

# TAIWAN'S ASIA PACIFIC ECONOMIC STRATEGIES POST-ECONOMIC COOPERATION FRAMEWORK AGREEMENT

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EABER WORKING PAPER SERIES

PAPER No. 63

**Taiwan's Asia Pacific economic strategies post-Economic Cooperation  
Framework Agreement**

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*Abstract*

Up to this point, Taiwan has had discriminatory trade and investment policies towards China, severely limiting economic engagement across the Straits. Not having free and open trade with China, one of the largest and most important parts of the East Asian economy, has resulted in Taiwan underperforming in attracting FDI, effectively cut Taiwan off from participating fully in the East Asian production networks and prevented the deepening of its specialisation in the regional and international economy. The Economic Cooperation Framework Agreement is a watershed in cross-Straits relations and gives Taiwan the opportunity to integrate more fully into the East Asian economy. There will be pressure now for Taiwan to pursue preferential trade deals with other countries. This would not seem a sensible way forward; rather Taiwan should pursue a multilateral trade strategy and focus on domestic reforms that will bring larger economic gains, economic diversification and avoid the political risks to the cross-Straits relationship associated with preferential deals.

Paper prepared for conference on *Beyond ECFA: Taiwan and Regional Integration in the Asia Pacific*, hosted by the Institute for National Policy Research, Taipei, 29 October 2010

## Background

The Economic Cooperation Framework Agreement (ECFA), signed on the 29 June 2010 and in force from 13 September, is a significant step in Taiwan's economic normalisation with China. It is also importantly a big step forward in Taiwan's removing protectionist barriers aimed at the mainland and further institutionalising the economic relationship. The ECFA is significant for cross-Straits relations, both politically and economically, and also for Taiwan's engagement in the regional and global economy (Xu, 2010).

The Taiwanese situation is unique. Taiwan has had a relatively open trade and investment regime except for the discriminatory barriers affecting trade and investment towards China in the name of security. The politics aside, severely limiting economic engagement with a dynamic China that is one of the largest and most important economies in the region, in close proximity, has limited the growth prospects and benefits not only from deeper economic engagement with China but also with the region and international economy more broadly.

The removal of restrictions of import bans on mainland goods in Taiwan has come in stages. Even recently the number of banned commodities was high. This list includes automobile parts and components. Even after both China and Taiwan acceded to the WTO in 2001, trade and investment remained severely restricted between them. At the end of 2000, 44 per cent of all 10,724 ten-digit commodities in the harmonised tariff schedule were prohibited from being imported into Taiwan from China. After accession, Taiwan removed import restrictions on Chinese imports for 2,058 products in February 2002 and in November that year a further 316 items were permitted<sup>1</sup>.

Under the ECFA, China will gradually lower tariffs for 539 categories of imports and open 11 service categories and 18 farm and fishery categories to trade while Taiwan has agreed gradually to reduce tariffs on 267 items, most of which are

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<sup>1</sup> Ministry of Economic Affairs, Republic of China.

industrial components. These policy measures will be phased in over time to minimise the cost of necessary structural adjustments. The 539 categories only account for 16 per cent of Taiwanese exports to mainland China. The ECFA is a 'framework agreement' that sets the foundations for further negotiations and cooperation but at this initial early harvest stage China has given more concessions and opened up more to Taiwan than Taiwan has. The ECFA will set up cross-strait economic cooperation committees and hold regular meetings for discussions on agreements covering investment protection, commodity trade, service trade, and a dispute resolving mechanism<sup>2</sup>.

**Table 1 Taiwanese import and export partners, 2000-2009**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
	Export Share (per cent)									
ASEAN	12.5	12.2	12.2	12.1	13.3	14.0	13.9	14.7	15.3	15.1
China	2.8	3.9	7.6	14.9	19.6	21.6	23.2	25.4	26.2	26.8
EU	15.3	15.5	13.6	13.5	12.8	11.6	11.0	10.9	10.9	10.5
Hong Kong	21.1	21.9	23.6	19.7	17.1	16.2	16.6	15.3	12.4	13.8
Japan	11.2	10.4	9.2	8.3	7.6	7.6	7.3	6.5	6.9	7.1
Korea	2.6	2.7	3.0	3.2	3.1	2.9	3.2	3.2	3.4	3.6
USA	23.5	22.6	20.5	18.0	16.2	15.1	14.5	13.0	12.1	11.7
	Import Share (per cent)									
ASEAN	14.5	14.9	14.8	13.8	12.1	11.6	11.5	10.8	10.7	11.4
China	4.5	5.5	7.1	8.7	10.0	11.0	12.3	12.8	13.1	14.1
EU	11.3	12.3	10.9	10.5	10.0	9.7	8.8	9.1	8.2	9.0
Hong Kong	1.4	1.6	1.5	1.3	1.2	0.9	0.8	0.7	0.5	0.4
Japan	27.6	24.1	24.2	25.7	26.1	25.3	22.8	20.9	19.3	20.7
Korea	6.5	6.3		6.9	7.0	7.3	7.4	6.9	5.5	6.0
USA	18.1	17.1	16.2	13.0	12.7	11.6	11.3	12.2	11.0	10.5

Notes: EU is the 25 EU countries and ASEAN is all 10 ASEAN members.

Source: World Integrated Trade Solutions (WITS) database.

The result of Taiwan's bans on trade between China and Taiwan is that China's share in Taiwan's imports trade remained low for much of the last two decades (Table 1). In 2000, only 2.8 per cent of Taiwanese exports went to China and 4.5 per cent of imports were from China. With accession to the WTO, and as bans were lifted, the share of China in Taiwan's exports and imports steadily increased with China becoming the largest destination for Taiwanese exports in

<sup>2</sup> Taiwan-mainland ECFA formally takes effect, *The China Post*, 12-09-2010, <http://www.asianewsnet.net/home/news.php?id=14257> last accessed 13 October 2010.

2004 and accounting for 26.8 per cent in 2009. Imports from China, however, still only accounted for 14.1 per cent of Taiwan's imports.

Taiwanese restrictions on imports from China have been imposed under the guise of political-security concerns and economic protection has been rampant in the name of Taiwanese sovereignty (Drysdale and Xu, 2004; Kastner, 2009). The argument is that economic interdependence across the Strait will allow China to force, coerce and manoeuvre towards unification (Skanderup, 2004). The argument is problematic and has lacked proper debate (Ho and Leng, 2004) as Taiwan also gains political leverage from economic interdependence with China and may reduce risks of hostility across the Straits through higher levels of engagement<sup>3</sup>. An alternative view is that closer economic relations and the ECFA would make the Taiwanese economy more valuable to the mainland and make the two economies mutual stakeholders in each other (Zhao and Tong, 2009). The economic relationship also serves as a constraint on both Beijing and Taipei politically (Skanderup, 2004).

There is no political-security rationale for a policy approach that in effect denies Taiwan competitiveness in the international marketplace (Drysdale and Xu, 2004).

The political circumstances have been improving in the last decade since WTO accession and have been accelerated since President Ma and the KMT came to power in 2008. But the impetus of the ECFA agreement came from the opportunity opened to policy makers from the 2008 global financial crisis (Zhao and Tong, 2009). Taiwan's underperformance in trade, economic growth and inability to attract FDI brought a sense of urgency to developing a new policy strategy and provided an opportunity to push for further economic engagement with the mainland. Taiwan was falling behind in GDP per capita terms as its neighbours enjoyed rapid growth leading up to the crisis (Zhao and Tong, 2009).

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<sup>3</sup> See Kastner (2009) for discussion on this.

## Trade performance

It is not possible to judge whether cross-straits trade is lower or higher than it should be simply by looking at the trade shares revealed in Table 1. China is clearly Taiwan's biggest trade partner in aggregate. But is its share smaller or larger than it should be on purely economic grounds? Assessing trade and economic relations between the two economies requires estimation of what the underlying characteristics of the two economies and their location in the international economy would suggest potential trade and investment might be.

Taiwan's trade with China has been compared to South Korea's trade in making judgements about its performance, given that Taiwan and South Korea share relatively similar income levels, industrial structures and proximity to China<sup>4</sup>. But in order to judge more accurately the performance of Taiwan's trade with China, both exports and imports, an appropriate benchmark or counterfactual is needed to be defined.

A counterfactual can be established using the gravity model, or a variation of it, which enables estimation of what trade should be, or how it is performing given the distance they are apart, the scale of those economies and other factors commonly found in gravity models<sup>5</sup>. Xu and Yu (2010), using the gravity model of trade and data up to 2005, show that Taiwan's imports could have been more than double the value of what they were in 2005, given the characteristics of both economies and their distance apart, if Taiwan relaxed its trade restrictions on imports across the Straits.

Drysdale et al. (2000) and Drysdale and Xu (2004) earlier assessed Taiwanese trade performance by combining the gravity model of trade with stochastic frontier analysis. This method gives results consistent with those of Xu and Yu (2009) but is thought to be better suited to answering the question of whether

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<sup>4</sup> See, for example, Drysdale and Xu (2004) and Xu (2010).

<sup>5</sup> See Armstrong (2007) for a discussion on other variables often used and the ad hoc nature of the choice of variables.

Taiwanese trade with China is underperforming<sup>6</sup>. Estimating trade potential, or a trade frontier, which is a counterfactual upper bound, allows a measure of the economic distance, or unmeasurable costs, in trade relationships. The hypothetical upper bound is estimated from the characteristics of the most liberal and free flowing trade relationships globally.

The earlier study by Drysdale et al. (2000) finds that, in the early 1990s, Taiwan's exports overall were at 52 per cent of potential and imports were at 41 per cent. Taiwan's trade with China both ways, on the other hand, was achieving only 15 per cent of its potential. Drysdale and Xu (2004) update these results for the period 1996 to 2001 and find Taiwan's overall export performance rose to 53 per cent and import performance rose to 47 per cent whereas Taiwan's exports to China had risen to 29 per cent and imports from China were still only 14 per cent of potential. It is clear that there were significant barriers to Taiwan's trade, especially its import trade, with China and that these barriers were very costly to Taiwan in terms of its realisation of potential trade with China. Drysdale and Xu show that if Taiwan's trade with China included trade through Hong Kong, the numbers improve drastically, but still show underperformance relative to total Taiwanese exports and imports as well as the world average.

Results from Armstrong (2009) tell a story that is different from, yet consistent story with that of the earlier studies for the period up to 2006. While the model specification is different and the counterfactual is estimated using a different (yet still large) sample of global trade, this study also allows comparison of Taiwan-China bilateral trade performance against overall Taiwanese trade performance. The underperformance of bilateral trade continues until 2002 but from 2003 to 2006 steadily rises to the point where Taiwan-China trade

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<sup>6</sup> The frontier gravity method is conceptually and technically favoured to comparing trade to the mean value that a conventional gravity model will predict. A key assumption of the gravity model is that the residual has a mean value of zero and is random by design. Underperformance of trade is not always or systematically random. Using a stochastic frontier approach, a random component is separated from the inefficient or 'underperformance' of trade. Armstrong (2007) details the applicability of the model.

performance both ways is comparable to Taiwan's overall performance in exports and imports in 2006. The lifting of bans on 2,368 product categories in 2002 was followed by an expansion of trade that has helped Taiwan realise more of its bilateral trade potential with China.

The cost of the economic barriers between Taiwan and China are beyond the extra cost of moving goods or capital through Hong Kong. The additional cost of moving goods or capital through Hong Kong might make other trade and investment partners cheaper (Korea or Vietnam, for example) at the margin. It effectively increases the distance between China and Taiwan and therefore the transactions costs. In the highly fragmented production networks in East Asia where margins are small and trade in parts and components is based on small price differences, additional trade costs have a significant impact. Also, the nature of some services (and trade in some goods) require FDI and so the potential for trade in services could not be realised.

The Chinese and Taiwanese economies are highly complementary. Taiwan is more industrialised with high technology and skilled labour production and China has a higher abundance of unskilled labour with low cost production. Drysdale and Xu (2004) show China's overall pattern of export specialisation matches the pattern of import specialisation of Taiwan to a very high degree. Yet the results from that study also show Korea has been able to take fuller advantage of the growing Chinese economy in its utilisation of comparative advantage than has Taiwan.

For Taiwan, the FDI story is similar to the trade story but its impact extends beyond the bilateral relationship. Taiwan's total inward FDI to GDP ratio was 12.7 per cent in 2009 compared to an average of 46.3 per cent in Southeast Asia (Table 2). A carefully constructed counterfactual as in the trade case would tell the same story: Taiwan has underachieved as an FDI destination.



Table 2 shows Taiwan's FDI stock to GDP ratio is comparable to that of Pakistan and Sri Lanka in 2009 and has been marginally higher in the last decade. Taiwan is comparable to Korea in most years, much higher than a relatively closed off Japan, but well below the world average and especially the average of Southeast Asia, for example, as a whole. There is significant variation within Southeast Asian economies but they all have higher FDI stock to GDP ratios than does Taiwan for each year since 2005 and for most economies and most years before that dating back to 1990<sup>7</sup>. By 2005 cross-Straits trade has started to rise as import bans were gradually lifted but there is no upward trend in FDI stock as a proportion of GDP in Taiwan.

**Table 2 FDI inward stock as a percentage of GDP, selected years**

Region/economy	1998	2000	2002	2003	2004	2005	2006	2007	2008	2009
<b>World</b>	18.5	23.3	22.8	25.2	26.4	25.4	29.1	32.5	25.4	30.7
European Union	18.5	27.5	31.7	34.0	36.0	34.1	40.7	44.7	36.4	45.5
Canada	23.2	29.3	30.7	33.4	31.8	30.1	29.3	36.3	29.5	39.3
United States	25.1	28.5	19.4	22.5	23.4	22.8	25.1	26.1	17.9	21.9
Australia	28.5	29.8	35.2	39.6	43.3	32.8	37.8	40.5	29.5	33.5
Japan	0.7	1.1	2.0	2.1	2.1	2.2	2.5	3.0	4.2	3.9
China	16.8	16.2	14.9	13.9	12.7	12.2	11.0	9.7	8.7	10.1
Hong Kong,	134.9	269.3	205.3	240.5	273.1	294.3	390.9	568.7	379.4	433.2
Korea	5.6	7.1	10.9	10.3	12.2	12.4	12.5	11.4	10.2	13.3
Macao	45.1	45.9	47.7	45.0	38.0	43.8	45.8	48.4	51.2	63.1
Taiwan	7.3	6.0	10.0	12.0	11.3	11.8	13.3	12.4	11.3	12.7
<b>South Asia</b>	4.4	4.2	5.5	6.1	6.0	6.1	7.9	9.1	8.9	11.2
Pakistan	14.4	9.7	8.2	8.5	7.9	9.3	10.8	17.9	11.3	11.1
Sri Lanka	12.7	9.8	10.0	10.3	10.5	10.0	10.4	10.9	10.5	11.2
<b>Southeast Asia</b>	47.4	44.5	41.0	41.5	41.9	44.7	45.8	50.6	43.3	46.3

Source: UNCTAD, FDI/TNC database, World Investment Reports (various years).

Notes: the ratio is between a stock variable (FDI) and flow variable (GDP). Regions (in bold text) are averages.

Table 3 shows another measure of how much FDI Taiwan has attracted. FDI inflows as a percentage of gross fixed capital formation show that Taiwan is attracting more FDI than Korea since 2006 and for some earlier periods when Taiwanese import bans on Chinese goods were wider-ranging. Table 3 shows that Taiwan is not attracting as much FDI as Southeast Asia, the global average or South Asia, by this measure.

<sup>7</sup> Source: UNCTAD, FDI/TNC database (<http://www.unctad.org/fdistatistics>).

**Table 3 FDI inflows as a percentage of gross fixed capital formation, selected years**

Region/economy	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
<b>World</b>	11.0	16.3	20.3	12.3	9.3	7.4	8.3	10.0	13.4	16.9	12.6	9.1
China	13.2	10.9	10.0	10.3	10.0	8.3	7.7	7.7	6.4	6.0	5.3	4.0
Hong Kong	29.4	58.6	9	55.7	26.4	40.6	96.4	90.4	5	3	9	2
Korea	4.8	7.5	5.6	2.8	2.1	2.3	4.3	2.9	1.8	0.9	3.1	2.4
Taiwan	0.3	4.2	6.1	6.8	2.4	0.7	2.4	2.0	8.8	9.0	6.4	4.0
<b>South Asia</b>	2.6	2.0	3.0	4.4	5.7	3.7	3.7	4.1	6.7	6.4	8.6	7.4
<b>South-East Asia</b>	18.0	23.2	17.0	15.3	12.3	15.8	19.8	19.5	22.4	23.9	12.5	9.4

Source: UNCTAD, FDI/TNC database, World Investment Reports (various years).

Notes: Regions (in bold text) are averages. Unlike Table 2, the ratio is of two flow variables instead of a stock to flow variable.

It is useful to compare these measures of FDI performance with indicators of the attractiveness of FDI destinations. Urata and Ando (2010) use the World Bank's *Ease of Doing Business* database and the World Economic Forum's *Global Competitiveness Index* to assess the investment climate in ASEAN. It is common to use indexes of economic freedom, such as the Heritage Foundation's *Index of Economic Freedom* and the Fraser Institute's *Economic Freedom of the World Index*, in cross country regressions to explain trade and FDI volumes. The more economic freedom an economy has, the higher trade, both imports and exports, and FDI, both outward and inward, tend to be once other factors are controlled for<sup>8</sup>.

Taiwan's underachievement in attracting FDI (for stock and flows, see Tables 2 and 3) is not obviously the result of lack of economic freedom or lack of competitiveness in Taiwan. Taiwan ranked 13<sup>th</sup> in the world in the Global Competitiveness Index and as high as 4<sup>th</sup> in 2004-5. Taiwan was in the top 10 globally each year during the period 2001-2005. Taiwan ranks highly in indexes of economic freedom (Table 4) but does not score so highly in the World Bank's Ease of Doing Business Index ranking 61<sup>st</sup> of 183 economies in 2009 and 46<sup>th</sup> in 2010.

<sup>8</sup> Ravallion (2010) provides a useful discussion on the limitations of composite indices such as those used here.

**Table 4 Global competitiveness and economic freedom in Taiwan**

Index	Period	Rank	Comparison
Global Competitiveness Index	2010-11	13 (of 139)	Korea (22), Hong Kong (11)
Economic Freedom of the World	2006	18 (of 141)	Korea (29), Thailand (56), Malaysia (72)
Index of Economic Freedom	2010	27 (of 183)	Korea (31), Hong Kong (1) Malaysia (59)
Ease of Doing Business	2010	46 (of 183)	Korea (19), Hong Kong (3), China (89), Malaysia (23)

Sources: *Ease of Doing Business* (<http://www.doingbusiness.org/>), *Global Competitiveness Index* (<http://www.weforum.org/en/initiatives/gcp/index.htm>), *Economic Freedom of the World* (<http://www.freetheworld.com/>) and the *Index of Economic Freedom* (<http://www.heritage.org/>).

Taiwan does much better than every Southeast Asian economy in the Global Competitiveness Index, with the exception of Singapore. The index is comprised of institutional quality, infrastructure, macroeconomic environment, health and primary education, as well as a host of efficiency enhancers and innovation and sophistication factors. Yet Taiwan has not been as successful as Southeast Asia in attracting FDI.

How have Taiwan's discriminatory policies toward China affected Taiwan's economic integration with other countries?

### Production networks

East Asian economic integration is often characterised as market-led and not institution-led, such as in Europe (Armstrong and Drysdale, 2010). The region's trade and investment integration have come about from domestic commitments to openness and unilateral trade and investment liberalisation. That, together with advances in transport and communications technology, has led to a complex set of production networks with deep specialisation often at each stage of production for manufactures, led by electronics and automobiles (Ando and Kimura, 2005) but extending to manufacturing in many sectors. In 2006 roughly 40 per cent of manufacturing trade in East Asia was parts and components trade

with half of all trade in machinery and transport equipment (SITC 7), and almost two-thirds of information communications technology goods trade in parts and components (Athukorala and Menon, 2010).

A typical pattern of production fragmentation can be seen as investment by multinational enterprises (MNEs) in Southeast Asia and China, which trade in parts and components between production bases in Southeast Asia and the rest of the region, and more often than not, assembly in China before the final good is exported to the United States or Europe (Athukorala and Yamashita, 2009). An important part of the production networks and the fragmentation of production happens because MNEs set up subsidiaries abroad which then either produce and trade parts and components or assemble final goods, or subcontract local firms for some activities. Japan, South Korea, Singapore and Taiwan typically supply technology-intensive parts and components while labour-intensive parts and components are produced in the Southeast Asian countries with lower wage costs. While this phenomenon is not new, the degree to which production at each stage in the value-add process has been split up and conducted in different locations is unprecedented and has been made possible by complex logistics and information communications technology management as well as drastic falls in transportation costs. Commonly that requires openness to FDI and trade related services as well as goods. It is in this way that full participation in production networks is allowing deeper specialisation in a country's comparative advantage.

The link between trade and FDI is a strong and important nexus that has driven these production networks<sup>9</sup>. The underperformance of Taiwan's trade with China is strongly related to Taiwan's overall FDI underperformance. Taiwanese investment into China is substantial but the persistence of commodity and service trade restrictions have hampered Taiwan's full integration into regional production networks.

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<sup>9</sup> For a full discussion, see Palacios (2007).

Taiwan's economic barriers and the discrimination against the mainland have limited the benefit from this wave of deep specialisation trade and production in East Asia (Drysdale and Xu, 2004). This has slowed Taiwan's climb up the value-added chain. Taiwan cannot add value to some cheap intermediate imports from China and is limited in what it can export to China. Taiwanese firms have not been able to take full advantage of China's upstream or downstream processing capacity. This severely limits, though not completely, the engagement of foreign MNEs in Taiwan looking to participation in these production networks. An important rationale for the ECFA is that it will enhance Taiwan's position as a platform for regional investment<sup>10</sup>.

The cross-strait economic relationship is nested in a many-country setting with complex interdependent economic linkages.

Thus, the effect of preventing Taiwan developing closer economic ties to China has impact beyond the bilateral relationship. It also retards Taiwan's economic engagement with the rest of the regional and global economy despite Taiwan's openness to the rest of the world. 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 and with major industrial economies outside the region (Drysdale and Xu, 2004 p.14).

### **The way forward**

The ECFA is also seen as an instrument that will free Taiwan to sign free trade agreements (FTAs), and it will be tempting to 'fix' or reduce the discrimination borne by the FTAs of Taiwan's trade partners. However, Taiwan's trade, investment and economic growth troubles were not primarily a product of political factors with China which prevented Taiwan from signing FTAs with large trading partners.

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<sup>10</sup> Economic Cooperation Framework Agreement Background, Mainland Affairs Council, last accessed 14 September 2010, [www.mac.gov.tw/public/data/051116322071.pdf](http://www.mac.gov.tw/public/data/051116322071.pdf)

The China-ASEAN FTA will discriminate against Taiwan and there is fear of Taiwan being cut off as it comes into force in 2011. Taiwan has, in fact, been cutting itself off from China anyway, and therefore effectively cutting itself off from fully participating in the regional production networks and limiting integration with other countries (Zhao, 2010). Japan, Singapore and the EU have signalled interest in pursuing FTAs with Taiwan post ECFA. The United States has made Taiwan's economic normalisation with China a precondition for Taiwan to sign an FTA with the United States. FTAs with Japan, the United States or the EU would be significant for Taiwan<sup>11</sup> but they may well impact more adversely than positively on Taiwan's trade in East Asia.

The FTAs that Taiwan has signed to date are not with trading partners with high enough trade shares in East Asia to make any meaningful difference. Taiwan has signed FTAs with Peru, El Salvador, Honduras, Guatemala, and Nicaragua in an attempt to gain access to the large North American market through Central America (WTO, 2010). To date, Taiwan's preferential trade agreements have not been significant enough to distort or disrupt its trade in East Asia, except through its negative discrimination in trade with China.

The options for initiatives in Taiwan's economic diplomacy post ECFA are to imitate its neighbours and start signing FTAs with major trading partners, or to take advantage of the fact that there are political risks in doing so, and the fact that it has a clean slate with no discriminatory deals in place and move forward with an agenda that delivers much higher multilateral gains from trade. The normalisation of economic relations across the Straits allows Taiwan to engage the region more substantially. FTAs would limit that engagement.

The literature that carefully measures the impact of FTAs on trade and investment show that the economic gains from Taiwan signing preferential, bilateral trade agreements will be minimal (Bhagwati and Panagariya, 1996;

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<sup>11</sup> An FTA with Singapore would not be as significant since tariffs are already close to zero but it would be the easiest for Taiwan to pursue given Singapore does not have an agricultural sector.

Garnaut, 2002; Adams, et al, 2003; Garnaut and Vines, 2003; Dee, 2007a; Dee, 2007b). FTAs are more discriminatory than their preferential tariffs would suggest because of the contingent protection from FTAs causing a 10 to 30 per cent increase in anti-dumping disputes (Prusa and Teh, 2010).

There is a large body of literature that estimates gains from alternative strategies of liberalisation and it demonstrates that comprehensive reform of impediments to competition from all, domestic and international sources, brings by far the greatest gains from liberalisation and reform<sup>12</sup>. Preferential trade deals are frequently an excuse for reform-weary government to avoid doing things that really matter (Dee, 2007a, p. 421). Domestic regulatory reform brings the largest gains, followed by multilateral liberalisation, with FTAs delivering trivial gains (Dee, 2007b). The WTO can still be targeted to deliver trade liberalisation in difficult sectors. Even for an ASEAN plus 3 FTA, which would deliver higher gains than bilateral FTAs, domestic regulatory reforms, or structural reforms, are estimated to deliver five times the gains (Dee, 2007a).

The problems with FTAs in the East Asia region, and more broadly, are well known. The rules of origin complicate trade in parts and components leading to many MNEs ignoring the preferences (ADB, 2008). Preferential trade agreements in East Asia, whether bilateral or involving more countries, go against the nature of production networks and the market forces shaping trade patterns in the region. Evidence of this is that, at most, only a quarter of trading firms in the East Asia region surveyed use the preferences of FTAs as shown in a comprehensive study by Kawai & Wignaraja (2009) and most estimates of their utilization are much lower (ADB, 2008).

The services and investment provisions in FTAs usually end up 'protecting competitors, not competition' (Dee, 2007a), hampering domestic reform efforts and further economic diplomacy with third party countries. PTAs with

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<sup>12</sup> See, for example, Dee (2007a) and Dee (2007b).

investment provisions typically give national treatment to foreign investors and experience has shown that in some sectors that means protecting a small number of domestic and foreign companies from competition. The investment chapters in PTAs would allow those foreign companies to take the Taiwanese government to arbitration in the case of Taiwan trying to open up the sector to competition. The benefits of locking in domestic reforms are greater than benefits from bilateral trade agreements, especially if they are preferential.

The political pressure on Taiwan from potential FTA partners will be large. There will also be a strong desire from within Taiwan to join the FTA game. There will be political risks to Taiwan signing FTAs with other countries that will discriminate against the mainland. Going down the FTA route is likely to be an uncertain and divisive strategy for Taiwan (Drysdale and Xu, 2004).

The fact that Taiwan may find it hard to sign into preferential agreements that discriminate against the mainland may be the cue for Taiwan to sign multilaterally consistent bilateral trade agreements that are not preferential (and therefore do not discriminate against trading partners, including China). FTAs can be used as tools to reform the domestic economy and they can include technical assistance, closer bilateral cooperation and enforcement of all sorts of regulation, including intellectual property rights. But not all are a positive force for domestic structural reform and not all of these are best done in a trade negotiating forum (Dee, 2007a). A better option for Taiwan would be to pursue structural reforms to make its economy more productive and to maximise the opportunities brought on by being able to deepen specialisation by fully participating in East Asian production networks.

If Taiwan has to sign bilateral trade agreements, its interests would be best served by signing onto non-discriminatory trade agreements with the option of sign-on by third party countries<sup>13</sup>. This is effectively a most favoured nation

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<sup>13</sup> Bilateral agreements can help air and shipping routes, which generally have to be done bilaterally, that can facilitate trade in production networks. A US FTA could facilitate US-Taiwan-



strategy that has in the past served Taiwan and East Asia well. FTAs are often pursued because unilateral reforms are politically more difficult (as they require more adjustment in the domestic economy) or because multilateral trade liberalisation is stalled at the WTO.

This is not an easy strategy to pursue when there is pressure to sign FTAs and Taiwan is seen as pursuing this strategy alone (although that is nothing new for Taiwan). But Taiwan, given its unique circumstance, is in a position to become an exemplar of a new drive towards multilateral liberalisation and structural reform. It may be an outlier in the region but the economic gains and minimisation of geopolitical complexities would soon provide momentum and confidence in carrying this strategy forward.

A relatively open investment environment will attract FDI now that Taiwan is not effectively cut off from China. The ECFA will result in Taiwan securing more FDI as Taiwan-China economic integration deepens (WTO, 2010). Taiwan is also recognised as having a relatively liberal GATS schedule given its level of development.

The ECFA does not have to become a preferential agreement. Taiwan's interests are served by avoiding an agreement similar to the Closer Economic Partnership Agreement (CEPA) signed between Hong Kong and China which brought deeper economic integration between the two but has preferential features. Pursuit of a closed common market with China, that is preferential and inward looking (as is the Hong Kong CEPA case), has the potential to create new distortions and new interest groups that cause retaliation from other important traders such as the United States and Japan (Drysdale and Xu, 2004), that also add to the political complexities. There is the argument that instead of political 'retaliation' of any sort, which actually has not happened anywhere recently, the domino effect of competitive liberalisation with FTAs will dominate. There is an added

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China shipping.

complexity, however, as Article 16 of the ECFA is a termination clause where either China or Taiwan can notify the other of termination of the ECFA which takes effect 180 days later<sup>14</sup>.

Careful analysis (Armstrong, 2009) finds that it is the multilateral setting of complex economic linkages and deep economic interdependencies beyond the bilateral relationship that has allowed the Japan-China economic relationship to prosper despite political tensions. An inward looking, preferential arrangement would likely mean that bilateral economic issues are dealt with in a bilateral context whereas Taiwan's best interests are served in dealing with economic issues in multilateral forums (APEC and the WTO) wherever possible to minimise the potential for bilateral political fallout. APEC would be the best option for issues that are not bilateral-specific and can be handled in discussions with other members present, acting as buffers. The WTO would be the best forum for trade and other economic disputes where rules and norms are established and tensions can be de-politicised.

The voluntary and diverse nature of APEC makes it the suitable forum for furthering domestic structural reform, just as it supported and gave confidence to unilateral trade reforms for member economies in the 1990s. Taiwan should focus its economic diplomatic resources on furthering the APEC agenda and shaping the agenda to suit its circumstance. Taiwan should also be able to play a more significant and active role in the WTO now that economic relations with China have been normalised. This global strategy, focused on what Taiwan does domestically, will position Taiwan to engage with its neighbours on equal terms, bring the largest welfare gains and allow Taiwan to play a positive role and be a positive force in regional and global arrangements at the same time as protecting its political interests.

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<sup>14</sup> See the Bilaterals.org website <http://www.bilaterals.org/spip.php?article18166> last accessed October 30, 2010.

This global strategy<sup>15</sup>, is now not only easier after the ECFA but its benefits are also larger and will come sooner as Taiwan is now open to fuller participation in global production networks. Pursuing preferential deals are only likely to complicate the politics and reduce Taiwan's ability to deeply integrate into the cross-Strait, regional and global economies.

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<sup>15</sup> See, for example, Drysdale and Xu (2004) and Skanderup (2004) for discussion of a global strategy prior to the ECFA.

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