



Executive Summary

Semiconductor Quarterly Report Second Quarter, 2007

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Introduction

The US-Taiwan Business Council is committed to providing our members with tactical and strategic advice on how to succeed in the Taiwan market. As part of a suite of information products distributed to our members, the Council publishes several analysis reports each year. These reports are published each quarter, with an expanded report in the fourth quarter that covers the entire previous year.

The Semiconductor report focuses on the semiconductor industry as it relates to Taiwan, China, and the U.S., and provides up-to-date analysis of developments during each quarter. Each report also contains contact information valuable in initiating and maintaining a relationship with Taiwan private and government entities, as well as other useful information including organization charts and a glossary.

The US-Taiwan Business Council's Semiconductor Report has been published since the first quarter of 2002. Although these reports are distributed exclusively to members and to U.S. government employees, this executive summary provides some insight into the focus and content of the report.

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**Quarterly Semiconductor Analysis
Published July 1, 2007**

Taiwan's next presidential election is just under a year away, yet it is already clear that the results of that election will have a profound impact on Taiwan's semiconductor industry. Politicians are key decision makers in Taiwan and wield tremendous power over industry.

It is a high stakes election. One candidate, from the Kuomintang (KMT, or Nationalist Party), promises direct shipping and air links with China, a Taiwan economy more aligned with the mainland, and a push to end political hostilities. The other candidate, from the Democratic Progressive Party (DPP, the current ruling party) will likely mean a continuation of most current policies of seeking a Taiwan identity separate from China. Although the DPP candidate appears to be more moderate than the incumbent president, he remains at the head of a party that is seeking independence from China. In the end, while he may bring about some economically beneficial policies with regards to China trade, he will also be under tremendous pressure to embrace President Chen's drive for greater international recognition.

In particular, there are key differences between the two candidates when it comes to the pace at which they might unwind the barriers to economic and political ties with China. The KMT candidate, Ma Ying-jeou, would surely move quickly to embrace the 1992 consensus and to undertake some unilateral measures to liberalize trade. Meanwhile, the DPP candidate, Frank Hsieh, might embrace a continuation of the policies driven by former Premier Su Chen-chang, which would instead mean slow but steady moves towards liberalization.

Taiwan's semiconductor industry as a whole has grown over the past eight years under DPP management, but more in spite of DPP policy than because of it. The DPP has slowed efforts by the chip industry to invest in and transfer technology to China out of a multitude of fears, some valid and others not. For example, they point out in political speeches that China could use Taiwan chip technology to build better missiles, and then use those missiles against Taiwan in the event of an invasion. But the fact is that such technology is already in China's hands, a result both of their own efforts and because they can gain such technology from many other nations, including the U.S., Japan, South Korea, Singapore, Germany and elsewhere.

The DPP has used the China card as a stalling tactic to keep chipmakers from sending high-end jobs overseas. It is also a strategy intended to prevent Taiwan from losing its best defense against a Chinese invasion - its "Silicon Shield". Presently, a production stoppage in Taiwan would effectively shut down the global information technology supply chain, and would likely severely affect other industries as well, since chips have become such a fundamental building block of so many products - from cars to refrigerators to telephones. Therefore, the loss of its vital place in the global semiconductor food chain would take away one major reason for the U.S. to support Taiwan in the face of an invasion by China, namely the island's chip industry.

However, the fact is that Taiwan need not put such strict controls on its chipmakers. The island's companies have and will continue to invest in the most advanced technologies at home, because U.S. policies already go to great lengths to keep such technologies out of China. What Taiwan chipmakers have asked for is the ability to move older production machinery to China to give it a second life, both because of technology investment incentives in China as well as demands by customers for some output on the mainland. To date, stalling by Taipei has not materially hurt Taiwan chipmakers. Further hindrances will, however, because not only is China building its own chipmakers, but companies from other nations, like Intel Corporation of the U.S., are also starting to take advantage of the incentives and of China's vast market by building chip factories there.

As always, this report will start with a discussion on the state of the chip industry in Taiwan. In the second quarter, the industry saw brisk sales and continued growth in new factory investments, but it also saw one of the biggest deals in its history fall apart.

The bulk of the report will focus on the two politicians chosen as presidential candidates for the March 22, 2008 election and on their economic policies. In particular, we will examine their China policy views, as a continuation of current Taiwan semiconductor policies with relation to China would have real consequences for its chipmakers. More new competitors are likely to spring up in China in the foundry and IC (integrated circuit) design segments, and foreign companies currently content to farm out production to Taiwan manufacturers may move towards building their own factories in China, as may have already happened in the case of the chip assembly industry.

This report will also detail how the announcement by Intel of its US\$2.5 billion (NT\$82.72 billion) plant in China has already prompted action by Taipei to allow some chipmakers to invest in the mainland.

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