eric Altbach (now at the National Bureau of Asian Research), deserves much of the credit for continued progress in the bilateral trade relationship.

There has been a careful adjustment in expectation by both sides as they have set their sights on "building blocks", with continued progress in major areas including intellectual property rights (IPR) and agriculture. The TIFA process is a framework well able to handle bilateral trade issues typical of any major economic relationship, and its rejuvenation is most welcome.

The IPR story particularly has come far enough for the USTR to remove Taiwan from the IPR 'Watch List'. While Taiwan's education system remains a problem, with the use of its intranet as an illegal platform for file sharing, the progress Taiwan has made in all other areas is reason enough to remove it for a year. There should be an explicit understanding however, that Taiwan will go back on the list if similar progress isn't made on the remaining issues.

In addition, both Taiwan and the United States have had preliminary discussions surrounding the launch of both tax and investment agreements. U.S. industry has shown considerable support for both initiatives, and the Council expects both bilateral agreements to pick up steam in 2008 after Taiwan concludes its elections this coming winter. These two areas constitute the core of our bilateral relationships building blocks, and should receive the full support of industry.

Mergers & Acquisitions (M&A) activity in Taiwan has remained heavy as increasing pools of global capital are looking at Taiwan as an investment opportunity. The largest sector to benefit has been banking, where myriad banks have been purchased both by private equity as well as by large global banks such as Citigroup and Standard Chartered. These institutions are looking at a double opportunity. They lead in the



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consolidation of Taiwan's over-banked economy, helping whittle down the number of institutions from the high 50s to approximately 10 national banks. In addition, it is apparent that 2008 will herald a significant uptick in cross-Strait liberalization, which will likely include the granting of licenses for Chinese and Taiwan banks to open in their opposite markets. This represents a huge opportunity for global financial institutions to enter China in a "Trojan Horse", and benefiting from banking China's most successful investment class, i.e. Taiwan entrepreneurs and businesses.

Financial services isn't the only area where Taiwan is seeing an increase in M&A interest and activity, with capital flowing to sectors as varied as manufacturers of golf equipment, bicycles, cable, and semiconductor chips. The fact is that Taiwan companies remain undervalued as a function of poor macroeconomic management by the Taiwan government. In addition, legacy China investment policies have forced Taiwan companies into business decisions that have meant that they don't fully realize their value in China. Any significant improvement in cross-Strait investment policy should release some of this pent up value and represents a potential boon to well placed investors.

As 2008 approaches, it would be useful to set some expectations and goals for the year in bilateral economic ties. The present momentum in the trade relationship warrants a continued response from the Bush Administration, which should include the removal of Taiwan from USTR's 'Watch List' as well as a formal launch of bilateral negotiations on tax and investment. Nevertheless, we shall surly continue to see challenges in beef, pork and rice, as well as in pharmaceuticals. The reality is neither the agricultural nor the pharmaceutical issues have easy fixes, and progress will require patience, commitment and flexibility from both sides. All said, however, 2008 is shaping up to be another positive year in the bilateral economic relationship.

Free Trade Agreement

The Council remains committed to promoting a US-Taiwan Free Trade Agreement (USTFTA). It remains imperative that the United States provide the necessary leadership in the Asia Pacific region to ensure that Taiwan is not marginalized in the process of bilateral and regional Free Trade Agreements. An economically strong and integrated Taiwan is both a positive for American companies as well as a force for tension reduction.

It is clear that the United States domestic political scene is not conducive to the launch of new FTAs, given the split in control of Congress and the White House and the lack of a political consensus on the launch, negotiation and conclusion of such agreements. That said, however, the effort to bring Taiwan into the World Trade Organization lasted fully 10 years prior to its January 1, 2002 accession, and went through many periods of uncertainty. The Council, as it did in the 1990s, should remain a clear voice for the interests of its membership in the market, which includes the opportunity to gain significantly improved market access through a Free Trade Agreement.

Defense & Security

As 2007 began, bilateral defense & security relations were abysmal. While military-to-military exchanges continued to show progress and to add value, a lack of consensus on defense spending in the Legislative Yuan cast a shadow over Taiwan politics and exacerbated deep tensions in the U.S.-Taiwan security relationship. The failure to pass a government budget in the winter session (2006-2007), which included no passage of the defense budget, represented the low point in DPP-KMT LY relations. The matter continued to affect bilateral relations through June of this year, with both analysts and government officials all unsure as to the ultimate outcome.



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Finally, in June the LY did indeed pass the budget, and unexpectedly the defense budget represented a change in both size (% of GDP spent) as well as in the attitude towards certain politically-charged purchases (P-3C). The LY passed a budget with money for PAC-II upgrades, P-3C aircraft and F-16s, representing total spending of 2.85% of GDP. This percentage ended up being somewhat inflated, as the F-16 money regrettably went unspent.

Taiwan's request to submit a Letter of Request (LOR) to purchase F-16s has unfortunately been handled very poorly. After spending the better part of 4 years chastising Taiwan for its failure to budget for force modernization programs, the Bush Administration is using the F-16 sale to telegraph its displeasure specifically at Chen's referendum on Taiwan application to the UN under the name Taiwan. America has always worked to ensure that our long-term defense commitment to Taiwan (not to any sitting Taiwan president) does not fall prey to short term disagreements in the bilateral relationship, and therefore this turn of events is worrying.

Nevertheless, the passage of the 2007 defense budget in June provided a welcome respite to 3-4 years of stalemate and of the systematic erosion of Taiwan's force modernization efforts. Meanwhile, China's massive force modernization and transformation has gone on unabated, and Taiwan must accelerate its own efforts if it is to maintain enough of a deterrent capability against Chinese adventurism or for it to enter into negotiations from a position of military strength.

I returned from a mid-November trip to Taiwan with the belief that it is poised to pass a 2008 defense budget that would be its most significant and important budget in a decade. It will spend close to 3% of GDP with new commitments on Apache attack helicopters, Blackhawk transport helicopters, F-16s, and PAC-III anti-missile systems. In the case of latter, the PAC-III was an important breakthrough and represented a significant change of position for the majority KMT in the LY. This change in position should be attributed to Ma Ying-jeou, who appears to be genuinely attempting to put his party on a firmer defense footing prior to the presidential election and what he no doubt believes will be a KMT victory. As with almost all legislation in this session (shortened due to the January 12 legislative elections) we can expect the defense budget to pass on or around December 31, 2007.

The passage of the 2008 budget will place considerable pressure on the arms sales process in Washington, D.C. As we recently witnessed in the aborted docking of the Kitty Hawk battle group in Hong Kong, among other cancelled bilateral China-US military exchanges in 2007, the Chinese demonstrate that these actions are viewed to be more in our interest than their own. We can expect them to demonstrate their displeasure in such a way in the future.

The Bush Administration handling of the F-16 LOR demonstrates that we must remain vigilant as a community. There remains a clear division between America's defense commitment to Taiwan, the balance of power in the Taiwan Strait and the Status Quo, and US-China relations - whether regarding Taiwan or in any other bilateral or multilateral matter. It will be easy to let the clock run out through January 2009, but the balance of power in the Taiwan Strait requires a far greater urgency.

Legislative & Presidential Politics

I arrived in Taiwan in mid-November convinced that Frank Hsieh and the DPP were well positioned to win the March 22 presidential election. Hsieh had closed the gap between the DPP and the KMT that was prominent this past summer and early fall, and the presidential discussions were well fixed on issues surrounding Taiwan identity politics and the issue of Taiwan's application to the United Nations (whether under the name Taiwan as proposed by the DPP or under the name Republic of China as proposed by the KMT). This was coupled with Ma's curious decision to disappear into southern Taiwan to acquaint himself with rural citizens



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by spending time on farms and in mountain villages at the very time when the KMT were enjoying both a lead in the polls and momentum on economic issues.

But a very public spat has broken out between President Chen and the DPP presidential candidate Frank Hsieh over cross-Strait economic policy. President Chen appears to play the role of champion of the Deep-Green faction (the most radical activists and strongest advocates for Taiwan independence) of his party and appears unwilling to give Hsieh the running room he requires to campaign in the center of the Taiwan political spectrum. This damages Hsieh's candidacy, while providing the KMT with a lightning rod issue that not only plays to their strength but also exacerbates internal DPP tensions. The disagreements between Hsieh and Chen are unlikely to remain contained around China economic policy, and Hsieh will surly find himself fielding attacks from both the KMT and from factions of his own party through to the election.

The March 22 election is likely to primarily be fought over who can press to their strengths better. It is good to see that both candidates are articulating proactive liberalized cross-Strait economic policies. Both are showing a practical approach towards removing many of the legacy barriers placed on trade with China, such as the 40% investment cap (China investment by Taiwan companies is capped at 40% of their net worth), while also advocating more transparency and speed when reviewing applications for mainland investment. This includes important technology areas, such as advanced technology semiconductor investment. The recent Intel announcement to invest in Dalian at 300MM should provide important leverage for Taiwan business and could result in a number of 300MM licenses being awarded in the 3rd and 4th quarters of 2008, regardless of the presidential victor.

A change in tone and some substantive practical changes on cross-Strait trade and investment can only benefit Taiwan's economy, and the extent of the gain should only be contingent on the boldness of the changes. The incoming president has an opportunity to both allow for Taiwan corporate consolidation - as offshore China businesses are consolidated with domestic legacy businesses - as well as to free up the depressed value in Taiwan businesses as a consequence of investment restrictions.

The areas neither candidate has addressed in nearly enough detail pertain to domestic macro-economic reform - government regulation and the lack of transparent process for investments - as well as to the significant parts of the Taiwan economy, such as power and energy, that remain subservient to a state owned industry and to heavy government regulation. There is tremendous value locked into these sectors, and Taiwan's economy would benefit greatly from the flow of capital and competition should the government choose to deregulate and privatize these sectors.

What it means for the U.S.

The United States is put in the enviable position of having two Taiwan presidential candidates it can work with, as they both take practical approaches to challenges such as China trade and defense and security. There is also the added upside of having Chen Shui-bian no longer in the equation - he has become hopelessly polarizing in both his own country as well as in the relationship with America, and his leaving will be a net gain.

However, holding elections is not a foreign policy end unto itself. The United States still has significant adjustments to make in its own expectations regarding Taiwan and its democratic evolution. Simply because Chen is no longer president does not mean that America's challenges in dealing with Taiwan identity issues will pass or that we can further downgrade Taiwan as an Asia-Pacific priority.

As America has made a particular point of personalizing the US-Taiwan relationship around its relationship with President Chen, the Bush Administration is under an obligation to respond positively to the arrival of a new Taiwan leader. Taiwan should be viewed as part of America's success in Asia, and this should represent



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a change in tone as well as a change in substance - setting up a bilateral relationship viewed in a positive, substantive way for the incoming U.S. president in 2009.

The Council recommends that the Bush Administration set the following immediate goals for America's relationship with Taiwan in 2008.

- To improve senior level exchanges, thereby improving the quality of dialogue and reducing the likelihood of a repeat of the worst of the Chen years.
- To publicly welcome the passage of Taiwan's 2008 defense budget by allowing the submission of a Taiwan's Letter of Request (LOR) and allowing the purchase of F-16 aircraft to move forward.
- To launch bilateral negotiations on tax and investment agreements.
- To remove Taiwan from the USTR's IPR 'Watch List'.

The Council remains committed to promoting the US-Taiwan relationship, and we thank our entire membership, colleagues and friends for their support in 2007.

I wish you every happiness and success this holiday season and in 2008.

Sincerely yours,

Rupert J. Hammond-Chambers
President
US-Taiwan Business Council