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# China, Hong Kong, and Taiwan: A quantitative assessment of real and financial integration

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## Abstract

The status of real and financial integration of China, Hong Kong, and Taiwan is investigated using monthly data on 1-month interbank rates, exchange rates, and prices. Specifically, the degree of integration is assessed based on the empirical validity of real interest parity, uncovered interest parity, and relative purchasing power parity. There is evidence stating that these parity conditions tend to hold over longer periods, although they do not hold instantaneously. Overall, the magnitude of deviations from the parity conditions is shrinking over time. In particular, China and Hong Kong appear to have experienced significant increases in integration during the sample period. It is also found that exchange rate variability plays a major role in determining the variability of deviations from these parity conditions.

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## 1. Introduction

The recent accession of China to the WTO has been heralded as a watershed event, marking a distinct break in China's economic relations with the rest of the world. Analyses focused on WTO effects include studies of [Chang, Fleisher, and Parker \(2001\)](#), [Ma \(2001\)](#), and [Wang \(2001\)](#) and articles in the winter 2001 issue of *China Economic Review*.

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Doubtless, the commitment of China to abide by international norms in trade in goods and services will cause a substantial change in the way the Chinese economy behaves. We believe that this event, important as it is, should be viewed in the wider context as a continuing process of economic integration of China with its neighbors. However, previous quantitative analyses have been mostly focused on sectoral/trade issues. Some empirical studies of trade linkages are Fernald, Edison, and Loungani (1999), Noland, Liu, Robinson, and Wang (1998), and Wei, Liu, Wang, and Woo (2000). More recently, Poncet (in press) uses trade flow data to assess and compare the degrees of economic integration between the Chinese provinces and the Chinese provinces and the rest of the world. A thoroughgoing investigation—corresponding to the many exhaustive studies of the financial and real links between East Asian countries—is notably lacking.<sup>1</sup>

Since its recent economic reform, China has been embarked on a process of financial and real integration with Hong Kong and Taiwan. Even before Hong Kong's return to China's sovereignty in 1997, it had achieved a high degree of integration with the mainland. With respect to trade, for instance, Hong Kong intermediates the lion's share of China's external trade via reexports and offshore trade. Regarding financial activity, a substantial amount of international capital (in the forms of foreign direct investment, equity and bond financing, and syndicated loans) financing China's economic expansion is raised via Hong Kong. At the same time, Hong Kong's role as an intermediary for trade and financial flows to China represents a major source of economic activity and greatly shapes its own economic structure. The deflationary pressure exerted by China on the Hong Kong price level is a manifestation of the close ties between the two economies.<sup>2</sup>

Perhaps more surprising to a casual observer, despite political and ideological differences and occasional tensions between China and Taiwan, economic links between these two economies have proliferated since the 1990s. According to official statistics, China is the largest recipient of Taiwan's overseas investment and Taiwan is China's third largest source of foreign direct investment. Furthermore, it is widely believed that the official statistics underrepresent the overall Taiwan economic interest in China. Some analysts count Taiwan's total investment in China as just behind that of Hong Kong's but ahead of that of the United States. Even without direct trade, the trade volume between these two economies has grown 2 or 10 times, depending on the data sources, in the 1990s.<sup>3</sup> Given current trends, it is likely that China will surpass the United States and become Taiwan's largest export market by the end of 2002 (Ma, Zhu, & Kwok, 2002).

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<sup>1</sup> On financial/monetary issues, see Cheung, He, and Ng (1994), Chinn and Frankel (1994, 1995), De Brouwer (1999), Glick and Hutchison (1990), and Tsang (2002). In the postcrisis era, see Kumhof (2001). In terms of real exchange rates, see most recently Cheung and Lai (1998), Chinn (2000), Fujii (2002), and Fukuda and Kano (1997).

<sup>2</sup> Ha and Fan (2002) and Shellekens (2002) study the interactions of prices in China and Hong Kong and the deflationary effect on Hong Kong.

<sup>3</sup> Because of trade restrictions and other political reasons, the official data from China, Taiwan, and Hong Kong on trade between China and Taiwan are usually perceived to be incomplete. For instance, the value (in billions of U.S. dollars) of total trade between China and Taiwan is 5.8 in 1991 and 10.5 in 2001 according to Hong Kong customs (reexport) data, 0.6 in 1991 and 10.6 in 2001 according to Taiwanese customs data, and 4.2 in 1991 and 32.4 according to Chinese customs data.

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