NORTH-HOLLAND

Available online at www.sciencedirect.com

SCIENCE DIRECT®

China Economic Review 14 (2003) 316–349

China Economic Review

WTO accession, the "Greater China" free-trade area, and economic integration across the Taiwan Strait

Zhi WANG*

School of Computational Sciences, George Mason University, Room N2109, 1800 M Street, N.W. Washington, DC 20036-5831, USA

Abstract

This paper evaluates the impact of China's World Trade Organization (WTO) accession on trade and economic relation across the Taiwan Strait and its implications for rest of the world by a recursive dynamic computable general equilibrium (CGE) model with import-embodied technology transfer and specification of tariff rate quotas (TRQ) for agricultural products. The simulation results predict that China will likely emerge as one of the world's largest manufacturing centers as it integrates into the world economy. Taiwan will likely become an upstream supplier for China's massive manufacturing production and gain more economically by further integrating its economy with China via a "Greater China" free-trade area (FTA) after its WTO entry. It will further reduce the cost of vertical integration among manufacturing industries across the Taiwan Strait and enable both China and Taiwan to become stronger competitors in the global manufactured goods market.

JEL classification: F02; C68
Keywords: WTO accession; Tariff rate quota; CGE model; China and Taiwan

1. Introduction

Taiwan has long been an active player in the world economy and an important trader in the global market. In recent years, Taiwan has actively pushed for its ambitious drive to be the Asia-Pacific Regional Operation Center along the line with its World Trade Organization (WTO) accession, which further liberalized its economy. With more than two decades of market-oriented reform, China has also advanced rapidly in international trade.

* Tel.: +1-202-694-5381; fax: +1-202-694-5662.
E-mail address: zwang@ers.usda.gov (Z. Wang).

1043-951X/$ - see front matter
doi:10.1016/j.chieco.2003.09.004

Its trade volume has grown from US$38 billion in 1980 to 474 billion in 2000, doubling more than three times in two decades, far faster than world trade growth as a whole in the same period. In 2002, China became the fifth largest exporter in the world with an annual trade over US$620 billion (exports US$325.6 billion). The total external trade of China, Taiwan, and Hong Kong has been over US$810 billion since 1999 (after netting out the intraregional trade among them), far exceeding the total trade of Japan and amounting to about half that of the United States. Their roles in the world economy are continuing to grow as the integration among Chinese economies intensifies by the reunification of Hong Kong and Macao with China and by the entry to the WTO of both China and Taiwan. As predicted by Lardy (2002),"within a decade China's trade is likely to surpass that of Japan and Germany, making China the world's second largest trader."

In spite of huge political differences, complementary factor endowments and mutual economic interests, geographical proximity, and cultural affinity, plus the efficiency of Hong Kong as a "commercial middleman," have enabled China and Taiwan to develop intense trade and investment linkages in the past 15 years. The indirect trade between Taiwan and China increased from less than US$1 billion in 1987 to more than US$40 billion in 2002. The dependence of Taiwan's exports on China and Hong Kong's market increased dramatically from less than 8% in 1987 to about 30% in 2002. Cross-straits trade has become the major source of Taiwan's trade surplus in recent years. Surplus with China has exceeded Taiwan's total trade surplus every year since 1993, and China surpassed the United States as Taiwan's largest export market in 2002. The rapid growth of indirect trade was fueled by Taiwan's direct investment in China. It reached US$25.5 billion by the end of 2002 and accounted for nearly half (48.3%) of Taiwan's total overseas investment.[1] Nearly 60% of China's total foreign direct investment (FDI) inflow during the reform period came from Taiwan and Hong Kong.

Although political tension over the issue of sovereignty promises no easy solution, economic relations between China and Taiwan are expected to improve further after the two economies entered the WTO. During the accession negotiation, neither China nor Taiwan exercised a legal option under Article 13 of the WTO charter to exclude the other from MFN treatment. The option was seriously considered by Taiwan, but rejected. It means that Taiwan accepted the obligation to grant mainland China full MFN treatment eventually, which is likely to intensify the already significant economic integration between the mainland and Taiwan. The increasingly deepening economic ties driven by market forces between the Chinese economies may eventually bond them into a common market exemplified by the West European experience (Cheng, 1998). Therefore, the world is very likely to witness the gradual emergence of a Chinese Economic Area (CEA) in East Asia. It would contain an array of potential markets that far exceed that of Europe and has the potential of being a principal engine of world economic growth in the twenty-first century.

[1] Taiwan's official statistics underestimate Taiwan's "real" investment in China because many Taiwan businesses began in the mid-1990s to invest in China through their holding companies in third tax-exempt countries. Perng Fai-nan, governor of Taiwan's Central Bank, estimated that by the end of 2002, the real figure of Taiwan's cumulative investment in China was about US$ 66.8 billion, more than 60% of Taiwan's total overseas investment (*China Times*, January 2003).