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of East Asia and the Pacific**

**Peter Drysdale
and
Xinpeng Xu**

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TAIWAN'S ROLE IN THE ECONOMIC ARCHITECTURE OF EAST ASIA AND THE PACIFIC*

The accession of both China and Taiwan to the World Trade Organization (WTO) had important implications for relations across the Taiwan Strait and Taiwan's position in the regional economy although it did not fundamentally change trade policies by either side towards the other. Accession strengthened China's position in the world economy and the momentum of economic reform. China's weight and importance in the regional and world economies has increased greatly. With the shift to regionalism and bilateral free trade agreements in East Asia and the Pacific, and China's new freedom to join this game, Taiwan has become even more isolated diplomatically. Moreover, despite WTO accession, Taiwan maintains discrimination in its trade policy against key imports from the mainland. This damages Taiwanese trade and economic performance by truncating the capacity of the economy to generate higher value added in Taiwan on the base of China's low-cost processing capacity. Because of these restrictions, Taiwan under-utilises trade potential with China and with the world at large compared with other economies in the region such as South Korea. The best strategy for Taiwan is to go global, promoting multilateral liberalisation globally and regionally as a deliberate strategy to strengthen and re-balance economic relations with the mainland.

Background

The accession of China and Taiwan to the World Trade Organization (WTO) is a major achievement in their international economic diplomacy¹ and has important implications for China itself, for cross-Straits relationships and for East Asia and the Pacific and beyond (Sachs and Woo 2003; Woo 2001; Xu 2002).

For China, accession to the WTO delivers a significant long-term commitment to economic liberalisation and to economic and political reforms (Drysdale and Song 2000). It provides a huge stimulus to the continuation of rapid economic growth and transformation and to the mobilisation of resources to support rapid growth. The accumulation of capital and technology is expected to accelerate, particularly because accession has given impetus to the inflow of foreign capital, already averaging around US\$45 billion annually. Productivity gains will flow from trade gains through cheaper imports and their impact on import and export sector efficiency and also from technology spill-over through foreign investment. Domestic liberalisation and reform and a more transparent regime are expected to reduce transaction costs and correct the distortions that were prevalent in a less liberal and less open

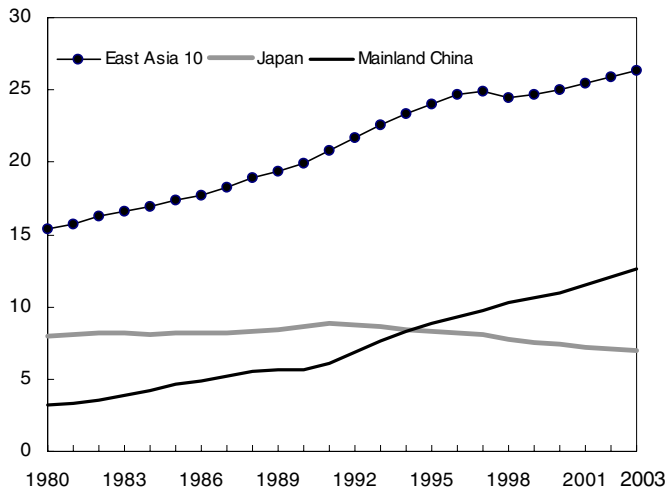


economy. Taken together, such effects suggest that, barring accident or policy miscalculation, China's high growth rate will continue for a significant period to come.²

China is already a major element in East Asia's rising share in world output. With a little over 7 per cent economic growth, China could double its income every 10 years. This prospect gives confidence that the East Asian economy will continue to increase in importance in the long term (Figures 1 and 2). The WTO commitments strengthen the corollary structural trend for China to be increasingly important in the East Asian economy and for the already evident relative decline of Japan to continue (see Figures 1 and 2).

China's accession to the WTO provides enormous trade and investment opportunities (Drysdale and Song 2000). It has set in train a new wave of trade and industrial transformation and a new regional and international division of labour. These changes will affect the East Asian, Pacific and world economies for many years. Accession will have a direct impact on growth and the structure of growth,

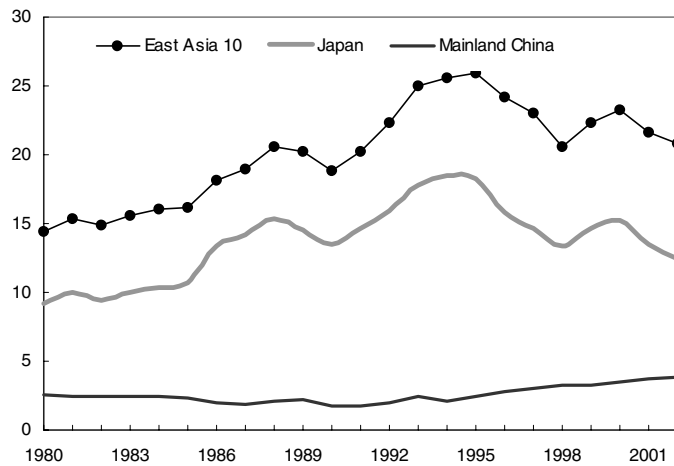
Figure 1 China and East Asia in the world economy: output share valued at purchasing power parity, 1980–2003 (per cent)



Notes: Shares of aggregate GDP based on purchasing power parity valuation of country GDP. East Asia 10 includes Japan, South Korea, mainland China, Taiwan, Hong Kong, Thailand, Malaysia, Indonesia, Singapore and the Philippines.

Sources: Authors' calculations based on data from International Monetary Fund, *World Economic Outlook* database, April 2004.

Figure 2 China and East Asia in the world economy: output share valued at market exchange rates, 1980–2003 (per cent)



Notes: Shares of aggregate GDP based on current market exchange rate in US dollars. East Asia 10 includes Japan, South Korea, mainland China, Taiwan, Hong Kong, Thailand, Malaysia, Indonesia, Singapore and the Philippines.

Sources: Authors' calculations based on International Monetary Fund, *World Economic Outlook* database, April 2004.

but will also have major indirect effects. For example, changes in the investment location strategies of multinational firms in the East Asian economy will result in changes in both intra-industry and intra-regional trade patterns and changes in the pattern of foreign direct investment (FDI) flows in the region. There has been a huge increase in FDI into China since the mid-1990s, a sizable part of it from Taiwan (see Tables 1 and 2). Increasing integration within East Asia and the rise of China within the East Asian economy are now established long-term trends in the world economy.

These developments are at the heart of the evolving East Asian cooperation idea of which Taiwan is yet to become a part. In particular, the move away from multilateral-oriented regional arrangements like the Pacific Economic Cooperation Council (PECC) and Asia Pacific Economic Cooperation (APEC) and towards bilateral free trade agreements (FTAs) and ASEAN+3 arrangements complicates Taiwan's involvement in the regional economy and economic policy dialogue. Moreover, Taiwan is yet to reap the full advantage of WTO accession, ironically because accession has not resolved its trading

Table 1 China's top sources of foreign investment (cumulative FDI) to 2003

	Cumulative FDI (US\$ billion)	Share (%)
Hong Kong	222.6	44.4
United States	44.1	8.8
Japan	41.4	8.3
Taiwan	36.5	7.3
Virgin Islands	30.2	6.0
Singapore	23.5	4.7
South Korea	19.7	3.9
United Kingdom	11.4	2.3
Germany	8.9	1.8
France	6.1	1.2
Others	57.1	11.4
Total	501.5	100.0

Notes: FDI = foreign direct investment.

Sources: Data up to 2002 are from official China FDI website, Ministry of Commerce, People's Republic of China (<www.fdi.gov.cn>). Data for 2003 are from *China Economy and Statistics Express*, National Bureau of Statistics, July 2004 issue.

Table 2 China: changing structure of FDI inflows, 1986–2003 (per cent)

	1986–90	1991–95	1996–2000	2001–03
Hong Kong	61.3	59.6	42.9	34.2
Japan	12.5	7.6	8.1	8.9
United States	10.9	7.0	9.0	9.2
Taiwan	2.2	10.0	6.8	6.7
European Union	5.0	4.1	9.3	7.8
Others	8.1	11.7	23.8	33.2

Notes: Figures are period averages.

Sources: Ministry of Commerce, People's Republic of China, *China Statistics Yearbook*, China Statistical Press, various years.



problems with China. A coherent and effective Taiwanese strategy in response to this new circumstance is yet to emerge. Taiwan continues to discriminate against a significant range of imports from the mainland. These restrictions, and the indirect trading links between Taiwan and the mainland, truncate Taiwan's ability to add value to cheap components and intermediate goods imports from China. This calls for a drastic shift in Taiwan's trade policy strategy. If Taiwan opened up its markets to Chinese imports as part of a general liberalisation of trade, its income and welfare would be boosted without any obvious compromise to its security interests.

The aim of this paper is to assess how Chinese accession to the WTO affects Taiwan's regional role and strategies. We start by examining how Chinese accession to the WTO affects regional trade, investment and growth and discuss the implications for the roles of China and Taiwan in the regional economy. We identify problems and challenges for Taiwan in taking advantage of the opportunities made possible by WTO membership on both sides of the Taiwan Straits. We then discuss challenges for Taiwan's regional diplomacy, setting out some options that have been canvassed. Finally, we offer some thoughts on alternative strategies that may serve Taiwan better than the strategies advocated thus far, both in economic and political terms, and suggest some possible ways forward.

Regional trade, investment and growth

To understand Taiwan's role in the economic architecture of East Asia and the Pacific following China's accession to the WTO, we must look first at the impact of accession on regional trade, investment and growth.

Various modelling exercises have been conducted, for example, by Drysdale, Zhang and Song (2000), Wang (2003), Ianchovichina and Martin (2003) and McKibbin and Tang (2000), which measure the effects of China's accession on the Chinese and regional economies. Most results suggest that China is a big beneficiary of accession to the WTO (Adhikari and Yang 2002). According to Ianchovichina and Walmsley (2003), accession added around US\$10 billion to GDP in 2001 (an increase of 1 per cent). But China's accession to the WTO is significant for more than the measured gain in GDP. At the core of China's WTO membership are long-term commitments to economic liberalisation and reform and to a more transparent regime that will be open to all of China's trading partners. Recent studies by development economists have identified three factors – openness, institutions and geography – as fundamental forces that drive economic growth (Rodrik, Subramanian and Trebbi 2002). It is China's commitment to liberalisation, reform and openness that draws it politically as well as economically closer to the world's major centres of economic power in North America, Europe and East Asia and that provides the foundations for substantial and sustainable economic growth at home.



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Reduction of tariffs and non-tariff barriers corrects distortions that have been in place for a long time; their removal is expected to generate sizable increases in productivity. The greatest productivity gains arise from opening sectors that have been highly protected, such as the services sector, because foreign firms bring in advanced technology and managerial expertise (Matto 2001; Ianchovichina and Walmsley 2003). For China, accession will spur on the rapid accumulation of capital and improvement in productivity, promising higher growth rates for a considerable time to come.

China is now established as an engine of growth in East Asia, through its rising share in regional production and trade and through its close structural links with other economies in the region (see Figures 1 and 2 and Table 3). In terms of current output, the economic size of China has been rising and is now almost one-third that of Japan – even based on market exchange rate calculated output measures (Figure 2). The contrast is even more striking if the comparison is based on purchasing power parity (PPP) calculated output measures, whereby China has already surpassed Japan and, after 1993, become the second largest economy in the world (Figure 1). With growth rates averaging more than 8 per cent per annum since 1990, China has been the most important new player in the regional and world economies, and this is expected to continue.

Table 3 China and East Asia: share in world exports, 1991–2003 (per cent)

	1991–93	1994–96	1997–99	2000–03
East Asia 10	22.8	23.9	22.9	23.8
China and Hong Kong	3.7	4.1	4.4	5.9
Japan	9.3	8.5	7.4	6.7
South Korea	2.2	2.5	2.5	2.6
Taiwan	2.6	2.7	2.6	2.5
ASEAN	5.0	6.1	6.0	6.1

Notes: Figures are period averages. East Asia includes Japan, South Korea, China (including Hong Kong exports net of intra-Hong Kong–China trade), Taiwan, Thailand, Malaysia, Indonesia, Singapore and the Philippines. Exports are merchandise exports only. ASEAN includes Thailand, Malaysia, Indonesia, Singapore and the Philippines.

Sources: Authors' calculations based on data from International Economic Databank, Australian National University.

Cross-Straits trade: a one-way street

Trade across the Taiwan Straits has been increasing steadily; from just over US\$5 billion in the early 1990s, it rose to US\$46 billion in 2003 (see Table 4). However, it has been a one-way street, with Taiwan ostensibly enjoying a growing trade surplus over the last decade, amounting to over US\$24 billion in 2003. In that year, almost 35 per cent of Taiwan's exports (worth US\$35 billion) went to Hong Kong and China (Table 5) and under 10 per cent of imports were drawn from Hong Kong and China (Table 6).³

China as a driver of growth in the region

The new wave of trade and industrial transformation that is sweeping the East Asian and international economies has been driven significantly by the commitment to more liberal trade and investment regimes in China. China's growing and more open market provides opportunities for countries in the

Table 4 Trade across the Taiwan Straits, 1982–2003 (US\$ billion)

	Taiwan's exports	Taiwan's imports	Trade surplus
1982	0.2	0.1	0.1
1985	1.0	0.1	0.9
1990	4.4	0.8	3.6
1991	7.5	1.1	6.4
1992	10.5	1.1	9.4
1993	14.0	1.1	12.9
1994	16.0	1.9	14.2
1995	19.4	3.1	16.3
1996	20.7	3.1	17.7
1997	22.5	3.9	18.5
1998	19.8	4.1	15.7
1999	21.3	4.5	16.8
2000	25.0	6.2	18.8
2001	21.9	5.9	16.0
2002	29.5	7.9	21.5
2003	35.4	11.0	24.4

Sources: Estimates by Mainland Affairs Office, Taiwan, available at <<http://www.chinabiz.org.tw>>, accessed on 5 August 2004. See footnote 3 for alternative estimates.

**Table 5** Taiwan: geographic structure of exports, 1980–2003 (per cent)

	Hong Kong and China	EU-15	Japan	South Korea	United States	ASEAN-5
1980	7.9	14.4	11.0	1.4	34.3	11.2
1985	8.3	8.9	11.3	0.8	48.4	7.7
1990	12.8	16.3	12.4	1.8	32.5	14.1
1991	16.1	16.1	11.9	1.7	28.9	13.0
1992	19.0	15.3	10.9	1.4	29.0	13.8
1993	21.8	13.5	10.6	1.5	27.7	14.5
1994	23.2	12.5	11.0	1.9	26.4	15.9
1995	23.8	12.5	11.7	2.3	23.8	17.0
1996	23.7	12.9	11.8	2.3	23.3	16.4
1997	24.1	13.3	9.5	1.9	24.5	16.1
1998	23.4	15.8	8.4	1.3	26.7	12.3
1999	23.8	14.8	9.7	2.1	25.4	13.4
2000	24.4	14.2	11.1	2.6	23.5	14.0
2001	26.6	14.2	10.3	2.7	22.3	13.4
2002	30.9	13.0	9.1	2.9	20.3	11.8
2003	34.5	12.5	8.3	3.2	18.0	10.0

Sources: Authors' calculations based on data from *Direction of Trade*, International Monetary Fund. International Economic Databank, Australian National University.

Table 6 Taiwan: geographic structure of imports, 1980–2003 (per cent)

	Hong Kong and China	EU-15	Japan	South Korea	United States	ASEAN-5
1980	1.3	8.8	27.2	1.0	23.7	10.6
1985	1.6	10.9	27.5	0.9	23.8	10.4
1990	2.4	13.8	30.2	2.5	23.8	10.3
1991	3.6	13.4	29.9	2.8	22.6	10.8
1992	3.6	14.1	30.1	3.2	22.0	11.6
1993	3.6	14.1	30.0	3.3	21.8	12.2
1994	4.1	15.0	29.3	3.6	21.4	13.9
1995	4.8	14.2	29.2	4.2	20.1	13.4
1996	4.7	14.1	26.8	4.1	19.6	14.1
1997	5.2	13.0	25.3	4.4	20.3	14.9
1998	5.9	13.2	25.7	5.4	18.9	15.6
1999	6.1	12.6	27.5	6.5	17.9	16.9
2000	6.1	10.8	27.4	6.4	18.0	18.2
2001	7.4	11.0	24.0	6.2	17.0	18.8
2002	8.8	11.4	24.8	7.0	16.4	15.0
2003	9.9	10.3	25.6	6.9	13.2	13.4

Sources: See Table 5.



region to participate further in the regional and international division of labour. Already more than half of China's imports are sourced from other countries in East Asia, with 30 per cent from Northeast Asia and 20 per cent from ASEAN countries. Lardy (2002) suggests that '(w)ithin a decade China's trade is likely to surpass that of Japan and Germany, making China the world's second largest trader'. When trade is properly measured, by including Hong Kong's trade together with China's trade net of intra-Hong Kong-China trade, China is already the fourth biggest single trading nation in the world, after the United States, Germany and Japan.

A central feature of deeper East Asian economic integration has been the remarkable growth of trade in intermediate goods and components. China is now a major player in this process. A growing feature of the international division of labour, especially in East Asia, has been the location of relatively labour-intensive component production and assembly processes within complex, integrated international production chains (Sharpton 1975; Helleiner 1973; Feenstra 1998; Athukorala 2003). The process began in the electronics and textile industries but is now common in many other industries as well. This process is sometimes called international product fragmentation. A recent and careful study of fragmentation trade in East Asia by Athukorala (2003) demonstrates just how important it is to the growth of the region and economic integration within it. Athukorala (2003: p. 18) reports that the intra-regional share in final trade was 48.3 per cent compared to 52.3 per cent of total trade. In 2000, over 60 per cent of 'final exports' from developing Asia went to countries outside the East Asian region (particularly North America and Europe), up from 55 per cent in 1992 (Athukorala 2003, p. 18). The fragmentation of the supply chain accelerates the growth of trade in components and makes the region more heavily dependent on extra-regional trade for 'growth dynamism' than is suggested by data that do not net out the trade in components (Findlay 2003a, 2003b). Athukorala shows that the most notable feature of international product fragmentation in recent years has been the rapid integration of China into regional production networks. He argues (p. 19) that this development is an important counterpoint to the popular belief that China's global integration would crowd out opportunities for export-led growth for other economies within the region.

In the manufacturing sector, FDI has been the driver of the substantial intra-industry and intra-regional trade growth, and the role of FDI is expected to rise, fostering deeper integration of the regional economies. The effort to cut production costs through greater productivity and more efficient procurement and outsourcing has led to the relocation of some segments of multinational firms' production processes within East Asia. The effect on trade and investment flows is significant. The increase in fragmentation and specialisation in production and trade that has been promoted by the activities of multinational firms in the region presents enormous opportunities for East Asian economies



to become integrated into international production chains and markets. It lifts productivity, output and trade growth. There are also challenges in developing policies to take advantage of these opportunities. In particular, there may be more intense competition among economies with similar output levels, factor endowments and export structures. A similarity with China's export structure, it might be argued, for example, is likely to increase the intensity of competition faced in taking advantage of the growth of fragmentation in regional trade in manufactured goods (Xu and Song 2002). McKibbin and Woo (2003) suggest that China's accession to the WTO could create significant welfare losses in ASEAN-4 countries if FDI is significantly directed away from these countries towards China and if they are unable to take measures to prevent losses from reduced FDI inflow. If the ASEAN-4 countries are not to fall behind technologically, they will have to find niches within lengthened international production chains. The evidence suggests that this is indeed what is happening and that China is providing a positive boost to Southeast Asian trade in the process (Deutsche Bank Research 2003).⁴

Opening up service sectors such as banking, transportation and communications, professional services and distribution services to international participation and competition is also offering enormous opportunity. Trade and income growth built on exports from the more labour-intensive segments of these industries for the less developed economies and the more human capital-intensive segments for the more advanced economies is generally faster than growth of industrial goods trade and output, within the region and globally.

The costs to Taiwan from trade discrimination against China

Despite the increase in cross-Straits trade, there are still no direct official trade links between Taiwan and China, and Taiwan continues to place important restrictions on imports from China. These restrictions severely constrain the share of China in Taiwan's imports, which was under 10 per cent of total Taiwanese imports in 2003 (Table 6). At the end of 2000, only 56 per cent of all 10,724 ten-digit commodities under the Harmonized Tariff Schedule (HS) system were permitted imports from mainland China. On 15 February 2002, shortly after WTO accession, Taiwan removed import restrictions on Chinese imports for 2,058 products, and on 18 November 2002 it removed restrictions on a further 316 items. However, 2,418 items (22 per cent of the 10,724 items categorised under the HS ten-digit tariff code) may still not be imported from mainland China.⁵

Taiwan's restrictions on imports from China affect a wide range of components and other products, including automobile components and parts, and constitute a significant barrier to the growth of Chinese exports to Taiwan. Restrictions on imports from, and investments in, mainland China prevent



Taiwan from fully participating in the regional and international division of labour and moving further up the value-added chain.

Theoretically, China's small share in Taiwan's import market could result from commodity specialisation or the geographic structure of trade rather than from official Taiwanese barriers to trade with China. Here, we gauge the extent to which Taiwan's import specialisation with China is distorted by Taiwanese import restrictions that discriminate against China. We take South Korea as a benchmark; its trade structure is not dissimilar to that of Taiwan and it is located in the same economic space but it does not impose on China any special or discriminatory barriers of the kind that Taiwan has in place.

Trade intensity analysis is a well-established technique for analysing the determinants of bilateral trade flows and what factors influence them (Drysdale 1988). Table 7 shows the trade intensity, bias and complementarity coefficients for trade between Taiwan and South Korea and China. Here China is defined as China including Hong Kong minus intra-Hong Kong–China trade so that the effect of Taiwan's indirect trade with the mainland can be taken into account. The coefficients are computed from a vast amount of data to provide a summary comparison of the structure of trade.

Complementarity in bilateral trade is derived from the relation of one partner's commodity specialisation in exports (relative to the rest of the world) to the other's specialisation in imports; thus a higher value indicates higher matches between the reporter country's commodity export structure and the partner country's import structure. Country bias derives from the relative closeness of the two partners in terms of geography, policy treatment, and cultural or other factors that affect economic space.

The striking result from the analysis set out in Table 7, as can be seen by comparing columns 5 and 8, is that China's overall pattern of export specialisation matches the pattern of import specialisation of both South Korea and Taiwan to a remarkably similar degree. For both economies the complementarity coefficient is between 0.77 and 0.92. For Chinese trade with both South Korea and Taiwan, complementarity has steadily increased over the last few years. This reflects China's growing role as an export-processing zone for all the higher-income economies of East Asia. Yet the import trade intensity between South Korea and China is much greater than that for Taiwan and China. The South Korean import trade intensity ranges between 0.97 and 1.82 over the period 1992–2002, suggesting that South Korea takes almost twice the value of imports from China that could be expected from both countries' shares in world markets. By comparison, Taiwan's trade intensity ranges between 0.67 and 1.11; in most years Taiwan did not import as much from China as would be expected from their world trade shares, despite their high degree of trade complementarity and their proximity in the international economy. It appears that South Korea's trade policy regime has allowed it to take fuller advantage of the opening up of the Chinese economy and the utilisation of comparative advantage with China than Taiwan has been able to do.

Table 7 China, South Korea and Taiwan: trade complementarity, bias and intensity indexes

Exports from	Exports to								
	China			South Korea			Taiwan		
	b	c	i	b	c	i	b	c	i
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
China	1992			1.25	0.78	0.97	0.87	0.77	0.67
	1994			1.52	0.78	1.19	1.19	0.78	0.93
	1996			1.74	0.84	1.46	1.22	0.80	0.98
	1998			2.29	0.78	1.79	1.39	0.80	1.11
	2000			1.94	0.83	1.61	1.07	0.86	0.92
	2001			2.16	0.84	1.82	1.21	0.88	1.07
	2002			1.96	0.89	1.75	1.16	0.92	1.07
South Korea	1992	1.22	1.62	1.97			1.24	1.16	1.45
	1994	1.33	1.60	2.14			1.15	1.19	1.37
	1996	1.72	1.46	2.51			1.19	1.16	1.38
	1998	2.00	1.37	2.75			1.66	1.25	2.09
	2000	1.82	1.33	2.42			1.74	1.22	2.1
	2001	1.90	1.31	2.49			2.00	1.11	2.20
	2002	1.88	1.35	2.54			1.93	1.15	2.23
Taiwan	1992	2.16	1.56	3.37	0.75	0.84	0.63		
	1994	2.26	1.49	3.37	0.80	0.93	0.75		
	1996	2.39	1.48	3.53	0.85	0.94	0.80		
	1998	2.61	1.46	3.82	0.83	0.97	0.81		
	2000	2.33	1.48	3.46	0.96	1.09	1.05		
	2001	2.34	1.51	3.52	1.08	1.07	1.16		
	2002	2.37	1.61	3.81	1.04	1.16	1.21		

Notes: China here includes the trade of Hong Kong and mainland China net of intra-Hong Kong–China trade; *b* is the bias index; *c* is the complementarity index; *i* is the intensity index; *i* equals *c* times *b*. For detailed definitions, refer to Drysdale (1988, pp. 86–88).

Sources: Authors' calculations based on data from International Economic Databank, Australian National University.

The issue can be further examined using another technique. Drysdale, Huang and Kalirajan (2000) apply a stochastic gravity model to examine trade efficiency, which is defined as the ratio of actual to potential trade flow. Their results indicate that, although the average efficiency index for Taiwan's export trade between 1991 and 1995 is 0.52 and the average efficiency index for its import trade is 0.41 (an index of 1 indicates that trade potential is being fully realised), its efficiency index for bilateral trade



with mainland China is very low (less than 0.15 for both exports to, and imports from, the mainland). This suggests that Taiwanese trade is in actuality less than 15 per cent of potential trade with China and that its trade with the rest of the world is only half of its potential trade or less (Drysdale, Huang and Kalirajan 2000). We have updated these results for trade data from 1996 to 2001. In that period, the average efficiency index for Taiwan's export trade rose to 0.53 and that for its import trade to 0.47. But efficiency in its bilateral trade with China remains very low, despite a sharp rise in the efficiency of its bilateral export trade. The index rose to 0.29 for bilateral exports but was still only 0.14 for imports from China. This will not have changed significantly over the last two years. By comparison, there was an export efficiency of 0.45 in South Korea's export trade with China and 0.39 in its import trade from China. This means that Taiwan's exports to China were only 29 per cent of their full potential on this estimate, and imports a mere 14 per cent. This is a disturbingly low figure, not reflected in figures for the efficiency of any other country's trade flows with China.

This analysis treats Taiwan's trade through Hong Kong as if it were not related to China. However, much of it is. A more accurate picture of the extent to which Taiwan-China trade potential is under-realised can be obtained by running the same analysis on Taiwan's trade with China but including Hong Kong, as part of China, net of intra-China-Hong Kong trade. The results of this analysis reveal a stronger Taiwan-China trade relationship because of the importance of indirect trade through Hong Kong: more than doubling the efficiency numbers when trade with China is measured to include Hong Kong.

The export efficiency of Taiwanese exports to China and Hong Kong, net of intra-China-Hong Kong trade, rises to 0.56 compared to 0.29 when Hong Kong is not included. And the import efficiency jumps from 0.14 to 0.29 when trade through Hong Kong is included, because a large amount of China-Taiwan trade is being channelled through Hong Kong. By contrast, bilateral export and import efficiency coefficients for South Korea do not change significantly when trade with Hong Kong is included in China's trade. The efficiency index for South Korean exports to China and Hong Kong, net of China-Hong Kong trade, rises by two percentage points, to 0.47; on the import side, it falls by four percentage points to 0.35.

Significantly, however, the efficiency of South Korean importing from China (including Hong Kong) is higher than that of Taiwan's importing from China (including Hong Kong). This reflects not only the costs of Taiwan's trading indirectly through Hong Kong but also the distortion to this trade caused by Taiwanese bans on imports from China.

The underdevelopment of Taiwan's import trade with China has a major detrimental effect on Taiwan's overall trade performance. The analysis above shows clearly that the restrictions on cross-Straits



trade, especially on imports from mainland China, have prevented Taiwan from fully specialising in sectors in which it has a comparative advantage and thus from taking full advantage of China's early-stage processing capacity. These effects are stunting Taiwan's industrial upgrading. Taiwan's restrictions on trade with China prevent it from capturing both sides of the benefit from the emergence of a huge reprocessing zone in China – the opportunity for low-cost production in China and the opportunity for value adding to low-cost Chinese imports in Taiwan.

This paper does not examine in depth the political-security implications of this foreign economic policy choice of Taiwan. But there is no obvious political-security rationale for a policy approach that in effect denies Taiwan competitiveness in the international marketplace. More specifically, there is no political-security rationale for a strategy that prevents Taiwan from developing an important and closer set of economic, trade and investment ties through more extensive international production chains with its neighbours, including China, and with major industrial economies outside the region. If Taiwan is to capture the full economic benefits of what is happening in China, it will need to develop such ties.

Proliferation of free trade arrangements

Regional trade policy environment

Since the late 1990s, there has been a surge of interest in preferential regional trading arrangements or so-called free trade areas in East Asia and the Pacific.⁶ The rich countries in the region, such as Japan, South Korea, Singapore, Australia, New Zealand and the United States, have all signed at least one FTA with their trading partners in recent years. Developing countries in the region, such as China and ASEAN countries, have also shown growing interest in FTAs, and a China–ASEAN FTA is already under negotiation.⁷

The motivations for participating in FTAs vary from country to country.⁸ East Asian countries have a longstanding commitment to, and continuing fundamental strategic interest in, the non-discriminatory liberalisation of trade, but economic and political circumstances have led them down the track of discriminatory trade liberalisation instead. This shift in policy thinking has arisen against the background of the long-term rise in East Asian economic interdependence, even though East Asian trade and economic interests remain more globally oriented than those of any other major economic area in the world (Drysdale and Ishigaki 2002). The proximate causes were related to the East Asian financial crisis (and a sense of economic diplomatic isolation that flowed from it). Other factors included the failure of the Seattle Ministerial Meeting to launch a new WTO round and the political circumstances (affecting Beijing's and Tokyo's dealings with Washington) that led to the formation of ASEAN+3 at



the end of the 1990s.⁹ In economic diplomacy, the multilateral-oriented institutions appeared to falter and failed to move forward quickly within either the WTO or APEC frameworks. However mistakenly, given the complex structure of the regional economy, countries in the region began to see FTAs as a way to more rapid progress. There was a decisive move away from working through multilateral-oriented regional arrangements like APEC and towards the proposal and negotiation of bilateral FTAs; the regional grouping, ASEAN+3, also emerged in East Asia.

The move towards bilateral negotiation of FTAs in East Asia had its recent origins in Japan. The first move was to forge an agreement with South Korea as part of the process of political rapprochement in the late 1990s. The proposal emphasised industrial integration and deliberately avoided hard agricultural trade issues. Thus far there has been no substantive progress towards a deal with South Korea but negotiations have recently resumed. The second agreement involved Singapore. The 'New Economic Partnership Agreement with Singapore' (where there were no major agricultural trade issues to deal with, except the famous issue of goldfish and cut-flower exports from Singapore to Japan) was negotiated and legislated in 2002. The Singapore agreement broke Japan's long commitment to the principle of non-discriminatory trade. The agreement had a trivial impact on the Japanese economy, but in Japan it came to be rationalised as a way of pushing the domestic reform agenda. However, like almost all such arrangements, it was an extremely limited instrument for achieving that objective. The third bilateral agreement involved Mexico. Japan concluded the negotiation of an FTA with that country in 2004, although the impact of the agreement is also very modest.

The Japanese policymakers who initiated these moves did not understand how other countries in the region would react to them. Most importantly, China, in dealing with Southeast Asian sensitivities about its economic rise, was freed to propose an FTA with ASEAN. Because of a more open approach to agricultural trade, it was able to trump Japan in its Southeast Asian diplomacy and move forward with a bolder and more attractive schedule for negotiations (Drysdale and Ishigaki 2002). Beyond Japan, South Korea was flirting with a broader bilateral FTA strategy, but even negotiations with Chile became bogged down. Australia moved rapidly to mimic Japan's deal with Singapore, then Thailand, and, more significantly, entered formal negotiation of an FTA with the United States – a development made possible in the aftermath of September 11 and Australian support for the Bush Administration's campaign in Iraq (Garnaut 2003a). At the Bali ASEAN+3 summit in 2003, China again seized the initiative in pressing a broader East Asian trade arrangement, supporting the ASEAN strategy for deepening Southeast Asian integration and outflanking Japan's initiatives for more divisive bilateral agreements with Southeast Asian countries. China is now considering FTAs with Australia and New Zealand. The United States has done its own deal with Singapore and has mooted bilateral agreements with other ASEAN countries.



Both economic and political considerations have influenced thinking among the Chinese leadership about the change in trade policy strategy. Findlay (2003a) provides the best interpretation of the background to China's evolving FTA strategy. He suggests that, in the face of other countries' fears that they would be crowded out by China's growth in Southeast Asia, China offered FTAs as a way of providing reassurance and as a vehicle for cooperation. Zhang (2003) suggests that an FTA involving all the ASEAN economies would make the whole region more attractive to foreign investors: this could allay the concerns of ASEAN members about the effect of China's WTO entry on patterns of FDI flows (Zhang 2003).

Zhang (2003) argues that an agreement between China and ASEAN could accelerate moves for Japan and South Korea to form their own bilateral agreements with ASEAN, could push China, South Korea and Japan towards further progress on bilateral arrangements of their own and could encourage a broader East Asian regional arrangement. Some people thus see the China–ASEAN FTA as a building block for wider regional cooperation. Zhang (2003) argues that the interest in a more formal institutional arrangement follows from concern about the vulnerability of market-based integration and from the emergence of institutionally based integration in Europe and the Americas.

ASEAN+3 'provides a framework for demonstrating East Asian leadership and influence on regional and international affairs' (Drysdale 2002: p. 141). In addition to the establishment of an East Asian Free Trade Area, the ASEAN+3 agenda includes cooperation on macroeconomic policy and financial market strengthening, and joint action on the provision of regional public goods. Zhang (2003) refers to the common interest in responding to drug trafficking, piracy, illegal migration, environmental disasters, money laundering and international terrorism and other trans-boundary problems. Beyond these areas, there might be interaction in relation to defence and military affairs, but that cooperation involves an even longer time horizon (Findlay 2003a).

From this perspective, the FTA strategy can be seen as being designed to contribute to China's capacity to 'form at some point a counter-power comparable to the United States and Europe by unifying Asian countries'.¹⁰ On this interpretation, the strategy is part of an attempt by China to build a 'strategic partnership' within East Asia, a partnership that can be used to 'work closely on regional and international issues' (Munakata; see footnote 10). It is not clear that the FTA component is actually required to achieve this goal, but certainly that is how it is presently viewed widely, both in China and Japan.

Zhang (2003) admits that it is too early for China to consider a fully institutionalised East Asian arrangement. One reason is that neither Japan nor South Korea is yet ready to negotiate an agreement with China, and vice versa. Another reason is that the region cannot confront the issues that would arise

from the treatment of Taiwan in a larger arrangement. In the immediate term the agenda is actually a subregional one, with the focus on China and ASEAN and on bilateral FTAs. We have yet to see how that will finally influence the shape of broader regional cooperation arrangements, but certainly there is limited room for Taiwan (and presently, we might add, Australia) in the growing institutionalisation of regional cooperation arrangements in East Asia.

The other important Chinese regional initiative is the Closer Economic Partnership Arrangement (CEPA) with Hong Kong, signed at the end of June 2003.¹¹ This arrangement is still evolving but it provides for duty-free access to a broad range of imports that qualify in terms of specified rules of origin and designated service providers. The agreement is deepening the integration of Hong Kong into the southern Chinese economy.

The stalling of the Doha Round of WTO negotiations at Cancun in 2003 gave further impetus to the surge of preferential bilateralism in East Asian and international trade diplomacy. But none of the bilateral agreements that have been put in place so far has made a substantial contribution to trade liberalisation (Adams et al. 2003). In East Asia there is an emerging mess of arrangements with more and more complicated rules of origin that have the potential to distort and derail rather than encourage and promote broader and deeper economic integration (Garnaut 2003a, 2003b; Garnaut and Baghwati 2003; Findlay, Piei and Pangestu 2003; Findlay 2003a; de Brouwer 2003).

Economic and political costs to Taiwan

For both political and economic reasons, the proliferation of FTA initiatives and the emergence of ASEAN+3 complicates Taiwan's involvement and interests in the region immensely. The political deadlock across the Taiwan Strait remains. Nor can we underestimate the impact of the rise of China and its dramatic success in integrating into the international economy. A key characteristic of FTAs is that they involve political preference and political as well as economic choice. An environment in which FTAs dominate international economic diplomacy is not congenial to Taiwan's economic and political interests. The understanding of this reality does not come easy in Taipei, where policy instinct still tends to favour preferred and special dealing of the sort that FTAs typically involve. We shall return to this issue at the end of this paper. Beijing's diplomatic initiative prevents Taiwan's automatic participation in the new international diplomatic game that is being played out in the East Asian region.

Taiwan's response to this new circumstance has been to seek its own preferential trading deals. It has made a huge diplomatic and policy effort to seal FTAs with other countries in the region and beyond, but has had limited success.



In October 2002, Taipei and Washington began a series of talks at working group level with a view to negotiating a trade and investment framework agreement (TIFA). However, formal talks never materialised. The United States complains that Taiwan has been slow to resolve issues concerning the protection of intellectual property rights, and opening markets to foreign rice and foreign telecommunication companies. The United States has been quick to use Taiwan's protection of its services sector and agricultural products as excuses for lack of progress with an FTA with Taiwan, but in reality it has deep political reservations about going down the FTA path with Taiwan. Taiwan continues to seek an FTA with the United States. On all estimates it would gain only a small overall economic benefit from an FTA with the United States.¹² The political leverage of an agreement, however, would be great.

We call this the 'back to the future' policy strategy. It hankers after a return to political and economic circumstances that no longer exist in the relationship between Taipei and Washington, because there is now so much at stake in Washington's relationship with Beijing.

After its accession to the WTO in 2002, Taiwan also sought FTAs with other countries, including Japan, New Zealand, Singapore, Panama and South Korea.

Negotiations with Singapore bogged down over Taiwan's insistence on negotiating a deal as a political entity, not an economic one.¹³ The controversy over the visit of Lee Hsien Loong, the then Singapore Prime Minister-in-waiting, to Taipei in 2004 has seen the end of any prospect of success on that front.

FTAs with Japan and New Zealand are at an early stage. The Taiwanese Minister of Economic Affairs, Lin Yi-fu, announced at the APEC meetings in Bangkok in October 2003 progress in commitment by Japan's Economic, Trade and Industry Minister, Shoichi Nakagawa, to an academic study of the feasibility of an arrangement with Japan. He also announced that Taiwan was approaching New Zealand about the possibility of an FTA. It would be difficult for Taiwan to sign an FTA with ASEAN as a whole, so it seems that Taiwan is seeking individual pacts with its individual member-states.¹⁴ In late August 2003, Li Tsai Fang, president of the Taipei Mission in Korea, was quoted as saying that the Taiwanese government expects to sign an FTA with South Korea.¹⁵

Taiwan has completed one FTA – the one with Panama signed in August 2003. That agreement went into effect on 1 January 2004. Both countries agreed to open markets for agricultural and industrial products and to open the service and financial sectors. However, the Panama agreement symbolises the failure rather than the success of Taiwan's FTA strategy, because Panama ranks 70th among Taiwan's trading partners, with bilateral trade of less than 1 per cent of Taiwan's total trade.

The economic benefits that would derive from any of the FTAs that Taiwan has sought to prosecute, including that with the United States, are far outweighed by the benefits that would derive



from multilateral or unilateral liberalisation of trade in goods and services. A multilateral or unilateral liberalisation strategy would also sensibly include the removal of trade discrimination against the mainland. Proponents of the FTA strategy believe that it has an over-riding political advantage, but that apparent advantage would seem to be a chimera given the new economic and political circumstances surrounding China's emergence in East Asia and the Pacific.

Linking globalisation to cross-Straits integration

Unilateral initiatives

Taiwan achieved tremendous economic success since the 1960s, thanks to a combination of domestic and international factors such as the accommodation of an export-oriented labour-intensive growth strategy in a favourable international economic environment. The challenge now is industrial upgrading, with labour-intensive industries no longer at the core of Taiwan's comparative advantage. Whether Taiwan can successfully transform itself into a technology- and capital-intensive economy depends on how it manages two major external forces that are overwhelming the region – the emergence of China and the proliferation of preferential trade agreements and subregional arrangements.

How should Taiwan use its international economic diplomacy to respond to the rise of China? How can Taiwan relate to the evolving economic dialogues and associations in East Asia, including ASEAN+3, the Manila Framework Group and the various FTAs and economic partnership arrangements that are under contemplation? We argue that, economically and politically, the best way for Taiwan is to go loudly and actively globalist. There is no future for Taiwan – or only the most uncertain and divisive future – in focusing on the FTA route.

'Globalisation' is a word that has resonance across the political spectrum in Taiwan. It is a popular idea for two reasons. It is used by people who believe that Taiwan should maintain protectionist measures against China, and discriminate against China, while being open to everyone else. It also appeals to people who believe that Taiwan's globalisation must include China as a key element, but not the sole element, in openness towards the world (Skanderup 2002). It is not yet clear which course Taiwan will take in its globalisation strategy.

As discussed earlier, accession to the WTO delivers a long-term commitment to a more liberal and open regime in China and provides tremendous economic and business opportunities for the region. A new wave of trade and industrial transformation is taking place across the region, as multinational firms rationalise their production processes and the way in which they deploy capital and other resources. China is leading the third great wave of regional transformation. The first took place in the 1960s and



1970s, when there was an industrial transformation very similar to that of today with the impact of Japan's growth on the region (and later its shedding of labour-intensive industries to the newly industrial economies, including Taiwan). The second occurred in the late 1980s, when newly industrial economies, including Taiwan, began to relocate labour-intensive industries to mainland China and Southeast Asia (Figure 3).

As we have explained, the current wave of industrial relocation involves both inter-sectoral and, more importantly, intra-sectoral re-specialisation in international trade and production. It involves upstream parts of an industry being located in one or more countries while downstream parts of the same industry are located in another country or in several other countries. A most favoured nation trade policy regime provides the best platform for multinational firms to rationalise their operations through the relocation of different parts of their production processes if they are to do so on the basis of efficiency rather than preferential trading arrangements with particular source countries.

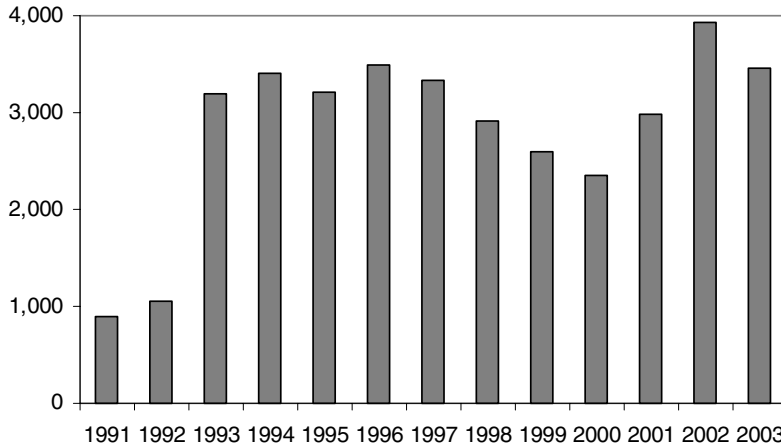
This observation applies particularly to China, now the main destination for early-stage processing activities in East Asia. Taiwan's trade policy of discrimination against China severely limits its ability to benefit from the most important positive force sweeping the East Asian economy or even cuts it out altogether. Taiwan's investment and trade have been on a large scale and have shown impressive growth rates, but they are truncated by the present regime, and this damages economic welfare in Taiwan and cuts off the supply of low-cost goods and inputs to consumers and producers alike. It is an irrational economic policy strategy – a strategy that has its logic in the economics and politics of an earlier time.

For these reasons, it would seem to be a great mistake for Taiwan to use globalisation as a rallying call for openness towards everyone but China while continuing to use protectionist measures against China. Such a strategy is founded on failure to accept the extent to which the rise of China will create economic opportunity in the regional and international economies. It would deny Taiwanese industries a golden opportunity to move further up the value chain – and would deny them this opportunity at greater and greater cost. This conclusion is not based on the assumption that there are no risks in the third wave of Chinese and regional transformation. However, as we shall argue, there is a choice of policy strategy for Taiwan that will minimise the risks.

The FTA route (back to the future of a cosseted relationship with the United States) is equally unpromising, both economically and politically. It makes no sense to channel large and very scarce policy and diplomatic resources into a strategy that is doomed to failure or to lose international cachet. It is unlikely that Taiwan will negotiate an FTA that would yield more than trivial economic benefits in the short term and that in the long term would lead to a path of painful adjustment when it eventually



Figure 3 Taiwan's investment in mainland China (US\$ million)



Sources: Official statistics of Ministry of Foreign Trade and Economic Cooperation, China. See *China Statistics Yearbook*, China Statistical Press, various years. Data for 2003 are from *China Economy and Statistics Express*, National Bureau of Statistics, July 2004 issue.

confronted the reality of China. Moreover, the FTA route invites increasing diplomatic ridicule. Taiwan is truly between a rock and a hard place in respect of trade and foreign economic policy strategy.

A common market without external tariffs

Some people have argued that Taiwan could seek a common market with China. This is a radical idea, given current economic and political relations. It could be seen as a way to define a political association that addresses the key interests of both Beijing and Taipei. However, it has a fatal flaw: it presumes a huge amount of trust in what would be a fundamental and early commitment to close political cooperation. This would be clearly harder for Taipei than for Beijing within a concord in which the ballast of other partnerships was lost. It might succeed if Beijing responded in a way that encouraged a greater degree of political goodwill, but it would exacerbate the schizophrenic attitude towards the mainland by the body politic in Taiwan and is therefore likely to fail. For economic reasons, Taiwan must deal with China sooner rather than later, but the traditional common market strategy is too up-front too soon. Taiwan is not Hong Kong and is unlikely to be in that position for some time.



There is an alternative route by which Taiwan could secure and maximise the economic benefits of deeper integration with mainland China at the same time as managing its political complexities. The arrangement would require commitment to deeper integration with the mainland through a unilateral liberalisation that applied equally to all Taiwan's trading partners, not only the mainland. This strategy could have two main elements, one focused on cross-Straits integration, the second focused on developing a leading role for Taiwan in the multilateral WTO agenda. A globalisation strategy that encompasses both the China factor and the global factor is likely to be the best way to serve both Taiwan's economic interests and its political interests. We call this strategy a global integration strategy.

A program of unilateral liberalisation should not be restricted to the liberalisation of trade in goods and services across the Taiwan Straits and beyond. Importantly, it should also include the liberalisation of capital flows. The best way for Taiwan-based business to take advantage of growing opportunities in mainland China is for Taiwan to allow its business community to invest freely there. And liberalisation of trade and investment is only one aspect of the strategy. The other is a program directed at facilitating trade and investment – application of the APEC agenda – a priority which should include all elements of trade and commercial linkages that have yet to be established between Taiwan and the mainland.

The merit of the common market idea¹⁶ is that it encompasses the element of trade facilitation as well as the element of liberalisation, both of which are central to opening up direct and efficient dealings across the Taiwan Straits. The long-established consensus is that geographical proximity, common language and culture and complementary factor endowments offer big gains when countries remove barriers to the movement of goods and services, capital and people, and that these gains would apply to both Taiwan and mainland China. Unravelling the political deadlock remains the key (Xu 1994). Global integration without a common market may be one way forward. It has the potential to lift Taiwan's leverage through constructive participation in the WTO. It would also define a new role for Taiwan that would help to bring the focus of regional arrangements back to the broader global agenda in which, as we have argued, Taiwan can be more comfortable about pursuing greater openness with China.

Market-driven integration between China, Hong Kong and Taiwan is already strong, though it is an incomplete triangular relationship. More than half of China's cumulative FDI inflows over the reform period (up to 2003) have come from Taiwan and Hong Kong (Table 2). The conclusion of a CEPA between Hong Kong and China brings still deeper integration to one side of the triangle. However, cross-Straits trade is still limited (Tables 3 and 7) and Taiwanese investment in China above a certain level is still restricted. Even small and medium-sized firms that already have operations in China face an array of problems – for example, double taxation, investment protection and safety and security



issues – that prevent both sides from enjoying the full benefits of integration. In developing a global integration strategy for Taiwan, the starting point is to give priority to the facilitation element of the common market proposal. Dealing with these issues does not require the creation of a common external tariff, as is required for a traditional common market, or preferential trading arrangements, as are required for an FTA. The issues can be dealt with perfectly well in a global integration strategy that delivers commitment to a scheduled package of liberalisation and facilitation measures at the same time.

A dynamic, prosperous Chinese economy will benefit all stakeholders across the Taiwan Straits. So too will a dynamic, prosperous Taiwan economy. Beijing's guiding principle for managing cross-Straits relations is 'pursuing common interests by leaving alone disagreement'. From this perspective, a common market might win favour in Beijing. Yet the element of exclusion in a traditional common market framework would make Taipei beholden to Beijing in a way that would present too many risks on the way to political transition on the mainland and across the Taiwan Straits. In addition, a 'closed' common market might accommodate less productive and efficient players, creating new distortions and new interest groups begging for retaliation by major players outside – for example, the United States, which remains one of the most important export destinations for the Chinese economies. The choice of an open global integration strategy by Taiwan would therefore seem to offer a promising way forward.

Regional strategies with a global face

A global integration strategy might provide just the response to the challenging external environment that now confronts Taiwan (Garnaut 2003a). But a number of questions would have to be considered and conditions met if it were to do so. The questions relate to Taiwan and China's position in the WTO and Taiwan's position in regional East Asian arrangements. The conditions relate to the domestic political platform and policy capacities that are required for success.

The first question is whether the membership of the Peoples' Republic of China and Taiwan in the WTO can be directed to delivering an agenda for deeper integration across the Taiwan Straits and within the region. Taiwan and China are yet to develop member-to-member working relationships within the WTO. There is no articulated agenda for cooperation on the intersection of bilateral issues in multilateral negotiations or on common interests in third-party dialogues. This situation has arisen for substantial political reasons – and the politics have become more complicated since the Taiwanese presidential election on 20 March 2004 – but also because of limitations in process, capacity and experience in centres of policymaking in Taipei and Beijing. Both Taipei and Beijing are new to the process, and their policy and negotiating capacities are severely overstretched. The development of



policy capacity will take time but there are quicker ways of acquiring it and more effective ways to engage. There are informal second and one-and-a-half track mechanisms that channel bilateral policy dialogue between the two capitals, but there is not an adequate mechanism for the policy shift called for here. Moreover, bilateral channels alone are not a suitable way to deal with issues that of their nature involve third-party interests in the region and beyond.

This leads to the second question. What are the implications of joint membership in the WTO for Taiwan's role in APEC and associations with other partners in the region – for example, with ASEAN? The short answer is that there are none. This flows inexorably from the answer to the earlier question. Membership of the WTO has not established any basis of common interest that carries through to regional dealings. That is not to say that common interests could not flow through to regional dealings, but they have not yet done so.

The first step could be to define the opportunities. The argument above suggests that an overarching priority for Taiwan is the global agenda and how to relate regional initiative and action to that global agenda. This is the core APEC agenda, and Taiwan has space to play there. It could also seek to promote these broader interests within the East Asian region through less formal initiatives with countries such as Australia which have no interest in disturbing cross-Straits relationships but which have every interest in forging broader and more open links within the region.

The deep question is this: If a global integration strategy presents such a good way forward in dealing with Taiwan's international economic diplomatic challenges, why has Taiwan shown no sign of adopting it with alacrity? The answer to that question lies in the allusion earlier to policy instinct and political focus. Policy instinct in Taiwan is rooted in the problems and solutions of the past. There is little or no understanding of what lies outside that box. The development of a new set of policy dialogues within Taiwan and between Taiwan and her neighbours could help to chart the way forward. This could be a precursor to an initiative of the kind suggested here, to escape from the atavisms of another era. That needs to be combined with strenuous efforts to strengthen policy capacity and build comprehension of the reality that now confronts Taiwan.

Taiwan's regional role and China's global choice: a way forward

Is an actively multilateralist and globalist role for Taiwan compatible with the evolution of foreign economic policy strategies in China and within the region? China is presently embarked upon a number of initiatives – including the ASEAN FTA enterprise and ASEAN+3 – which could entrench exclusionary policies within the region. These initiatives are largely the product of political and foreign policy



considerations, but there is a constraint on their extension beyond the Southeast Asian subregion. For example, China is comfortable with a multilaterally oriented TIFA with Australia, for example, but is now contemplating an FTA with Australia and examining whether and how it would cut across its many global interests, including the interests of America.

China is already a big economy, and it will not be easy to serve its trade and foreign economic policy interests by confining them to special ties with particular countries or regions. China is rapidly outgrowing even the East Asia region. It is steadily becoming more and more important to its neighbours in East Asia; in turn, they will become less and less important to China as China extends its global reach. Under these circumstances the protection of the WTO framework, and open regional arrangements, will assume greater and greater importance to China's partners in East Asia as time goes by. In brief, if its development ambitions are to stay on course, China must make the global choice.

The challenge is to turn China's positive political and strategic initiatives within East and Southeast Asia into a project of regional economic integration which is wholly consistent with the main game of China's multilateral global interests and the vision of a strong and open East Asian economy. This challenge will come into sharp relief if China enters formal negotiation of an FTA with Australia, as now seems likely.

Clearly, the best way forward will be to develop a broad cooperation agenda on trade liberalisation, investment cooperation, trade facilitation and infrastructure development. Trade liberalisation with ASEAN, for example, would sensibly contribute to the goals of China and East Asia for the multilateral freeing of trade. Taiwan's interest is in reinforcing that idea through its role in APEC, initiatives within the WTO and its own active and independent support of policy dialogue directed to that objective within the region.

Earlier we noted the risks in the Chinese wave of industrial and trade transformation within East Asia, and most importantly in the management of the economics and politics of the process within China itself. In this period of trade and policy transition in China, the dangers are real. Chinese leaders know that it will be at least two decades until transparent market institutions are fully entrenched in the national economy. The transition must involve political system change. During this period, China's major partners in the WTO will, correctly, subject to extra and rigorous scrutiny any special trading deals that China seeks to make with partners within the region or, especially, outside the region.

The Chinese economy is not yet like that of the economies of North America or Europe, even as they were 50 years ago. The challenge for China's domestic reform relates to the fact that what made sense for North America or Europe does not necessarily make sense for China in East Asia today. Whatever value traditional FTAs had in building modern Europe or dealing with particular political and



economic problems in late twentieth century North America (and they had large costs even to these economies), they are reflective of another place and another age. The needs of East Asia in the twenty-first century are different. East Asia has its own characteristics. The ASEAN+1 and ASEAN+3 groupings make sense even if they are not organised around the substructure of traditional discriminatory trading arrangements.

Taiwan's commitment to a global integration strategy at this time can support cross-Straits interests and help to shape a regional framework that is with the sweep of history rather than battling against it. That will help to advance the evolution of an economy in China that genuinely conforms to WTO principles and that occurs within a multilateral economic framework that encourages economic and political openness and transparency, contributing both to East Asia's trade and political goals and to a stronger WTO system. In this way, Taiwan's strategic foreign economic policy interests within the East Asian region might be better served.

Notes

- * This paper is based on a chapter in *Taiwan, the Peoples' Republic of China, and the WTO: Implications and Impact* (eds Stephen Goldstein and Julian Chang, 2004). The authors are grateful to Dr Jongsoon Kang, Mr Marpudin and the staff of the ANU's International Economic Databank for assistance with data and Mr Shiro Armstrong for excellent research assistance. Peter Drysdale is Emeritus Professor in the Asia Pacific School of Economics and Government at the ANU. Xinpeng Xu is Assistant Professor at Hong Kong Polytechnic University.
- 1 The People's Republic of China became a WTO member on 11 December 2001 after more than 15 years of negotiation and Taiwan became a member as the 'Separate Customs Territory of Taiwan, Penghu, Kinmen, and Matsu' on 1 January 2002, having launched its application 12 years before.
- 2 The discussion here assumes that China will be able to manage the risks associated with WTO entry and subsequent liberalisation in its capital account, in particular the challenges that arise from the present vulnerability in the domestic banking system. These risks are discussed in more detail later.
- 3 There are many statistical discrepancies in the data for Taiwan's export trade with China. For example, Taiwan's total exports to China in 2002 were US\$9.9 billion according to Taiwan's customs statistics but US\$38.1 billion based on mainland China's customs statistics. According to Hong Kong customs reports, Taiwan's exports to mainland China were US\$10.3 billion for the same year. Taiwan's customs data underestimate Taiwan's exports to China because some Taiwanese exporters report their destination as Hong Kong when in fact the destination is mainland China via Hong Kong.



- 4 The McKibbin and Woo conclusion follows from a simulation exercise which they undertake. See also Abeysinghe and Lu (2003).
- 5 This information is from the Ministry of Economic Affairs (Taiwan) website, <www.moea.gov.tw>.
- 6 For a detailed analysis of the effects of FTAs, see Bhagwati and Panagariya (1996).
- 7 China and ASEAN reached agreement on a framework to establish an FTA at the end of 2001. Japan has also declared interest in forming an FTA with ASEAN countries. (Information on Japan's FTA strategy is available at the Ministry of Foreign Affairs of Japan's official website, <<http://www.mofa.go.jp/policy/economy/fta/strategy0210.html>>, accessed on 31 October 2003.)
- 8 See Findlay, Piei and Pangestu (2003) for an excellent discussion of the risks and motivations behind FTAs.
- 9 For an alternative view, see Ravenhill (2003).
- 10 Naoko Munakata, Research Institute of Economy, Trade and Industry in Tokyo, quoted in the *Far Eastern Economic Review*, 17 July 2003, p. 29.
- 11 So far, 273 tariff items are covered under the agreement. Other exporters of these products to China are subject to tariffs that range from 5 per cent to 35 per cent. Other products will be added to the list at the request of manufacturers. In the initial phase of the agreement, the rules of origin requirements are spelt out for each product. Rules of origin requirements were not settled until September 2003. The criteria are that processing must involve either a change in the tariff heading or 30 per cent value added in processing. There is also accelerated access under WTO accession obligation for service providers in 18 sectors, including telecommunications, a provision added after conclusion of the initial agreement (Findlay 2003a, pp. 5–7).
- 12 A report released by the International Trade Commission of the United States (2002) concludes that an FTA between the United States and Taiwan would probably have a 'negligible impact' on the US economy and only a 'small impact' on Taiwan, with Taiwan's GDP increasing by 0.3 per cent as a result of the complete elimination of trade barriers under an FTA.
- 13 *Washington Times*, <<http://washingtontimes.com/upi-breaking/20031014-070643-9566r.htm>>, accessed on 30 October 2003.
- 14 See <<http://news.tradingcharts.com/futures/8/3/41093538.html>>, accessed on 30 October 2003.
- 15 See <<http://www.yonhapnews.co.kr/Engnews/20030829/300200000020030829173243E8.html>>.
- 16 Vincent Siew proposed a China common market in May 2001, according to a CNN report 'Taiwan ex-PM seeks to build China common market'; see <<http://edition.cnn.com/2001/WORLD/asiapcf/east/05/08/taiwan.expremier/>>, accessed on 18 September 2003.



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