

The 2008 Referendum: A Test for Cross-Strait Economic Interdependence

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There has been increasing speculation in recent weeks of a possible military stand-off in the Taiwan Straits in the early part of 2008 in the context of the proposed referendum on the island over Taiwan's membership to the United Nations (UN)—as 'Taiwan' (not 'Republic of China'). The referendum is to be held at the time of Taiwan's presidential election in March 2008 and the move comes even as Taiwan's last twelve attempts to join the UN as the 'Republic of China (ROC)' failed. The sources for the recent speculation on heightened cross-strait military tensions emanate from Chinese, Taiwanese and Western sources (both unofficial and official). The speculation is traced to two major developments in the past six months. The reshuffling of the top brass of the People's Liberation Army (PLA) in the run-up to the 17th National Congress of the Chinese Communist Party (CCP) is the first cause of worry.¹ It has been reported that at least five members of the new Central Military Commission (CMC) line-up have a background in Taiwan-related affairs.² They are:

1. Chen Bingde and Liang Guanglie (served as commanders [successively in the 1990s] of Nanjing Military Area Command—which is one of the most proximate military zones to launch an offensive against Taiwan).
2. Wu Shengli (Former Chief of Staff and commander of a navy base in Fujian province—which faces Taiwan).
3. Li Jinai and Jing Zhiyuan (Experts in missile deployment).

¹ Toshinao Ishii, 'Hu looks for new Taiwan approach But China's soft stance may change if moves toward independence continue', accessed 18 November 2007, <http://www.yomiuri.co.jp/dy/world/20071027TDY05306.htm>

² For details refer Fong Tak-ho, 'China reshuffle sends message to Taiwan', 2 October 2007, accessed 28 November 2007, <http://www.atimes.com/atimes/China/IJ02Ad01.html>

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The new military line-up is seen as a strong political message to Taiwan. The second major reason for fears of crisis in the Taiwan Strait in the early 2008 has been the intensification of the People's Republic of China's (PRC) military exercises in the Taiwan Strait over the past six months. The Taiwanese media has carried reports³ (citing experts) on 'unusual military exercises being conducted' in the coastal regions facing Taiwan—military drills with live fire. The United States Department of Defense 2007 Annual Report to the Congress⁴ also highlights that China's military modernisation and the deployment of advanced capabilities opposite Taiwan have not eased. The report hints that 'tension could also increase as Taiwan prepares for its next presidential election planned for March 2008'. It would also be pertinent to note that even during Indian Prime Minister Manmohan Singh's visit to China in January 2008, the Joint Statement entitled 'A Shared Vision for the 21st Century'⁵ was made to include a reference to the 'One China' principle:

The Indian side recalls that India was among the first countries to recognise that there is one China and that its one China policy has remained unaltered. The Indian side states that it would continue to abide by its one China policy, and oppose any activity that is against the one China principle. The Chinese side expresses its appreciation for the Indian position.

This is not the first time that PRC–Taiwan relations have witnessed the possibility of a military stand-off or threats thereof. Until the early 1990s, the political separation of Taiwan from mainland China was kept alive by both sides as a legacy of the prolonged civil war between the Communist party in China and the Kuomintang (KMT). The political contestation till then was clearly over which government legitimately represented the 'Chinese' state (Hughes 1997). Following the lifting of martial law in 1987 and the turn to a multiparty constitutional democracy in Taiwan, new political forces emerged on the centre stage. The Democratic Progressive Party (DPP) has acquired prominence on the Taiwanese political landscape—shifting the political discourse from 'reunification' to 'independence'. The PRC's response to the political dynamics on the island has been in the form of keeping alive the option of 'use of force', reiterated in a series of official documents, military signalling and law-making in China. These include:

1. PRC's first *White Paper on Taiwan* (August 1993),
2. Jiang's Zemin's 'eight points' offer to Taiwan, issued in January 1995,

³ See Charles Snyder, 'Expert warns on PRC's military drills', *Taipei Times*, 22 August 2007, p. 3.

⁴ *Military Power of the People's Republic of China 2007*, Annual Report to Congress, Office of the Secretary of Defense, Department of Defense, United States of America.

⁵ See Ministry of External Affairs, Government of India website URL: <http://meaindia.nic.in/> for the entire text of the Joint Statement.

3. Military exercises, including the launching of missiles, before the 1996 presidential election in Taiwan,
4. PRC's second *White Paper on the Taiwan Issue* (21 February 2000),
5. PRC missile exercises before the 2000 Presidential elections in Taiwan,
6. PLA military drills on Dongshan Island (involving about 18,000 troops) in the summer of 2004,
7. The Anti-secession Law of March 2005.

Add to this the ongoing military modernisation in the PRC and the regular discourse on 'reunification' emanating from the mainland, a clear message seems to emerge—that threats regarding 'use of force' against Taiwan cannot be ignored. However, as this comment suggests, the possibility of armed conflict in the Taiwan Straits has decreased over the years, particularly since the 'opening up' of the PRC in the Deng era and the consequent integration of both economies inter se and into the globalised world economy. The paper would examine the reasons why the nature of trade and investment between the PRC and Taiwan reduces the possibility of an armed conflict. It will also address vital questions relating to Taiwan's relatively greater economic and political vulnerability to economic pressure from mainland China.

TRADE AS VULNERABILITY

Over the past two decades, PRC–Taiwan relations have moved in a direction wherein despite the threat of war, the actual developments, influenced by bilateral, regional and global factors, have reduced the possibility of armed conflict in the Taiwan Straits. One key factor that holds some explanatory power in explaining the absence of bloody confrontation across the Strait seems to be the strengthening of economic integration between PRC and Taiwan.

Taiwanese firms were officially prohibited from directly trading with or investing in the PRC under Chiang Ching-kuo's 'Three Nos' policy of 1979 (no contact, no negotiation, no compromise with the PRC) (Sutter 2002: 524). The push for economic contact came with the new opportunities associated with the PRC's 'opening-up' policy in the late 1970s. The 1980s were difficult times for Taiwanese firms which were losing competitiveness in the labour-intensive production sector due to rising wages within Taiwan. With the incentives for investment in export industries in the PRC, the Taiwanese leadership allowed indirect trade between the two entities in 1987. Taiwan went on to liberalise indirect imports of mainland goods into Taiwan in June 1989 and in October 1990, indirect investment and technical cooperation were liberalised, thereby allowing Taiwan businessmen to register their investment on an approval list with the government (Smith and Harris 1997).

The PRC–Taiwan economic relations have been on an upswing ever since. In 1987, it is estimated by the Mainland Affairs Council⁶ (MAC) that the value of the total trade between China and Taiwan was only US\$ 1.5 billion (Smith and Harris 1997). Today, China is Taiwan's largest trade partner and top export destination with the value of trade between Taiwan and China grossing US\$ 88 billion in 2006.⁷ The largest portion of Taiwan's trade surplus comes from trade with China, as Taiwan exported US\$ 63.33 billion worth of goods and services to China, while importing only US\$ 24.78 billion worth in 2006. If Taiwan's trade with Hong Kong is included, Taiwan's trade with China accounted for 27.22 per cent of Taiwan's total foreign trade during the first five months of 2007.⁸ Likewise, according to the Investment Commission under the Taiwanese Ministry of Economic Affairs, for the period between 1991 and December 2005, 34,452 cases of large-scale investment in China involving US\$ 47.32 billion were approved. However, the present value of Taiwanese investments (the single largest source of foreign investment in China) is estimated by others at over US\$ 100 billion growing at a rate of four to six billion dollars per year (Yang 2006). According to one count, about 70 per cent of Taiwan's foreign investment ends up in the mainland (The Atlantic Council of the United States [ACUS] Issue Brief 2006).

However, Chinese exports to Taiwan as a percentage of Chinese total exports have increased only from 0.7 per cent in 1987 to 2.8 per cent in 2004, keeping the percentage of Chinese trade with Taiwan as a portion of total Chinese trade at 5.3 per cent in 2004 as compared to 2.1 per cent in 1987 (Singapore Institute of International Affairs Report 2006). Worried at the increasing outflow of Taiwanese capital to the mainland and the 'skewed' trade figures, the Taiwanese government has evoked 'threat to national security' as a main concern for Taiwan's economy.⁹ The 'hollowing-out' argument fears that the quantum of Taiwanese investment locked in the PRC (argued to be at the expense of domestic investment) could be used by the mainland to force political concessions. Two major policy shifts are cited in most literature (Chen 2003; Saunders 2005; Wong 2005; etc.) on cross-strait economic relations—Lee Teng-Hui's 'Be Patient, Go Slow' policy (*jieji yongren*, i.e., caution and self-restraint) of October 1996 and Chen Shui-bian's 2001 policy of 'Proactive Liberalisation with Effective Management'. Interestingly, the latter was further refined by President Chen Shui-bian in his 2006 New Year's Day address to 'proactive management and effective

⁶ Taipei and Beijing established special government agencies responsible for the overall planning and coordination of policy related to cross-strait affairs, namely the Mainland Affairs Council (ROC) and the Taiwan Affairs Office (PRC) respectively.

⁷ <http://www.mac.gov.tw/big5/statistic/em/173/6.pdf>

⁸ <http://www.mac.gov.tw/english/english/csexchan/rpt/174.pdf>

⁹ For an updated discussion on the security dilemma in economic integration see Fu-Kuo Liu, 'Cross-strait Development and Taiwan's Security Dilemma: A New Strategy for 2008', 26 April 2007, available at http://iis-db.stanford.edu/evnts/4865/Cross-strait_and_security_dilemma.pdf (accessed on 17 January 2008).

liberalisation'. This recent change in text, often confused with the earlier stance, is quite significant in many ways as it underlines the fears of 'hollowing-out' more explicitly.

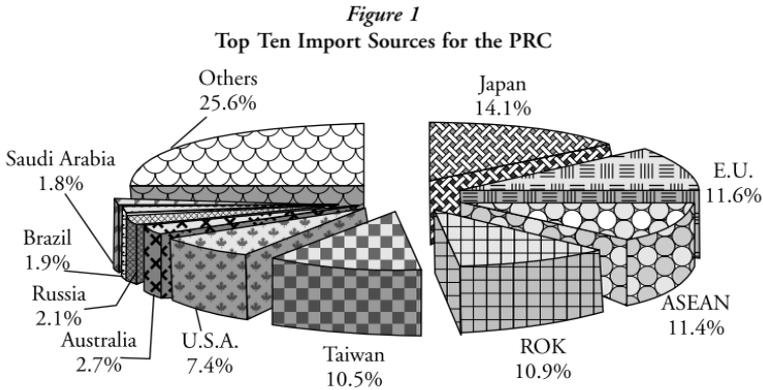
Ostensibly, Taiwan enjoys trade surplus primarily due to the high volume and value of exports to the mainland. However, does the imbalance in figures alone justify fears, both political and academic, that the nature of trade and investment dependence may not be 'two-way'? To appreciate the importance of trade and investment as a pacifying factor in cross-strait tensions, one has to understand the qualitative shift in the patterns of investment and trade from Taiwan to the mainland. Equally important is the need to appreciate the driving forces behind China's own growth over the past two decades.

CHINA'S 'ECONOMIC' RISE

China's double digit growth figures for the most of the past two decades has kept the PRC ritually in the news. The dynamic rise of China, primarily as an engine of cheap exports, reflects what has been called the 'disintegration of the production process'—the process through which companies spread their production activities globally, where each stage of production goes to the lowest-cost region. Consistent with this growth pattern, from 1992 to 2005 the composition of China's exports has undergone a qualitative transformation. There has been a significant decline in the share of agriculture and soft manufactures (textiles, apparel, etc.) with growing shares in hard manufactures (consumer electronics, appliances and computers) (Amiti and Freund 2007: 38). China recorded a US\$ 112.5 billion trade surplus¹⁰ in the first half of 2007 and the growth has been driven primarily by processing trade—the practice of assembling duty-free intermediate inputs in special zones, with no local sales (see Figure 1). According to Lall and Albaladejo (2004), four-fifths of China's high-tech exports (electronics, precision instruments and other machinery) consist of processing trade.

Interestingly, the bulk of imports/components for fuelling this export growth has come from economies such as Japan, Korea and Taiwan. In fact, intermediate products alone have accounted for almost three-fifths of the increase in trade within Asia over the past decade (Li 2007: 45). The vast majority of Taiwan's exports to the mainland are parts and components rather than final goods (Tung 2003). According to Gaulier et al. (2005), China's high-tech trade, the backbone of its economy, is heavily dominated by foreign affiliates. According to John Tkacik (2001), for the year 2000, an astonishing 72.8 per cent of the total US\$ 25.535 billion production value

¹⁰ See 'Export cut to close trade surplus gap', Gov.cn, the official web portal of the Central People's Government of the People's Republic of China, accessed online 22 November 2007. URL: http://english.gov.cn/2007-07/26/content_697978.htm



Source: Top Ten Import Sources (2007/09) Department of General Economic Affairs, Ministry of Commerce, PRC; accessed on 17 November 2007, <http://zhs2.mofcom.gov.cn/aarticle/ie/statistic/200711/20071105218448.html>

of China's information technology (IT) hardware sector was manufactured by Taiwan-invested enterprises (TIEs) that play a very important role in importing intermediate and capital goods from Taiwan and exporting finished goods to developed countries, in particular to the United States and Japan. According to one official source,¹¹ sixty-three of the 500 biggest companies in mainland China were Taiwanese companies (12.6 per cent) in 2005. The total trade share of these sixty-three companies was US\$ 135.4 billion or 9.5 per cent of China's total trade in 2005.

Electronics manufacturing, communication and audio manufacturing, and electrical equipment manufacturing have been the sectors attracting the greatest amount of Taiwanese investment. In fact, for an increasingly important export category such as IT products, Lardy (2002) argues that 'without Taiwan technology, machinery, training, and marketing skills, the mainland would not rank among the top ten global producers of information technology products'. According to Yang (2006), Taiwanese businesses own 60 to 70 per cent of China's IT market and about 50,000 Taiwanese firms operate on the mainland. According to the *Taiwan Economic and Trade Development Report* of February 2007, Taiwan remains among the world's largest exporters of notebook PCs, thin film transistor-liquid crystal display (TFT-LCD) monitors, motherboards, ADSL and cable modems, memory disks, LAN cards and many other high-tech tools.¹²

These figures are fairly consistent with the trends within East Asia as a whole, wherein production-sharing between the PRC and other Asian countries has upgraded

¹¹ 'Taiwan's relations with its major trading partners', Taipei Representative Office, Brussels, February 2007, URL: <http://www.taiwanembassy.org/public/Attachment/731918345371.pdf> (accessed on 12 October 2007).

¹² Taipei Representative Office, Brussels, accessed online 23 April 2007. URL: www.roc-taiwan.org/public/Attachment/731918311571.pdf

the PRC's export capacity. The trend is largely driven by China being used as an export base by the firms located in advanced Asian economies which, instead of exporting finished goods to the American and European markets, now export intermediate goods to their affiliates in China (Gaulier et al. 2005). The growing two-way trade in capital intensive products (machinery and electrical equipment) within the region also reflects the rapid growth of intra-industry trade and intra-firm trade by multinational corporations (MNCs) (Yue 2004).

The fears over Foreign Direct Investment (FDI) outflow from Taiwan to the PRC may also be exaggerated as demonstrated by the pattern of FDI flows in the region. According to Gilboy (2004), since the launch of reforms in 1978, China has absorbed over US\$ 500 billion in FDI—'ten times the total stock of FDI Japan accumulated between 1945 and 2000'. The pattern of FDI-receipt is seen to be consistent with China's policy of allowing foreign firms to develop new markets for their goods and services, especially high-value-added products.

Despite the fact that Taipei has tried to restrict cross-strait transfers of strategically significant technological and capital assets over the years, Taiwanese investors have circumvented these restrictions by investing in the mainland through off-shore companies routing investment through Hong Kong, Macao, etc. (Morrison 2003). Interestingly, in the figures cited in Table 1, the Latin American investment that comes from the British Virgin Islands (now the second largest investor in China) and the Cayman Islands (now eighth) is widely accepted as originating in Hong Kong and Taiwan—routed for tax purposes. Kevin Honglin Zhang (2005) points out that there is also a qualitative difference in the investment that comes from Hong Kong and Taiwan when compared to that flowing in from the European Union, the US and Japan. The former is dominated with export-oriented FDI, that is, relocation of production

Table 1
Top Ten Origins of Foreign Direct Investment (FDI) in the PRC* (US\$ billion, %)

<i>Country/Region of Origin</i>	<i>Amount Invested 2005 (\$ billion)</i>	<i>Amount Invested 2006 (\$ billion)</i>	<i>Year-on-Year Growth (%)</i>
Hong Kong	17.95	20.23	13
British Virgin Islands	9.02	11.25	25
Japan	6.53	4.60	-30
South Korea	5.17	3.89	-25
United States	3.06	2.87	-6
Taiwan	2.15	2.14	-1
Singapore	2.20	2.26	3
Cayman Islands	1.95	2.1	8
Germany	1.53	1.98	29
Western Samoa	1.36	1.54	13

Source: MOFCOM at the US–China Business Council website, accessed on 15 November 2007, <http://www.uschina.org/info/forecast/2007/foreign-investment.html>

Note: *Does not include financial sector flows.

stages to China in order to take advantage of cheap labour and cost incentives. In the process, Taiwanese factories have created employment, served as centres of manufacturing, recreation, education, and have even created social networks closely connected with the prosperity of China's coastal areas (Leng 1997). Investment from the European Union, the US and Japan, in contrast, is mainly associated with market-oriented FDI aiming at China's huge market.

Is Taiwan 'dependent' on the mainland in a purely asymmetric sense, that is, has Taiwan locked-in its valuable technology and Research and Development (R&D) in the mainland in the entire process of cross-strait trade and investment? Wong (2005) allays fears of the 'hollowing-out' argument as R&D is still largely based in Taiwan though labour-intensive production has been shifted. According to Deng (2000), most of the manufacturing activities that have been relocated to the mainland were no longer competitive in Taiwan. Besides, Taiwan still has restrictions on investment in certain Chinese industries (upper-end technology and infrastructure projects). At the same time, the PRC's own performance in assimilating technology despite the prominence of high-tech exports is below par. R&D intensity (research and development expenditure as a percentage of value added) at China's industrial firms is only about 1 per cent, seven times less than the average in countries of the Organisation for Economic Cooperation and Development (OECD) (Gilboy 2004). Even in the latest assessment of the large share of processing trade in China (Amiti and Freund 2007), the increase in the 'skill content' of China's exports is attributed to China importing intermediate inputs with higher skill content that it then assembles for export—and not its own. Without Chinese firms absorbing the technology they import and diffusing it throughout the local economy, it would be premature to predict that China could do away with the need for foreign inflow of technology and investment. And to that extent Taiwanese and Chinese firms would continue to be increasingly integrated into global production networks that export around the world. Thus, any bilateral disruption of cross-strait economic activities is bound to have a serious impact on the entire region as well.

THE THEORETICAL DEBATE

In theory, the economic interdependence argument is often argued to be Taiwan's best hope for discouraging a military takeover by Beijing (Acharya 1999). However, there are diverging assessments on this issue as well. Dependency theory posits that trade can exacerbate conflict in a situation of asymmetrical dependence—the more independent state has power to subject the dependent state to political-economic manipulation. The Realist school argues that economic integration can increase the likelihood of military confrontation among trading nations—after all, gaining access to vital resources is an essential means to acquire wealth and power in an anarchical

set-up. However, as was demonstrated during the cross-straits crises of 1995–96 and 1999–2000, China has resorted to military and political means of coercion but not economic coercion (sanctions, for instance) that could destabilise Taiwan's economy. According to Wong (2005), such has been the caution that 'the Chinese leadership has never explicitly linked the severance of economic ties with political demands and threatened to impose sanctions if Taipei refused to acknowledge the "One China" principle'.

Kastner (2006) argues that 'sending a strong enough signal of economic sanctions could be posited as one way of inflicting damage without actually fighting the war'. However, the fact that the PRC has shown restraint in not tying its political demands on Taiwan to the actual trade and investment between the PRC and Taiwan does point to the reliability of the interdependence argument to some extent. Choon Yin Sam (2007) discusses an instance of such restraint in the events that followed then Taiwan President Lee Teng Hui's 'special state-to-state relationship' comment on 9 July 1999. Beijing was reported to have targeted Taiwanese companies Acer, Chi Mei Group, Continental Engineering Corporation and Evergreen for their support of Chen Shui-bian during the presidential election. However, the PRC did not follow up the threats with concrete sanctions.

According to Wu et al. (2005), the anticipation that war will disrupt trade and lead to a loss of gains from trade helps to deter states from easily waging wars against trading partners—'the more economically interdependent the states become, the more they will have an interest in maintaining peaceful political relations in order to sustain economic interactions and avoid economic loss'. Scholars such as Acharya (1999), in fact, argue that the interdependence argument cuts both ways in that not only could it explain China exercising restraint in taking over Taiwan by force, it also equally constrains Taiwan from pursuing outright secession.

CONCLUSION

The PRC clearly has shown restraint in allowing economic relations to remain unscathed even as the political and military threats are revived occasionally. However, even here there seems to be a subtle shift. In his political report to the Congress¹³ (the document that sets China's policy direction for the upcoming years) in 2002, Jiang Zemin clearly outlined that:

We will work in utmost sincerity and do all we can to strive for a peaceful reunification. Our position of never undertaking to renounce the use of force is not directed

¹³ Full Text of Jiang Zemin's Report at 16th Party Congress accessed 15 November 2007 at http://english.peopledaily.com.cn/200211/18/eng20021118_106985.shtml

at our Taiwan compatriots. It is aimed at the foreign forces' attempts to interfere in China's reunification and the Taiwan separatist forces' schemes for 'Taiwan independence'.

However, in his political report (approved by the Congress in October 2007), Hu Jintao has omitted reference to China's possible use of military force against Taiwan. Instead, Hu urged Taiwan 'on the basis of the one-China principle' to join talks on 'a formal end to the state of hostility' and 'reach a peace agreement'.¹⁴ China's internal priority (since October 2005) has formally been to build 'a new socialist countryside' responding to rural discontent and concerns about growing inequality (Lunn et al. 2006). The Eleventh Five-Year Plan (endorsed by the National People's Congress in March 2006) shifts the focus from blindly pursuing economic growth to moving towards equitable growth.¹⁵ The stress on economic development in the PRC also underlines the domestic considerations within the PRC. Any armed conflict would deteriorate the regional environment that China needs for economic growth and development. Reverting, again, to the interdependence argument—deep economic integration across the Taiwan Strait seems to be acting as a check on Beijing's recourse to use of force against Taiwan.

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¹⁴ Full text of Hu Jintao's report at 17th Party Congress at http://news.xinhuanet.com/english/2007-10/24/content_6938749_9.htm

¹⁵ Wen Jiabiao's report delivered at the Fifth Plenary Session of the Sixteenth Central Committee of the Party (March 2006), *Xinhua News agency*, accessed on 29 November 2006, <http://www.people.com.cn/252/10307/0314/20030301937898.html>

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