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Geoeconomic and Geopolitical Considerations

Any discussion of a prospective US-Taiwan FTA is embedded in a broader context, which is that the United States is using FTAs strategically to prod forward the sluggish pace of multilateral trade liberalization talks—or, in the worst case scenario, as an alternative to such talks. C. Fred Bergsten, director of the Institute for International Economics, has pointed out that "America's new penchant for preferential deals [i.e., FTAs] is readily understood. Robert Zoellick, US trade representative, is pressing for 'competitive liberalization'—bilateral, regional and global—to place pressure on nonmembers of individual free trade agreements either to join the group itself or to conclude broader agreement" ("A Competitive Approach to Free Trade," *Financial Times,* December 4, 2002).

A US-Taiwan FTA would also have unique geoeconomic and geopolitical dimensions, which are examined in this chapter but which were implicit in the earlier examination of Taiwan's status vis-à-vis the USTR's 13 criteria for prioritizing FTA partners.

Geoeconomics

In a May 2002 speech entitled "Taiwan, Mainland China and the United States: Another Golden Triangle in the Global Supply Chain," prominent Taiwanese lawyer and professor Paul Hsu (2002) laid out a vision of Taiwan's economic destiny as a middle man between mainland China and the United States:

> Over the past twenty-five years . . . a supply chain has developed between the US, mainland China, and Taiwan companies. In this supply chain, US companies

> are the center for research and development (R&D), brand management and marketing; mainland China companies provide a manufacturing powerhouse for the production of goods with low labor and operating costs; and Taiwan is a bridge that economically links the US and mainland China as a manufacturing network integrator. This trend of division of labor between the three is beyond doubt.

Taiwan, unable to compete with China in labor-intensive manufacturing, wants to be what has been called a "regional service center" for doing business in China. This "golden triangle" strategy echoes Taiwan's earlier campaign to be an "Asia-Pacific regional operations center."

How would a US-Taiwan FTA enhance the golden triangle strategy? If the agreement did in fact enhance such a strategy, how would this affect US economic interests? Taiwanese businessmen are busy at work in China and enjoy some cultural advantages in operating there. Taiwan has already specialized its manufacturing to take advantage of low-cost Chinese production, and US and Taiwanese high-technology firms have committed to working together to add value by distributing their production alliances in the United States, Taiwan, and China—in effect "dis-integrating" the production process. The US-Taiwan Business Council argues that US productivity growth depends on Taiwanese companies because they are leaders in innovative IT products and are a critical source of technology for US firms. On the other hand, the council argues that Taiwan's position is predicated on its economic integration with China, and that an FTA "would certainly enhance our relationship with this most important strategic technology partner."[1] In short, a US-Taiwan FTA would strengthen Taiwan's position in the US-China supply chain, indirectly benefiting the United States.

These indirect gains would be substantially enhanced if the US-Taiwan FTA were to provide sufficient comfort to Taiwanese political authorities to lift the restrictions currently imposed on cross-strait trade and investment. The bans appear to violate Taiwan's WTO commitments, although China has not initiated any action to challenge Taiwan's policy. Lifting those restrictions would strengthen Taiwan's geoeconomic advantage in the IT sector and further consolidate its position in the US-China supply chain, thus maximizing the gains of the golden triangle strategy to both Taiwan and the United States.

Broader Regional Trends

The key geoeconomic consideration is whether a US-Taiwan FTA would dovetail with production and trade trends in the wider Asia-Pacific region.

1. Statement by the US-Taiwan Business Council at public hearings held by the US International Trade Commission on May 13, 2002.

Regionwide models by the Global Trade Analysis Project (GTAP) of the effects of Chinese growth to 2020 predict (at the margin) that developing southeast Asian countries and wealthier, newly industrialized Asian countries will provide inputs and raw materials to China; that value-added manufacturing and transformation will take place in China; and that final consumption will take place in member nations of the Organization for Economic Cooperation and Development (OECD). Assuming this is the trend, an FTA with the United States might not help Taiwan but would not hurt it either, unless the agreement stimulated a reallocation of domestic resources in a way that reduced Taiwan's ability to realize advantages in the region, or unless Taiwanese policymakers focused on an FTA to the exclusion of other badly needed initiatives.

Unfortunately, both of those circumstances that might prompt a negative result appear to be in the offing. First, the FTA models suggest a considerable reallocation of resources away from comparative advantage sectors in order to expand apparel exports to the US market. While the model shows that this would be profitable for Taiwanese apparel firms, it appears to make little sense from the broader perspective of Taiwan's long-term economic growth. Moreover, such a reallocation of resources would antagonize other lower-cost producers, most of which are in Asia and would lose market share. Second, as soon as Taiwan completed its WTO accession, Ministry of Economic Affairs officials started calling for an FTA with the United States as though it were the key to the island's future economic welfare (Ministry of Economic Affairs 2002). By emphasizing the US-Taiwan connection through an FTA instead of the Taiwan-China connection through improved cross-strait relations, Taiwan may be missing more important objectives. Further, the continued absence of direct cross-strait shipping links increases the likelihood of a reduced US business presence in Taiwan as the island becomes less relevant to the regional business strategy of these firms. That, in turn, reduces the potential gains to Taiwan from the golden triangle strategy.

Cross-Strait Economic Relations

Despite the restrictions Taiwan continues to impose on direct flights and shipping with mainland China, as well as on investment outflows to the mainland, the Taiwanese and Chinese economies are increasingly integrated. By 2002, Taiwan's exports to the mainland exceeded $33 billion, more than three times the 1992 level and representing just over a fourth of all Taiwan's exports. China is now Taiwan's largest export market, in the process displacing the United States from its long-time position as the largest buyer of Taiwanese products. Despite the fact that trade flows in the reverse direction are still constrained by Taiwan's bans on mainland products—prohibited imports from the mainland cover about a quarter of Taiwan's tariff schedule—Taiwanese imports from China in 2002 reached almost $7 billion and accounted for more than 7 percent of all of the island's imports.[2]

Cross-strait investment has also grown rapidly, reflecting the increasing migration of labor-intensive manufacturing from Taiwan to the mainland. Both the Chinese Ministry of Commerce in Beijing and the Ministry of Foreign Economic Affairs in Taipei publish data on direct investment in the mainland by Taiwanese firms. These agencies placed the cumulative investment by year-end 2002 at $33 billion and $27 billion, respectively.[3] Because Taiwan—officially at least—has imposed legal restrictions on investment in the mainland, both numbers appear to be gross undercounts. The Taiwan Central Bank's estimate of $66.8 billion by year-end 2002 is probably the most realistic assessment of the cumulative flow of investment from Taiwan to the mainland.[4] This larger number makes it clear that the mainland is far and away the most important destination for outward direct investment from Taiwan, and even suggests that Taiwan might be the single largest source of foreign investment in the mainland.[5]

Negative FTA Spillovers in an Important Neighborhood?

The prospect of a US-Taiwan FTA raises a fundamental question for US trade policy: What would be the effect of such an agreement on US trade relations with Japan, South Korea, and northeast Asia in general? The United States has concluded FTAs with Singapore and Australia but has not yet announced its intent to negotiate agreements with any other Asian country. While a US FTA with Singapore is estimated to have only the smallest of effects on northeast and southeast Asia, a US-Taiwan

2. See Chinese Board of Foreign Trade at www.trade.gov.tw/prc&hk/bi_ch/mo.

3. For China, see Ministry of Commerce (various years) at www.mofcom.gov.cn; for Taiwan, see Ministry of Economic Affairs (2002) at www.moea.gov.tw.

4. See "Locals Invest US$66.8 bn in China Last Year," *China News Agency*, January 17, 2003, 11, www.taipeitimes.com/news/biz/archives/2003/01/17/191346. The Taiwan Central Bank has not disclosed the methods it uses to estimate outflows of FDI to the mainland. It appears to start with foreign direct investment (FDI) in the mainland that is recorded with the Ministry of Economic Affairs and then to add some portion of FDI that China reports as originating in the British Virgin Islands, Cayman Islands, and so forth. According to the data released in Beijing, one of the largest sources of FDI is the Virgin Islands, ranking fourth in 1999 behind Hong Kong, the United States, and Japan, and just ahead of Taiwan, which ranked fifth.

5. This is possible in part because the listing of Hong Kong as the single largest source of investment is misleading, since a large but unknown share of these funds does not originate with Hong Kong companies.

Table 4.1 Impact on Taiwan of other US free trade agreements

Partner	Welfare (millions of 1997 dollars)	Exports (percent)
South Korea	–130.7	–0.14
Thailand	–55.4	–0.06
Indonesia	–43.1	–0.03
Malaysia	–26.4	–0.03
Australia	–14.1	–0.02
Philippines	–12.7	–0.03
Singapore	–10.3	–0.01
Rest of Southern African Customs Union	–8.5	–0.01
Chile	–7.5	–0.01
New Zealand	–3.5	0.00
Morocco	–3.4	0.00
Botswana	–0.2	0.00

Source: Gilbert (2003).

FTA could have negative consequences in terms of welfare for both regions, including adverse effects on countries with which the United States has important economic and security relationships. Estimates by John Gilbert (2003, 89) show modest adverse welfare effects on both South Korea ($59 million) and Japan ($284 million), consistent with the pattern of trade diversion discussed above. Adverse effects on China ($527 million) and Southeast Asia ($239 million) loom much larger relative to the size of these economies. In negotiating bilateral FTAs, the United States must keep relations with other affected countries clearly in mind. It may well be necessary for the United States to prioritize FTAs with less adverse regional implications, or to simultaneously make the case for broader trade liberalization to offset bilateral effects.

Conversely, what effect would other FTAs in the region have on Taiwan? Table 4.1 shows the welfare and export value effects on Taiwan from each of the other FTAs examined by Gilbert (2003). The numbers are extremely small except in the case of a US FTA with South Korea. Because there is greater similarity in production and export structure between South Korea and Taiwan than with the other countries examined, the adverse effects on Taiwan are predictably greatest.

Of greater concern to Taiwan are Asian regional trade agreements that include China but not Taiwan. Taiwan's exports to China are growing rapidly, but an ASEAN+3 arrangement would impose large diversion costs on the island because intra-ASEAN+3 trade would expand for goods for which Taiwan is a lower-cost producer. Robert Scollay and Gilbert

(2001, 68–69) estimate that the negative welfare effect on Taiwan from an ASEAN+3 FTA would be the equivalent of 1.1 percent of GDP.[6]

In sum, a US-Taiwan FTA would have some negative consequences on the region, but US FTAs with other major Asian economies also would have negative consequences for Taiwan (and other nations). This is the very reason why completing such agreements could impel competitive liberalization—that is, prompt nonmembers to follow suit bilaterally, regionally, or multilaterally. The problem is that China has prevented Taiwan from pursuing such competitive liberalization in the rational manner in which Taiwan's neighbors—which are simultaneously partners and competitors—can pursue that process. In terms of geoeconomics, it would be in the best economic interest of all the players, including China, to facilitate Taiwanese participation in regional trade integration through bilateral competitive liberalization via FTAs, or better yet in a regionwide integration scheme like ASEAN+3.

If China continues to block Taiwan from participating in regional trade liberalization, then a US-Taiwan FTA could at least offset some of the welfare losses the island would suffer from being the only economy left out of bilateral and regional agreements. On the other hand, if Taiwan *could* participate, then the priority assigned to a bilateral agreement with the United States would be greatly diminished. In this sense, perhaps the greatest value of proposing a US-Taiwan FTA is that it would define a set of minimum gains that Taiwan could look to if more comprehensive integration is not possible. That said, were Taiwan to more deeply integrate with its neighbors, then the case for US investment in Taiwan as a stepping stone to China and other markets—which is one potential benefit of a US-Taiwan FTA—would be significantly enhanced. Box 4.1 lays out the reasons Taiwanese welfare would be enhanced more by trade integration with China and the rest of Asia than with the United States.

Geopolitics

This study has alluded repeatedly to pressure from China to limit Taiwan's ability to pursue economic integration in Asia. This section considers the geopolitical context in which this pressure occurs. FTAs can be motivated by political and security considerations as well as—or instead of—economics. In the case of Taiwan, there is certainly a mix of interests involved. Major support comes from pro-Taiwan political and security voices in Washington looking to bolster Taiwan against political pressure

6. Their estimating procedures, which do not take into account China's policy of exempting a broad range of imports from paying any import tariffs, may overstate the welfare losses to Taiwan from an ASEAN+3 FTA.

Box 4.1 Taiwan's welfare: East, west, or south?

The gains from forming an FTA between any pair of countries depend largely on two variables: the nature of preexisting trade barriers in each country and the magnitude of initial bilateral trade. Clearly, if initial tariff and nontariff barriers are high, creating an FTA that eliminates such barriers will generate a substantial increase in bilateral trade flows, with concomitant trade gains for both participants. Similarly, the larger the initial bilateral trade volume, the greater the gains from forming a bilateral FTA.

For example, Canada's benefits from forming an FTA (the North American Free Trade Agreement) with the United States and Mexico were huge because the United States was far and away Canada's largest trading partner. An FTA with, say, Malaysia would have generated much more modest gains for Canada, since its bilateral trade volume with that country was about 0.4 percent of its bilateral trade with the United States.

This framework can be used to compare the potential economic gains Taiwan could expect from an FTA with the United States against the gains from such an agreement with China. The current barriers to trade between Taiwan and the United States are extremely low. In 2002, the average Taiwanese import tariff was 7.1 percent, and the average US import tariff was even lower at 2.8 percent. Each side maintains tariff rate quotas on a few agricultural products as well absolute import quotas on a few key products. For example, Taiwan imposes a quota of 145,000 tons on rice imports, a product of key interest to US farmers, and the United States imposes quotas on a broad range of textile and apparel products that are of interest to producers in Taiwan.

Trade barriers are not only relatively low, but are also coming down. For example, Taiwan, under commitments made when it joined the World Trade Organization (WTO) in 2002, will reduce its average import tariff to 4.2 percent by 2007. The United States, under commitments made in the Uruguay Round agreement, will eliminate import quotas on textile and apparel products at the end of 2004.

In contrast, trade barriers between Taiwan and China are substantially higher than those between Taiwan and the United States. The average tariff imposed on imports by China is currently 11.5 percent. Even when China fully implements its WTO commitments in 2005, its average import tariff will be 10 percent, several times the rate that Taiwanese goods face in the US market. More importantly, goods from the mainland also face substantially higher barriers in Taiwan than do US goods because Taiwan continues to ban the import from China of more than 2,000 items, a quarter of all items in Taiwan's tariff schedule.

A comparison of Taiwan's relative trade volumes with the mainland and the United States reveals a much more balanced picture. Taiwan's exports to China have grown explosively in recent years. By 2002, China became the island's largest single market, absorbing just over one quarter of Taiwanese exports. Because of restrictions on the import of many goods from the mainland, trade is highly imbalanced, although in 2002 China managed to supply 7 percent of total Taiwanese imports.

The United States for many years was Taiwan's largest export market, but with the migration of many Taiwanese industries to the mainland, goods the United States previously imported from Taiwan increasingly come from China.

(box continues next page)

Box 4.1 Taiwan's welfare: East, west, or south? *(continued)*

As a result, the share of Taiwanese exports going to the United States fell from a peak of 49 percent in 1984 to only 20 percent in 2002, for the first time falling behind the share of Taiwanese goods sold to the mainland. The United States supplied 16 percent of Taiwanese imports in 2002. The net result is that the United States remains Taiwan's largest overall trading partner, but by an increasingly narrow margin of only 4 percentage points.

While Taiwan's trade volumes with the United States and China are now almost the same, the barriers to trade across the Taiwan Strait, particularly the bans Taiwan maintains on so many products from China, are far higher than those across the Pacific. The economic gains that Taiwan could reap from an FTA with the mainland far exceed those that would accrue from such an agreement with the United States.

from Beijing. The conservative think tank Heritage Foundation's backgrounder of June 2002[7] opined:

> In a broader sense, there are political benefits to tying Taiwan closer to the United States that argue for moving ahead quickly with an FTA in Washington. The closer US-Taiwan economic ties are seen to be in Beijing, the less likely Beijing will assume that it can take military action against Taiwan without involving America. Beijing would then see the benefits of resolving frictions with Taipei through enticements, concessions, and general goodwill rather than with threats of military force. If a US-Taiwan FTA can have this effect alone, it would be worth giving it priority attention in Washington.

Relations between the United States, China, Taiwan, and the rest of Asia are in a dynamic phase, largely due to China's rapid economic development. There are a variety of points of view, each based on a desire to see China-Taiwan affairs evolve peacefully. But in any case, Taiwan would not be helped politically by any FTA that diverts the island from realizing advantages in Asian trade, or that distracts it from addressing weak links in its position between the United States and China, especially while US businesses increasingly deal directly with the mainland.

If China remains intent on preventing Taiwan from deepening its trade integration with the economies in the Asia-Pacific region, then the merits of a US-Taiwan FTA as an economic lifeline are greatly enhanced. For the time being, any change in the Chinese position does not appear likely: Chinese officials have made clear that they object to Taiwan negotiating FTAs. Chinese trade minister Shi Guangsheng was quoted in the June 21, 2002, official Chinese *People's Daily* as saying, "If countries with dip-

7. See backgrounder at http://new.heritage.org/Research/TradeandForeignAid/BG1557.cfm (accessed February 12, 2004).

lomatic ties with China sign free trade agreements with the Taiwan authorities, they are bound to bring political trouble to themselves." At the Asia Pacific Economic Cooperation (APEC) forum in November 2002, the same minister accused Taiwan authorities of "making use of forming official pacts with foreign countries on free trade arrangements for the purpose of realizing de facto 'Taiwan Independence.' This represents a sensitive political issue."[8]

Chinese officials tried to extract a commitment from US trade officials at the APEC forum not to undertake an FTA with Taiwan, but they were given no such assurances. Still, other nations clearly are feeling the pressure. Wu Rong-I of the Taiwan Institute of Economic Relations (TIER) quoted a Japanese official at the forum as saying that "the political pressure from China is so high so far that Japan thinks it's premature to negotiate with Taiwan until the US negotiates an FTA."[9]

Ironically, APEC itself could provide just the opportunity for China to set a precedent in setting aside objections to Taiwanese participation in regional trade liberalization. If the APEC forum were on track to meet its goals of free trade among developed APEC economies by 2010 and among developing members by 2020, then the need for Taiwanese participation in other arrangements would be moot. That is not the case, however. Taiwan's participation in APEC as an economic entity, sidestepping the question of its sovereign status, should be extended to bilateral and regional trading arrangements. If the nomenclature of "free trade agreement" is contentious, then it could be set aside in favor of "closer economic partnership arrangement" or some such terminology. In essence, Beijing could deprioritize discussions of Taiwan-US trade arrangements simply by unblocking Taiwanese participation in more relevant regional arrangements.

The United States can assess the possibility of an FTA with Taiwan based on anticipated bilateral economic benefits and on principles and preexisting commitments. The geopolitical principle and bilateral obligation of the United States to Taiwan is to support the island's ability to address the question of "One China"—be it a matter of eventual reunification or otherwise—from a position of security and liberty. But even as the United States strongly asserts its right to pursue an FTA with Taiwan, all parties involved should understand this is a second-best option. The welfare gains for Taiwan, China, and the region from normalized Taiwan-China economic relations and from including Taiwan in regional trade integration would be far greater today and sustainable into the future than an FTA between the United States and Taiwan.

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8. Xinhua News Agency, April 13, 2002, www.china.org.cn/english/taiwan/49504.htm (accessed February 12, 2004).

9. *Taipei Times*, April 27, 2003, www.taipeitimes.com/News/taiwan/archives/2003/04/27/203674 (accessed February 12, 2004).