

Taiwan Post-Pelosi

By Brunswick's China Hub and Geopolitical Practice

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Nancy Pelosi Leaves Taiwan

US Speaker of the House Nancy Pelosi left Taiwan after a whirlwind visit that brought a furious response from China, including plans for three days of live-fire drills off the Taiwan coast – a significant military escalation with implications for regional shipping and supply chains.

Immediate implications for global businesses

Global businesses will feel the reverberations from Pelosi's visit for some time. Those operating in Asia should prepare for steadily increasing cross-Strait tensions, reflecting China's concerns that the US is retreating from its commitments to a "One China" policy, a cardinal concept that has kept the peace in East Asia.

Three risks in particular stand out:

Armed conflict, while remote in the foreseeable future, is not out of the question. Businesses must now at least consider the risk of supply chain mayhem as well as massive US sanctions.

A technological arms race between China and the US risks accelerating, with Taiwan caught in the middle. The CHIPS Act and the \$369 billion climate and tax package proposed by Democrats in the Senate are adding to a combustible mix. The semiconductor industry is rapidly becoming a new strategic flashpoint.

Political rhetoric on Taiwan is hardening in both the US and China. For instance, former US Secretary of State Mike Pompeo has publicly called for formal US recognition of Taiwan. China's position, too, is becoming increasingly inflexible. Over time businesses will face pressure to take sides. Already, China expects businesses earning profits in China to support the Chinese Communist Party's domestic and foreign policy priorities, and none is more important to Beijing than Taiwan.

Many foreign companies have faced a commercial backlash in China after publishing maps or making statements that suggest Taiwan is a separate country. Businesses can now expect added scrutiny — and tougher repercussions — if they tread on China's sovereignty-related "red lines" in the future.

Stock prices in Asia fell ahead of Pelosi's visit, but had rallied by the time she left Taiwan.

Looking ahead, there is now rising concern that in addition to whatever happens between China and Taiwan, Beijing may now reconsider other key foreign policies in response to what it regards as an act of diplomatic aggression — notably, its largely non-interventionist stance on Russia's invasion of Ukraine.

Trade and technology at the heart of Pelosi's visit

During her visit, Pelosi met the president of Taiwan, Tsai Ing-wen, and other senior officials along with human rights advocates, underlining US support for the island's democracy. But her trip also focused on trade and the all-important semiconductor industry at a time when the US is challenging China's efforts to dominate key technologies. Taiwan is an important part of that strategy, given that it produces roughly 90% of the world's most sophisticated chips used in everything from missiles to gaming consoles.

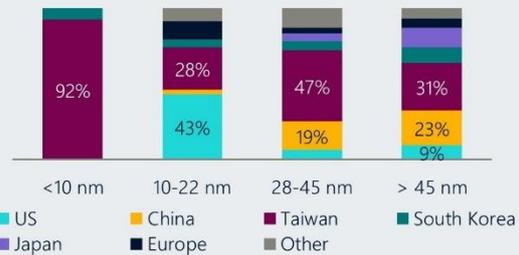
US top 10 trading partners in 2021 (trade volume in \$bn)



Source: US Census Bureau

Semiconductor manufacturing capacity by nanometer (nm)* in 2019 (% of total)

Taiwan holds **92%** of high-end (<10 nm) manufacturing



Source: BCG, SEMI fab database

*Nanometer: refers to the length of a transistor gate, the smaller the gate the higher the processing power.

Pelosi met both the founder of chip giant Taiwan Semiconductor Manufacturing Company, Morris Chang, as well as the Chairman, Mark Liu. TSMC is among companies likely to benefit from the CHIPS and Science Act passed by Congress last week that offers \$52 billion in incentives to build semiconductor plants in America. The firm is constructing a new facility in Arizona.

Trade and technology are now more clearly part of the geopolitical tug-of-war between China and the US over Taiwan, whose economy ranks 21st in the world.

China's angry response

China's Foreign Minister, Wang Yi, said Pelosi's visit "seriously breached the One China principle" and "maliciously violated China's sovereignty."

Live-fire drills will begin on Thursday, the day after Pelosi's departure, in six areas of water surrounding Taiwan, effectively blockading the island. The People's Liberation Army issued coordinates for the no-go areas where missiles are expected to splash down. In several places these intrude into areas that Taiwan claims as its territorial waters.

Beijing also increased the pressure on Taiwan's economy by halting exports of natural sand used in construction as well as semiconductor manufacturing. Previous trade sanctions against the island have targeted more symbolic items, like citrus fruit, along with tourist flows from the mainland.

Military escalation in the Straits

During the last Taiwan Straits crisis in 1996, China launched missiles that landed off the northern and southern tip of the island, although further out to sea beyond the boundaries of Taiwan's claimed territorial waters. The US responded to those actions by sending two aircraft carrier groups to the area, one of which sailed through the Taiwan Strait. It is not clear whether US and Taiwan military ships and planes will obey Chinese warnings and stay out of the no-go areas.

Over the past year, China has sent almost daily sorties of warplanes into Taiwan's Air Defense Identification Zone and across the median line that runs through the Taiwan Strait, a narrow strip of water that separates Taiwan from the mainland.

Military analysts expect those intrusions to increase in number over the coming days. They are watching carefully to see whether China escalates by sending planes or drones above the island itself, a move that could provoke a military clash.

Neither the US nor China want war. But a key risk is a military accident in crowded skies around Taiwan, or a collision between naval vessels.

Some of the world's busiest shipping lanes also pass by Taiwan, crowded with vessels carrying oil from the Middle East to Japan and South Korea, and exports from those countries to the rest of the world.

The stakes are much higher today than in 1996. Back then, relations between the US and China were on an upswing, while today they have plunged to arguably their lowest level since the two sides established diplomatic relations in 1979. The Chinese military has also dramatically increased its capabilities, and now boasts the world's largest navy.

But an amphibious Chinese invasion of the island would be a challenge unprecedented in modern warfare. Taiwan is the size of the Netherlands, with the population of Australia and the topography of Norway. The seas around the island churn in frequent storms. Only a few beaches are suitable for a landing, and Taiwan defenders have been digging in for more than half a century.

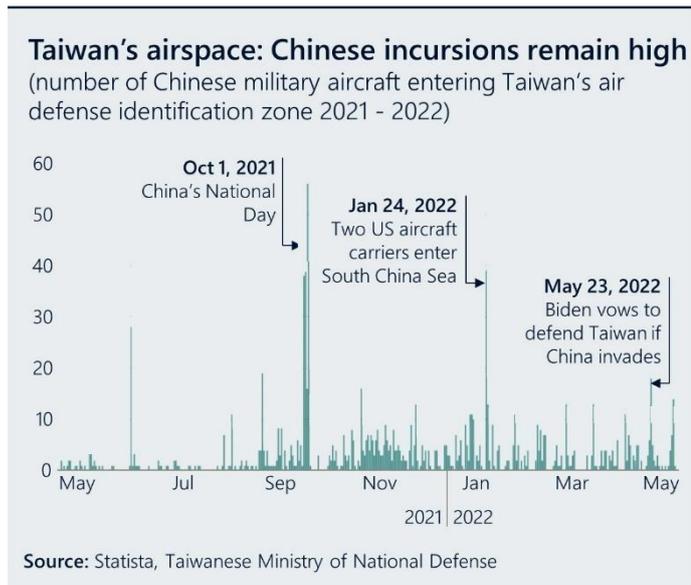
Nonetheless, Chinese President Xi Jinping is determined to achieve "reunification" with Taiwan as the culmination of what he calls the "great rejuvenation of the Chinese nation."

"One China Principle" versus "One China Policy"

When the US and China normalized ties in 1979, Washington recognized the People's Republic of China as the "sole legal government of China" — the one and only China. However, its "One China policy" does not go so far as to recognize that Taiwan is a part of China, which is China's "One China principle." The US merely acknowledges China's position that Taiwan is a part of China.

That delicate formulation allowed the US to have formal ties with China, and unofficial ties with Taiwan.

Pelosi's visit has further convinced Beijing that the US is abandoning its "One China policy," and that this shift is encouraging agitation for independence on the island.



Recent US relations with Taiwan

US imports of Taiwanese trade goods increased by +76% between 2001 - 2021

(trade volume in \$bn)

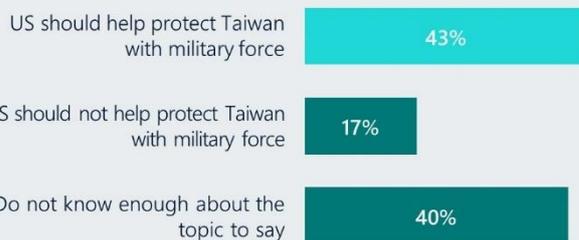


Source: US Census Bureau

The US has been steadily upgrading its relations with Taiwan since the Donald Trump administration. Pelosi, accompanied by four members of Congress, is the latest in a stream of US visitors that have included serving and former cabinet officials and military leaders. Taiwan's chief representative in Washington was invited to President Joe Biden's inauguration.

China has also been alarmed by Biden's pronouncements on several occasions that the US will defend Taiwan in the event of war, a shift from the official doctrine of "strategic ambiguity." White House aides each time have walked back Biden's comments, but China sees the rhetoric as encouraging Taiwan independence.

2 in 5 Americans believe US should help protect Taiwan with military force



Source: YouGov, survey of 3880 US adults, Aug 2, 2022

Q: In the future, if an armed conflict were to arise between China and Taiwan, do you think that the U.S. should or should not help protect Taiwan militarily from China or do you not know enough about the topic to say?

An ironclad guarantee to defend Taiwan would essentially write the island a blank check. Washington has always been concerned that such an assurance could encourage rash behavior in Taiwan, including a bid to formally declare statehood. Moreover, it would likely require the US to upgrade its military forces in the Asia-Pacific region and coordinate even more closely with allies, including Japan and Australia.

The danger is that China would seek to preempt such outcomes with military action.

Adding to strategic tensions, the US lately has been publicizing its efforts to train the Taiwan armed forces and prepare them for an invasion by adopting a "porcupine" strategy.

This doctrine calls for large numbers of small, maneuverable and cheap missiles, like the ones Ukraine has deployed to devastating effect against Russian invading forces. Until now, Taiwan has focused on large and expensive platforms like submarines and warplanes.

Scenario planning for Taiwanese businesses

The latest outbreak of tensions put Taiwan businesses in a bind. Since Tsai took power in 2016 she has pursued a "go South" strategy aimed at diversifying investments away from China to Southeast Asia, South Asia and elsewhere. Still, there is no substitute for the vast Chinese market. And China remains a magnet for talented young Taiwanese entrepreneurs, tech engineers, scientists and researchers. As many as one million Taiwanese live and work in China, out of a population of 24 million.

Many of the high-end semiconductors produced by TSMC end up in electronic products assembled across the Taiwan Strait on the Chinese seaboard, the world's factory floor. Strategic analysts debate whether semiconductor fabrication plants, known as "wafer fabs," in Taiwan act as a "silicon shield" for

the island or represent a potential prize for invading Chinese armies. The reality is that chip production is an immensely fragile process, dependent on intricate global supply chains, and wafer fabs would likely not survive a military onslaught.

Partly for that reason, war across the Taiwan Strait would devastate the global economy and derail China's economic rise.

Implications for international businesses operating in China

This is a somber moment for multinational corporations, which have spent decades investing deep and wide in mainland China, but now enter a new period of uncertainty. All, but especially US companies, must deal with the Chinese government tightening up scrutiny and regulation of their operations.

Many will be thinking how to reshape their business operations in China and come up with a feasible contingency plan.

Companies must assess the current state and scope of their business, their commercial health and locations, taking into account their existing network of stakeholders.

Brunswick's China Hub brings together the firm's expertise on China-related issues, working closely with senior advisors in our Geopolitical team to counsel clients.

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