
Introduction

Taiwan and the United States have built a strong and mutually beneficial economic relationship over more than half a century. Taiwan has been a supportive partner of the United States on security issues in Asia, and Americans across the political spectrum admire Taiwan's rapid economic development, technological innovation, and successful transition from an authoritarian state to a multiparty democracy. Thus there is considerable sentiment in the United States for assigning priority to talks on a free trade agreement (FTA) with Taiwan.

As of January 2004, the United States had concluded FTAs with half a dozen countries. The Office of the US Trade Representative (USTR) was negotiating agreements with a dozen other countries and notified Congress of its intent to open talks with eight additional countries in 2004.¹ But to date Taiwan has not been included on the list of potential FTA partners.

As "FTA fever" sweeps across Asia, the United States is not alone in pursuing FTAs. Almost every Asian country, including China, is exploring trade agreement possibilities with neighbors. Japan has completed an FTA with Singapore and launched talks with South Korea. The United States has completed FTAs with Singapore and Australia. Australia has concluded bilateral FTAs with Singapore and Thailand. Even long-time adversaries India and Pakistan have announced their intention to establish an FTA.

1. See Schott (2004) for the complete list of countries.

Broader discussions also have been held on regional trade liberalization. One such possibility is an FTA between China and the Association of Southeast Asian Nations (ASEAN), first proposed by China's Premier Zhu Rongji at an informal China-ASEAN summit in November 2000. This led to the signing of a framework agreement on economic cooperation in November 2002 that called for a step-by-step process of trade liberalization leading to an FTA by 2010. In mid-2003, China and Thailand signed an agreement eliminating tariffs on almost 200 fruit and vegetable products beginning in 2004.² This bilateral agreement is part of the "early-harvest" scheme of the China-ASEAN FTA, sometimes referred to as ASEAN + China. With these commitments, China has demonstrated its seriousness and leadership on regional trade, thus upping the ante in terms of consequences to other economies if they fail to conclude a global pact.

Taiwan, however, is conspicuously absent from these intra-Asian FTA discussions. Because of Chinese objections when countries have contemplated bilateral FTA negotiations with Taiwan, the island has been relegated to negotiating agreements with distant and extremely minor trading partners such as Panama.³

The prospect of a US-Taiwan FTA thus has considerable significance not only for its potential to increase bilateral trade, but also because it might facilitate Taiwan's participation in intra-Asian trade liberalization. Some believe that an FTA between the United States and Taiwan would make it more politically feasible for Japan to negotiate such an agreement with Taiwan, which in turn could pave the way for Taiwan's participation in other bilateral and regional trade liberalization initiatives. However, this prospective benefit from a US-Taiwan FTA is quite uncertain. Given China's rapidly increasing importance as an export market for all of Asia, it could well turn out that no Asian countries would be willing to risk incurring China's wrath by pursuing an FTA with Taiwan, even if the United States had already set the precedent.

The importance one attaches to the prospect of a US-Taiwan agreement is in part a function of one's outlook on prospects for multilateral trade liberalization. Taiwan became a member of the World Trade Organization (WTO) in 2002 and will of course benefit along with other members from any liberalization that comes out of the Doha Round of trade

2. The "China-Thailand Zero Tariff Fruit and Vegetable Agreement" of January 10, 2004. http://english.people.com.cn/200310/02/eng20031002_125300.shtml (accessed August 20, 2004).

3. Panama is Taiwan's 66th largest trading partner and accounts for only a miniscule portion of the island's total trade. Taiwan's FTA with Panama was signed in August 2003 and took effect in January 2004. See Jessie Ho, "Free-trade pact with Panama to take effect today," *Taipei Times*, January 1, 2004. <http://taipeitimes.com/News/biz/archives/2004/01/01/2003085960> (accessed January 26, 2004).

negotiations. The prospects for Doha, however, are far from clear. Indeed, one rationale for negotiating bilateral and regional FTAs is that they can spur “competitive liberalization” in two ways. First, new FTAs may compel nonmember economies to quicken their pace of trade liberalization and secure better trade access by negotiating their own bilateral deals with countries involved in FTAs. Second, the proliferation of FTAs may speed the pace of multilateral trade liberalization. As trade concessions are offered to more individual countries through bilateral or regional FTAs, domestic resistance to making these concessions available to all trading partners presumably weakens.

If one believes that the conclusion of a growing number of FTAs is likely to accelerate the pace of multilateral trade liberalization, the cost to Taiwan of being excluded from FTAs in Asia might be modest. But, clearly, the longer it takes to conclude the Doha Round, the more Taiwan is punished through trade diversion if it remains excluded from intra-Asian trade liberalization. This exclusion could have adverse effects not only on Taiwan’s economic growth, but also on development in Asia in general, given Taiwan’s important and innovative position in key areas such as the semiconductor industry.

Notwithstanding the catalytic role that a US-Taiwan FTA might play in facilitating Taiwan’s participation in intra-Asian trade liberalization, what is the economic case for such an agreement from the point of view of the United States?

In 2003, US Trade Representative Robert Zoellick spelled out 13 criteria for selecting potential FTA partners for the United States.⁴ Table 1.1 lists each of the criteria—some of which go beyond making an economic case for such an agreement—and assigns (subjective) comments as to the extent to which Taiwan meets them. Taiwan performs well in terms of most of the criteria and certainly performs better than many other economies that are candidates for FTAs with the United States, particularly Middle Eastern nations that appear to be in pre-FTA consultations with the United States primarily as a reward for support in the war on terrorism. Taiwan is democratic, US-Taiwan economic relations are significant, the Taiwanese government is willing to negotiate on a broad spectrum of issues, and Taiwan enjoys political support within both US political parties in Washington.⁵ In addition, an FTA could promote further domestic economic reform within Taiwan, provided it was designed with economic gains and not just political considerations in mind.

4. Zoellick offered these points in a speech at the Institute for International Economics on May 8, 2003.

5. Some members of the US Congress have petitioned the USTR to focus on larger markets in Asia, including Taiwan, as stated in a letter listing preferred FTA partners that Senator Max Baucus (D-Montana) and others sent to Zoellick on June 11, 2003.

Table 1.1 Taiwan and the US Trade Representative's 13 criteria for partners in free trade agreements

Criterion	Extent to which Taiwan meets criterion
1. Guidance from the US Congress both from those who support a specific agreement as well as those who oppose it	US Congress very supportive
2. Support from the US business community, particularly the agriculture sector	Strong support from agriculture, but generally little support from other sectors because of the modest potential gains of a US-Taiwan FTA, and perhaps due to reluctance to antagonize China
3. The extent to which the influence of special interest groups might affect whether the FTA can pass in Congress	Interest groups generally support Taiwan, and there are no opposing interests
4. Seriousness of the partner in terms of high-level government support, negotiations that include all sectors, fulfillment of past commitments, and having negotiating teams that can work with one another	Taiwan would relish the chance to engage in FTA negotiation with the United States but needs to do more to fulfill past commitments before the US trade office will consider talks.
5. Commitment of the partner to work within the World Trade Organization (WTO), particularly the dispute resolution process	WTO membership is especially important to Taiwan
6. The extent to which the FTA will encourage "competitive liberalization" in the region	Predominance of trade diversion in a potential agreement encourages countermeasures, the results of which are uncertain
7. The extent to which FTA negotiations will help push through local reforms by the partner that can then be supported through the agreement	Some Taiwanese leaders suspect negotiations would be a ploy to distract the public from other needed reforms
8. The extent to which the FTA will support the partner's civil society in areas such as the environment, the labor market, the business environment, and the general degree of openness in the society	Taiwan's strong performance in this area demonstrates its commitment to democracy
9. How much the partner cooperates with the United States on foreign affairs and security issues	Stalwart ally of the United States

(table continues next page)

Table 1.1 *(continued)*

Criterion	Extent to which Taiwan meets criterion
10. Whether the FTA with the partner runs counter to preferential agreements that either the partner or other countries in the region have with US competitors	An agreement would not circumvent any preferential bloc and could counter Taiwan's isolation
11. Regional feasibility of the FTA, particularly in terms of promoting regional integration	Would have a highly positive impact if it prompts China to accept Taiwanese participation in regional FTAs
12. Developed and developing countries welcome to participate in FTAs	Taiwan is a high-income economy
13. Whether there are other FTAs under negotiation in the region that might be of a higher US priority	There are other FTA negotiations in the region, but they would not necessarily preclude efforts to forge an agreement with Taiwan

With so many variables at play—economics and politics, bilateral effects, and regional development—discerning trade policies that best serve US interests is no easy task. This study aims to promote enlightened debate on this complicated question by analyzing the economic fundamentals that would be the foundation of a potential US-Taiwan FTA, and then considering them in the context of other regional trends like pan-Asian FTA consultations.

US-Taiwan trade is already quite open, whereas the major welfare-enhancing economic adjustment of the day is occurring in other Asian economies, particularly China. The evidence thus suggests that Taiwan's further integration with Asia, including China, would contribute more to its economic growth than a bilateral FTA with the United States. As already noted, however, other nations in the region are reluctant to enter into bilateral trade negotiations with Taiwan because of pressure from Beijing. A US-Taiwan FTA might help overcome this reluctance. And even if the economic effects of an FTA with the United States were minimal for Taiwan, such an agreement might still be desirable if it fostered Taiwan's inclusion in intra-Asian trade liberalization. Taiwan certainly wants to avoid the losses that would occur if everyone else in Asia negotiates FTAs while it is left on the sidelines. The challenge from the US perspective then becomes not only to carefully analyze the economic effects of a bilateral FTA with Taiwan, but also to determine the likelihood that such an agreement would facilitate Taiwan's participation in regional trade liberalization.

Some may question whether the United States should risk jeopardizing what are commonly described as the best relations it has ever enjoyed with China by pursuing a bilateral FTA with Taiwan.⁶ Such an agreement, however, would be consistent with the long-term US policy of opposing any unilateral actions by either Taiwan or mainland China that might cause a shift in cross-strait relations, as clarified by US President George W. Bush during the visit of Chinese Premier Wen Jiabao to the United States in December 2003.⁷ The status quo, of course, depends on freedom of economic action. Given the acceleration of intra-Asian trade liberalization, Taiwan must move in step with others in the region if it is to maintain its economic place. If a US-Taiwan FTA helps Taiwan participate in intra-Asian trade liberalization, it would contribute to maintaining the status quo in terms of Taiwan's freedom of economic action.

The USTR office, however, has been reluctant to commence formal FTA talks with Taiwan until certain preexisting economic and trade issues are addressed to its satisfaction. In addition, even when these issues are resolved, the trade office is already stretched to its capacity or beyond by the Doha Round of multilateral trade liberalization negotiations, as well as by a full menu of ongoing regional and bilateral trade negotiations. Thus, even if rapid progress is made on resolving existing issues, the United States is unlikely to initiate FTA talks with Taiwan until 2005 or, more likely, later.

This introductory chapter provides the background on the Taiwanese economy and US-Taiwan economic relations necessary to appraise the effects of an FTA between them. The broader context includes the economic disputes that would need to be settled prior to FTA talks. Chapter 2 looks at the quantitative evidence on the likely impact of a US-Taiwan FTA, and chapter 3 offers a qualitative analysis with a focus on key sectors. Chapter 4 broadens the analysis to compare bilateral effects with other scenarios—specifically better integration of Taiwan in Asia—and concludes with a discussion of the geoeconomics and geopolitics of the US-Taiwan FTA question.

Taiwan's Economy

Taiwan has been one of the world's most successful economies over the past five decades. Its long-term growth—just over 8 percent per annum in real terms—has been more rapid than any other economy, propelling

6. Some say that a more modest "closer economic partnership" rather than an FTA with Taiwan might be a better objective for US-Taiwan trade talks.

7. See the US government press release at <http://lists.state.gov/SCRIPTS/WA-USIAINFO.EXE?A2=ind0312b&L=us-china&D=1&H=1&O=D&F=&S=&P=710> (accessed December 22, 2003).

its GDP to over \$280 billion by 2002. The growth process transformed the structure of the Taiwanese economy. While agriculture was the major source of output initially, by the early 1970s the sector's share of output had fallen to under 10 percent, and today agriculture accounts for less than 2 percent of GDP. Manufacturing expansion drove Taiwan's growth from the early 1950s to the early 1980s, when its contribution to output peaked at a little more than two-fifths of GDP. Over the past decade, services have become the major source of growth and now account for two-thirds of GDP.

In the early 1950s, Taiwan restricted imports to promote the development of the industrial sector. But by the end of that decade, the island began to adopt trade and exchange rate policies that transformed it into a major trading economy. Exports grew annually by an astounding 25 percent in the 1960s and 30 percent in the 1970s, making Taiwan a leading trading economy by 1980.

Trade expansion continued in the 1980s even after most countries shifted their formal diplomatic recognition from Taiwan to mainland China, and Taiwan lost its membership in the United Nations and related bodies such as the World Bank and the International Monetary Fund. Taiwan retained its membership in the Asian Development Bank after China became a member in 1986, and it joined the Asia Pacific Economic Cooperation (APEC) forum in 1991. Nevertheless, until Taiwan became a member of the WTO in 2002, it was largely isolated from major international economic organizations.

By the 1990s, Taiwan had abandoned its earlier protectionist industrial policy strategies and had in place a more competitive market structure, in contrast to the Japanese and South Korean economies, which were dominated by giant industrial groups.⁸ While no *laissez-faire* angel, Taiwan's industrial policies are now more consistent with American concepts of competitiveness and free markets.

US-Taiwan Economic Relations

Taiwan is a little larger in area than Maryland and in population than Texas. Relative to the size of the island, US-Taiwan economic relations have taken on disproportionate importance because of their long-standing political and security relationship. Taiwan is the eighth-largest US trading partner, ranking just ahead of North Atlantic Treaty Organization (NATO) allies Italy and France and just behind South Korea. Taiwan's per capita income in 2002 purchasing power parity terms of \$18,000 puts

8. See Noland and Pack (2003, 51–57) for a comparison of Taiwan's industrial policy with those of Japan and South Korea.

it squarely within the group of higher-income nations—greater than the Czech Republic (\$15,300), even with Portugal (\$18,000), and shy of New Zealand (\$20,200).⁹

Both the United States and Taiwan are “industrial” democracies, although both economies are in fact dominated by the services sector. Services account for 80 percent of US GDP and 66 percent of that of Taiwan. The trend away from industry and toward services in Taiwan has been consistent since the mid-1980s. Over the past 10 years, labor-intensive manufacturing has shifted out of Taiwan (largely to China), much as it did from the United States in earlier decades (partly to Taiwan).

Today, Taiwan is known particularly as an information technology (IT) powerhouse. Its IT sector is a source of strength both to Taiwan itself and to consumers of IT products in the United States. Taiwanese firms rank number one globally in the production of a large number of important IT products, including scanners (91.5 percent of the global market share), motherboards (70.4 percent), notebook computers (55.3 percent), and monitors (54.2 percent). Although China in 2002 became the second largest global producer of IT hardware (after the United States), almost three-quarters of its output was produced by Taiwanese firms that had relocated to mainland China (Rosen 2003). After both China and Taiwan agreed to join the WTO Information Technology Agreement upon accession to the trade organization, Taiwan commenced participation almost immediately. China’s participation was delayed, however, until it modified WTO-inconsistent requirements in April 2003 that it had initially imposed on imports designated as IT products.

In 2003, the United States exported goods and services valued at about \$17 billion to Taiwan (only Japan exports more) and imported about \$31 billion from Taiwan (table 1.2). The United States is now Taiwan’s second largest export market after mainland China, although much of Taiwan’s exports of electronic parts and components to China are ultimately destined for the United States and Europe as finished goods. US-Taiwan trade reached a historical high of almost \$65 billion in 2000, but by 2003 had fallen to only \$48 billion, a 26 percent decline. The decline in US exports in part reflected Taiwan’s 2001–02 recession, which was unprecedented in the island’s economic history since World War II. The slump in US imports from Taiwan, which appears to have ended in 2003, reflected the global downturn in the IT sector. As IT investment softened in the United States, imports of Taiwanese high-tech products declined. That decline was reinforced by the growing migration of Taiwanese IT manufacturing activity to the mainland. The United States has long sustained a trade deficit with Taiwan, but that deficit appears to have peaked in 2000. US imports of computers and electronic products produced by

9. Economic comparisons are from the *CIA Factbook*.

Table 1.2 US-Taiwan trade, 1985–2003
(billions of dollars)

Year	Exports	Imports	Balance
1985	4.70	16.40	-11.70
1986	5.52	19.79	-14.27
1987	7.41	24.61	-17.21
1988	12.13	24.71	-12.58
1989	11.33	24.31	-12.98
1990	11.49	22.67	-11.18
1991	13.18	23.02	-9.36
1992	15.25	24.60	-9.36
1993	16.17	25.10	-8.93
1994	17.10	26.70	-9.60
1995	19.29	28.97	-9.68
1996	18.46	29.91	-11.45
1997	20.37	32.63	-12.26
1998	18.16	33.12	-15.00
1999	19.13	35.20	-16.01
2000	24.41	40.50	-16.10
2001	18.12	33.37	-15.25
2002	16.95	29.45	-12.50
2003	17.49	31.60	-14.11

Source: US Census Bureau, www.census.gov/foreign-trade/balance/c5830.html.

Taiwanese firms increasingly originate in China rather than in Taiwan itself.¹⁰

The stock of US foreign direct investment (FDI) in Taiwan was \$10.1 billion at the end of 2002, with a flow that year of \$900 million. The stock of Taiwanese FDI in the United States in the same year stood at \$2.3 billion. That number was down significantly from 2000 because Taiwanese firms reduced their FDI in the United States in 2001 and 2002.¹¹ For comparative purposes, FDI flows in 2002 from Taiwan to China were \$4 billion and from the United States to China were \$5.4 billion (National Bureau of Statistics 2003, 672–74).

The United States and Taiwan have a long-standing record of cooperation on economic matters. In general, Taiwan was proactive in WTO accession negotiations with US interlocutors not only on the topic of tariff and nontariff barriers, but also on more contentious issues such as competition policy that are debated only at a working group level within the WTO.

10. This is one reason why economists stress that much of the marginal Chinese trade surplus with the United States is not a net increase of the US deficit but rather a shift of deficit among trading partners.

11. Bureau of Economic Analysis, "International Economic Accounts: Direct Investment." www.bea.doc.gov/bea/di1.htm (accessed January 26, 2004).

Trade Barriers and Concerns

Trade barriers between Taiwan and the United States are modest. Taiwan's nominal average tariff was 8.2 percent just before its accession to the WTO in 2002, and the government reduced the average rate to 7.1 percent upon accession. As part of Taiwan's WTO commitments, it will further reduce the average rate to 4.2 percent by 2007 (USITC 2002a). Even after Taiwan has fully implemented its WTO obligations, however, tariff peaks will remain in certain product areas. The three models discussed in subsequent chapters of this study forecast that the removal of those tariffs, particularly on agricultural products and vehicles, would lead to gains in US exports.

US nominal average tariffs are an even lower 2.8 percent, with peaks in agriculture (poultry and juice) and various goods such as apparel and textiles, steel and steel products, including fasteners, and trucks. The removal of apparel and textile tariffs would account for the bulk of gains in Taiwanese exports under an FTA. Taiwan also has nontariff barriers against imports of agricultural products and vehicles. Likewise, the United States uses nontariff barriers as well as tariffs against imports of certain agricultural products.

The assessment of quantitative impacts of an FTA will show that a relatively low level of existing barriers would result in modest benefits from liberalization. However, the corollary is that the adjustment costs would be modest as well (in most sectors), thus making an agreement relatively easy in terms of domestic adjustment and, hence, trade politics.

Preexisting Concerns

The USTR has called for Taiwan to improve its protection of intellectual property rights, liberalize telecommunications, and improve market access for agricultural products (USTR 2003a). It also has formally objected to Taiwan's rice import system, which appears to be inconsistent with the island's WTO commitments (USTR 2004).

The US-Taiwan Business Council and the American Chamber of Commerce in Taiwan also have highlighted a number of key issues that Taiwan should address: reform of financial institutions, tighter protection

12. Under a trade and investment framework agreement (TIFA) concluded in September 1994 between the United States and Taiwan, a Trade and Investment Council was created for dialogue on trade and investment liberalization. The Council met a few times over 1995-98, but US talks with Taiwan on trade issues subsequently shifted to the negotiations that led to Taiwan's accession to the WTO in 2002. The USTR office has been reluctant to resume the bilateral TIFA dialogue, which could be a prelude to FTA negotiations, until Taiwan makes greater progress in implementing its WTO commitments.

of intellectual property rights, stronger anti-corruption efforts, rice import quotas, unfair labeling requirements for agricultural goods, lack of openness in the telecommunications market, and problems in the health care market, including market-restricting regulatory reforms and lack of intellectual property rights protection for pharmaceuticals. The American Chamber of Commerce in Taipei publishes an annual *Taiwan White Paper* detailing key industry-specific concerns that business people often deem more pressing than negotiating an FTA (American Chamber of Commerce 2003).

Progress was either made or expected on several of these issues in the second half of 2004. Taiwan's legislature amended several provisions of the Copyright Act, and the government stepped up IPR enforcement action. In telecommunications the government took steps to establish an independent regulatory authority, to issue additional fixed-network licenses on a competitive basis, and to reduce the paid-in capital and other requirements to encourage new entrants in the fixed-line telecommunications business. Progress was made toward resolving or at least alleviating shortcomings in pharmaceuticals and rice.

As a result, the American Chamber of Commerce in Taiwan urged the US government to remove Taiwan from the Special 301 Priority Watch List. It is thus possible that the United States will agree to resume so-called Trade and Investment Framework Agreement (TIFA) talks.¹³

Broader Context of US-Taiwan Relations

The value of US-Taiwan economic relations cannot be separated from their unique foundation in security and political concerns. US security interests in Taiwan vis-à-vis mainland China date from the Cold War and are comprehensively outlined in the Taiwan Relations Act of 1979.¹⁵ The United States also values Taiwan as an important model of democratic transition, particularly in light of the island's recent positive human rights record. Further, Taiwan has been supportive of US security interests.

National security and foreign policy considerations argue in favor of arrangements that sustain Taiwan's economic welfare. The "status quo" in

13. The USTR office may agree to resume the bilateral TIFA dialogue, which could be a prelude to FTA negotiations because of progress Taiwan has made in implementing its WTO commitments.

14. Personal communication with Rupert Hammond-Chambers of the US-Taiwan Business Council on June 24, 2003, and with Richard Vuylsteke of the American Chamber of Commerce in Taiwan on April 8, 2003.

15. The most comprehensive treatment of this history is in Romberg (2003). For the US Congressional Research Service backgrounder on Taiwan, see Dumbaugh (2001). The most recent book-length treatment of Taiwan's 20th century history is in Roy (2003).

economic linkages between Asia-Pacific markets is a moving target, given the recent acceleration in trade liberalization in the region. The question is how and in what manner a US-Taiwan FTA would in fact help sustain Taiwan's economic welfare. The quantitative and qualitative analyses that follow will help answer that question.