

PART IV

SECURITY FAULT LINES

TAIWAN AND OTHER POTENTIAL CONFLICTS

BACKGROUND AND CURRENT STATUS

The current and recent status of relations between the People's Republic of China (PRC) and Taiwan can be characterized as movement without progress. Both China and Taiwan have been admitted to WTO membership. Trade and investment relations between them—mainly conducted indirectly through Hong Kong—continue to flourish, and the tone of occasional rhetorical exchanges between them though rarely warm is not bellicose. These exchanges have been periodically propitiated by official PRC endorsement of bilateral conversations between business groups in Taiwan and mainland China on the subject of direct economic linkages between the two.

The status quo entails benefits for both the PRC and Taiwan, as well as the United States—especially when compared with some of the possible alternatives to it and the paths that might be associated with movement toward these alternatives. Thus, the status quo allows the PRC to concentrate its resources—physical and financial resources, and especially the key resources represented by the time and attention of its new leadership—on the numerous difficult challenges described in the preceding chapters of this study.

Similarly, the status quo enables Taiwan to pursue its overdue efforts to restructure and reform an economy overly dependent on exports and distorted and corrupted by decades of the KMT's (Taiwan's Nationalist Party's) overt and covert penetration of political influence into industry and finance, as well as efforts to enhance and mature its impressively evolving democracy.

The status quo also enables the PRC and Taiwan to accommodate their respective WTO commitments without jeopardizing this process by political or military conflict between them. Furthermore, the status quo has the considerable benefit for both parties of extending the time horizon in which leadership and institutional changes in the PRC may move in political and economic directions that would be more congenial to and compatible with those in Taiwan, thereby facilitating unification, or at least harmony, between them in the longer run.

From the U.S. point of view, the status quo also has major advantages. It enables the United States to pursue its top-priority national security focus on the complex, multifaceted war on terrorism, with at least modest support from both the PRC and Taiwan, and without the serious distraction that a possible crisis in the Taiwan Strait would create.

However, the status quo also entails consequential risks for the parties—risks that may lead to destabilizing moves by them with serious consequences. For example, from the PRC's standpoint, continuance of the status quo, including Taiwan's admission to the WTO as a customs entity, may further enhance Taiwan's *de facto* stature as an independent state. For Taiwan, continuation of the status quo entails a possibly increased risk of its being "encircled," isolated, or even shunted into irrelevance by China's plausible ascent to a dominant economic, political, and military position in the Asian region. Among the indicators of this possibility are the following:

- Expressions of concern by Taiwan's top leadership that it faces "growing business pressure" (from Taiwan as well as U.S. and other foreign business interests) to establish the "three links"—trade, aviation, and postal service—between Taiwan and the mainland.
- Increasing advocacy by some Asian governments and academics of movement toward an Association of Southeast Asian Nations (ASEAN)-China Free Trade Zone, along with the possible future establishment of the Chinese RMB as a zonal currency for the trade zone.

THE POSSIBILITY OF SERIOUS DETERIORATION FROM THE STATUS QUO

One of the major adversities that could derail China's sustained economic growth is a possible deterioration of the status quo from relative quiescence to tension, hostility, and military conflict. The deterioration might escalate from a blockade to a missile attack from the mainland, and even to invasion.

Security analysts in Taiwan envisage scenarios at the second and third rungs of this escalation ladder as plausible possibilities. They envisage that the PRC might "launch a series of missile strikes to damage or destroy" Taiwan's air bases, runways, radar stations, and port facilities, "to enable the PLA [People's Liberation Army] air force and navy to secure air and sea control in the Taiwan Strait" and to create a "tremendous psychological impact on civilians [that] could compromise Taiwan's emergency mobilization and morale."¹ Some Taiwan security analysts suggest that China's 150-plus ballistic missiles would be able to accomplish these results and thereby pave the way for special forces and rapid reaction forces from the mainland to invade and physically occupy, control, and "reunify" Taiwan with the mainland.

While this scenario is not entirely unrealistic, there are numerous technical and logistic reasons for skepticism about its practicability. Furthermore, this scenario would appear to be a distinctly less favored option were the PRC's leadership to decide to use coercive force to resolve the Taiwan issue.² One major reason why such an escalatory strategy would be less favored is that its outcome might be precariously ambivalent, conceivably even resulting in a loss by the PRC, thereby seriously damaging the leadership's stature and the legitimacy of the PRC regime. Among the factors that could lead to this outcome are Taiwan's recent and prospective military en-

¹Andrew Yang, *Cross-Strait Arms Competition and Impact on East Asia Security*, Asia-Pacific Center for Security Studies Conference on "Conventional Arms Rivalry in the Asia Pacific," Honolulu, Hawaii, October 2001.

²See David Shlapak, David T. Orletsky, and Barry Wilson, *Dire Strait? Military Aspects of the China-Taiwan Confrontation and Options for U.S. Policy*, RAND, Santa Monica, Calif., MR-1217-SRF, 2000.

hancements from U.S. weapons sales, including F-16s, AEGIS missile defense, and diesel submarines.³

Instead, a more plausible scenario for use of coercive force by the PRC to accomplish its reunification objective is one that RAND developed for a political-military-economic war game conducted for Taiwan's National Security Council in 1999. Although this scenario would confront the PRC with possible U.S. intervention, the likelihood of intervention would perhaps be diminished because the challenge would be more ambiguous than in the scenario previously described.

In the scenario that we believe is more plausible, the precipitating circumstances and responses to them would be more gradual and ambiguous. Consider the following sequence of events. The PRC might become increasingly frustrated and antagonized by Taiwan's accumulating success in enhancing its international stature through diplomatic initiatives, military modernization, international economic cooperation, and its own national economic performance. Reflecting the PRC's repeated and unheeded expressions of concern and aggravation about these affronts to its sovereignty, the PRC might, in this scenario, be moved to deliver a definitive warning to Taiwan expressing Taiwan's obligation to rescind these hostile moves, or face serious consequences.

If, as would be likely, Taiwan refused to accede to these demands, instead calling them threatening and confrontational, the PRC might plausibly declare a blockade of Taiwan's two principal ports, Keelung and Keelung. Such a blockade could be enforced by perhaps a dozen initial missile launchings in areas adjacent to the sea lines of communications (SLOCs) approaching these ports. The PRC might then formally declare that merchant ships entering these SLOCs would be subject to the risk of attack unless they were to reverse course upon receiving warning from Beijing.

³Indicative of this possibility is the recent purchase by a unit of U.S. Bank One of a 75 percent controlling stake in a German submarine producer; prior to this acquisition, it was unclear whether and how the United States could include diesel submarines in its possible sales to Taiwan because of a lack of production facilities for making them. See WSJ, June 13, 2002. See also Yang, 2001, *op. cit.*, pp. 7-9.

Taiwan's economy would be extremely vulnerable to such a blockade. Its foreign trade is about 75 percent as large as its GDP, and 95 percent of Taiwan's energy consumption is imported. Of the total volume of its sea traffic, about 30 percent is carried by Taiwan's own merchant fleet, an additional 20 percent by "convenient-flag" vessels registered in other countries by Taiwanese firms, and more than 50 percent of the traffic is carried by ships of other countries. The latter would, very likely, be especially sensitive to and probably deterred by the PRC's blockade. Insurance premiums for commerce in the Taiwan Strait would drastically rise. In the wake of these events, a near-panic wave of stock market selling might ensue in Taiwan. The Taipei stock index could well plummet within a few days by 30 or 40 percent (say, from 5,400 to 3,000), the Taiwan yuan might depreciate sharply from, say, 34 per U.S. dollar to 40–45—the lowest value in the past decade.

While there would be significant repercussions on the mainland in the Shanghai and Shenzhen stock markets, these repercussions would likely be less severe—perhaps reducing market capitalizations by 15–20 percent, rather than 30–40 percent. However, foreign direct investment and foreign portfolio investment in China would likely cease completely in the short- to mid-term.

Under these circumstances, the key question that would arise pertains to the U.S. reaction, as well as anticipation of this reaction by the PRC. U.S. reaction is not a foregone conclusion. Were the United States to be deeply immersed in Operation Enduring Freedom (the Pentagon's umbrella label for the global war against terrorism)—perhaps along with reaffirmation by the PRC of its support for that effort—and were the circumstances surrounding this scenario sufficiently shrouded in ambiguity, and were the United States perhaps to be further distracted by such other events as proliferation of weapons of mass destruction to one or more terrorist organizations with the support of one or more of the "axis-of-evil" powers, then the United States might plausibly be expected to avoid committing forces to support Taiwan.

However this sequence of events might develop, and indeed in advance of its occurrence, the growth of tensions between the PRC and Taiwan would have serious effects on the economies of both China and Taiwan. RAND's most recent forecasts of China's economic

growth between 2000 and 2005 placed its average annual rate at about 5 percent. Associated with this growth, we estimated China's military spending in 2005 to be \$31–\$46 billion in 1998 U.S. dollars at nominal exchange rates and \$152–\$228 billion in 1998 U.S. dollars at purchasing power parity rates of exchange, with China's accumulation of military capital placed at \$84–\$106 billion at nominal exchange rates and \$295–\$374 billion in purchasing power parity rates.⁴

Since these estimates were made in 2000, China's military spending has increased more rapidly—approximately 14 percent in real terms per annum—than our estimates envisaged. Under the circumstances assumed in the scenario outlined above, it would not be unreasonable to anticipate that ensuing reallocations from other uses (and especially for meeting other resource claims arising from the various types of adversities described in the preceding chapters of this study) would further boost China's military spending by perhaps an additional 10 to 20 percent. As a further consequence, the rate of growth in the civil capital stock posited in our previous estimates might fall from 8 to 9 percent annually by as much as 2 percentage points to a lower annual figure, between 6 and 7 percent, while the average annual rate of growth in total factor productivity would plausibly decline by, say, 0.5 percent.⁵

The result of these reallocations can plausibly be estimated as reducing China's rate of economic growth by between 1.0 and 1.3 percent per year.⁶ In addition, it can be plausibly inferred that foreign direct investment would severely shrink, not simply in the short run during the crisis in the Taiwan Strait, but for a lengthy period. This would result from a combination of increased allowance for risks, from higher costs of cargo insurance, from exchange rate uncertainties, and from reduced means and increased costs of hedging these risks.

⁴See Wolf et al., 2000.

⁵See *ibid.*, pp. 34–36 and pp. 88–89. See also Figure 1.1 in the above chapter showing the interactions referred to in this text.

⁶This rough estimate is derived by applying the capital share (0.4) in GDP to the assumed reduction in the growth of capital stock, plus the assumed reduction in TFP: Reduction in GDP growth = (0.4)(0.02) + (0.005) = 1.3 percent.

This chain of circumstances is what we referred to earlier⁷ as China's risk-adjusted, after-tax return on investment, compared with that in other emerging markets and in capital-exporting countries themselves. Investing in China would become less attractive for foreign investors compared with investing elsewhere.

The ensuing impact on the Taiwan economy would be even more grievous, despite the considerable efforts that Taiwan has been making both to upgrade its defensive capabilities against missile attack on the island and against its SLOCs. These efforts and their associated expenditures involve effective early-warning radar systems to detect multiple missile threats over the horizon and acquiring land-based and sea-based missile defense systems and integrating them through better battle management and command and control systems. Taiwan's "defensive" efforts also include measures to acquire offensive capabilities against the mainland (including the submarine assets referred to earlier) for deterrent as well as war-fighting purposes.

However well those military enhancements proceed, they would hardly spare the Taiwan economy from deeply adverse consequences. Taipei's plans for economic restructuring would be indefinitely postponed; Taiwan's domestic capital markets and Taiwan's access to foreign direct and portfolio investment would be gravely undermined, and its socioeconomic outlook would sharply deteriorate.

OTHER CONFLICT POSSIBILITIES

While the Taiwan Strait is certainly the "wildest" card among conflict adversities facing China, there are several other "untamed" cards, as well. Although less grave, they would have unsettling repercussions throughout the region and, more specifically, negative effects on China's economic growth prospects.

There are four lower-level conflict contingencies that might involve China, as well as have serious consequences on it. Briefly summarized, they are as follows:

⁷See above, Chapter Eight, pp. 149 ff.

- Recurring and intensified *frictions in the South China Sea* over the issue of the PRC's sovereignty claims relating to oil exploration and exploitation in the South China Sea, and the extent of its claimed maritime waters. According to PRC claims, China's riparian rights extend 200 miles from any abutting island that is a part of China. China's claims are contested by Malaysia, the Philippines, Indonesia, and Vietnam, which contend that the riparian rights are limited to 12 miles from the nearest island claimed by China. Were China to attempt to enforce these claims by using its expanding naval capabilities, or to prevent the exercise of counterclaims by one or more of the Southeast Asian countries, adverse effects would ensue with respect to China's internal development, and especially with respect to its ability to attract foreign investment. These adverse effects would be consequential, though of smaller scale than those associated with a security crisis over Taiwan.
- As Chinese naval capabilities expand, periodic disputes in the past might recur between China and Japan over the *Senkaku/Diaoyu islands*, which are claimed by both countries. If, as seems not unlikely, Japan's own considerable naval capabilities were to contest and repel China's assertions of sovereignty over these islands, a serious confrontation between them could ensue.

Also, it is not implausible that political developments in Japan may be moving in the direction of a strengthening of relatively hard-line, antipiracy, and expanded naval and air force military capabilities. These developments might make a confrontation between China and Japan more likely in the future than it has been in the past.

Were such a confrontation to ensue, and once again reverting to Figure 1.1 in Chapter One, the ensuing heightened resource claims for military spending and military procurement in China would have consequential effects on slower rates of civilian capital formation and reduced total factor productivity, thereby lowering China's expected growth rates.⁸

⁸See above p. 164.

- Another contingency is one that might arise on the *Korean peninsula*. Were North and South Korea to become engaged in conflict—one that presumably would have been initiated or provoked by the north—China might be inclined, if not compelled, to support its communist neighbor. However the contingency might evolve, its effect on the allocation of China's domestic resources, and quite possibly on the further upward adjustment in expected rates of return required by foreign investors to allow for the added risks they would face, would have severely adverse consequences for China's economic growth.
- Finally, tensions between *China and India* might grow if, for example, the PRC's military and technical assistance to Pakistan were, or at least perceived by India, to add fuel to the Kashmir fires that India has attempted to extinguish. The result could be a resumption of the Sino-Indian border clashes of the mid-1970s and early 1980s, with possible further escalation beyond those prior clashes. Once again, the consequences for reallocation of resources in China—perhaps reducing rates of civil capital formation as well as of factor productivity growth—would have negative effects on China's prospective economic growth.

The bottom line of this summary of conflict contingencies that China may face in the coming years is simple: They constitute another of the numerous and serious obstacles and potential adversities that China confronts in its efforts to sustain high rates of economic modernization and expansion in the coming decades.