



Deepening China-Taiwan Relations through the Economic Cooperation Framework Agreement

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On Sunday, June 13, 2010 representatives from China and Taiwan¹ held a third round of talks in Beijing on an Economic Cooperation Framework Agreement (ECFA) that would liberalize important aspects of cross-Strait economic relations. Details of what was agreed and what remains under negotiation are still trickling out, and in any case the nature of this framework is that various elements will be agreed upon on an ongoing basis rather than at once. But it is clear from available details that ECFA will be an ambitious accord that fundamentally changes the game between Taiwan and China and hence

affects the regional economy and even the transpacific tempo for the United States.

While the exact terms and sequencing of ECFA remain to be seen, we have prepared an analysis of its implications using the general parameters of the undertaking as described to us by senior officials in Beijing and Taipei.² In the study, we explore the existing abnormalities in the cross-Strait economic relationship, the long-term costs of those abnormalities for both sides, the motivations in moving to a new framework, and the projected economic implications of something like ECFA. We also examine the security concerns arising from an even deeper interdependence and compare those with the concerns arising from business as usual.

MOTIVATIONS

At first glance, some think the status quo has been favorable to Taiwan. China mostly extends World Trade Organization (WTO)—standard most-favored nation status to Taiwan—meaning trade terms equivalent to those all other WTO members receive—while Taiwan imposes unilateral barriers to imports, investment, and visitors from China. Economically speaking, however, the more “protected” party—Taiwan—saddles its household consumers and enterprise manufacturers with more expensive inputs where China would be most competitive, deprives the economy of productive investment, and cuts off skilled labor mobility that could benefit Taiwan. Moreover, the ambiguity of Taipei's stance and uncertainty about competitiveness likely scare away domestic investment and other Asian and Western investors.

Not only is this status quo not optimal for Taiwan but also with the advent of deeper economic integration accords in the region—such as the free trade agreement between the Association of Southeast Asian Nations and China (ASEAN+China), which entered into force on January 1, 2010—Taiwan's position in the world's most important new market is eroding, as its peer competitors agree on preferential trade and investment terms with Beijing that go beyond the WTO standard. Therefore, the baseline situation that motivates Taiwan is not merely

1. We use the terms China and Taiwan in the vernacular, without prejudice to preferences in either capital about the ideal nomenclature for the polities.

2. Daniel Rosen and Zhi Wang, *The Implications of China-Taiwan Economic Liberalization* (Washington: Peterson Institute for International Economics, forthcoming 2010).

business as usual but rather diminishing marginal benefit from regional trends.

For its part, China is frank in stating that it supports an ECFA undertaking because it believes this will maximize the prospect for eventual political integration across the Taiwan Strait. But officials in Beijing argue that this belief is rooted not in the idea that ECFA would enhance their ability to coerce Taiwan but in the view that it would maximize

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mutual prosperity and Taiwan's perception of common interest, thereby establishing the goodwill necessary to facilitate political rapprochement in the future. Our conjecture is that the security and political consequences of marginalization for Taiwan under the current, abnormal conditions are at least as deleterious to the island's core interests as normalizing economic relations would be.

PROJECTIONS

To assess the economic impact of ECFA, we employ an economic model similar to the Global Trade Analysis Project (GTAP) platform, which can capture the economic liberalization already happening and likely to happen in Asia in the near future, in order to simulate the dynamic context around the choices confronting Taipei and Beijing.

Our first important projection is that by implementing an ECFA along the lines of the ASEAN+China agreement, Taiwan would increase its 2020 GDP by about 4.5 percent, or \$21 billion, from the current trend line. But we also conclude that the trend line will not stand still, and other agreements in the region will be negotiated (ASEAN+3), which will impose costs on Taiwan, if it does not do an ECFA, to the tune of almost -0.8 percent of GDP. So the net effect of ECFA for Taiwan would be some 5.3 percent improvement in GDP by 2020.

We can think of few (if any) other policy reforms available to Taipei that could deliver such gains. While some of these gains arise from Taiwan dismantling its non-WTO compliant import prohibitions on China, the gains also rely on China reducing tariffs on key Taiwan goods to free trade agreement

levels. Other aspects of the relationship necessary to realize the benefits of tariff reductions—like normal government-to-government regulatory communication—rely on negotiated, not just unilateral, outcomes.

This alone is an important result and is greater than in most other studies because (among other things) we recognize that the bulk of economic benefits from ECFA accrue only in the medium term, so we set the end year to 2020. We also argue that this is a conservative projection: Our model falls short of projecting a slew of economic benefits, especially service-sector gains and cross-border investment flows.

Since an insight of the study is that the regional economy around China and Taiwan is not standing still but is extraordinarily dynamic, we do not stop with this ECFA-only scenario. One of the most heated questions in Taiwan (though it is largely left out of formal discussions such as those that took place on June 13) is whether Taiwan could follow ECFA with similar liberalization agreements with other economies—at least the ones that already have free trade agreements with China itself, like ASEAN—*without interference from China*. This is a delicate political consideration from Beijing's perspective, though we would argue that it is time for China to set aside these anxieties.

While we can't model the correct way forward on the politics of this question, we did model the projected benefits for Taiwan from being able to do so. If after ECFA Taiwan joined the ASEAN+China regime, for instance, its 2020 GDP would rise 4.9 percent instead of 4.5 percent, or roughly 5.7 percent if measured from the reduced GDP outcome that eventuates should Taiwan eschew cross-Strait normalization. This additional benefit is positive, clearly, but the more important point is that it is very *modest* compared with the gains from ECFA itself. The reason is simple: Taiwan already has normal trade relations with the rest of Asia; it is with China that it maintains welfare-diminishing barriers, and so it is with China that liberalization would bring the greatest gains. The corollary insight—which is just as important—is that once ECFA is achieved, the bulk of gains available to Taiwan from regional trade liberalization would be locked in regardless of whether it resolves the impediments to doing free trade agreements with other economies. This is not to say those other arrangements would not benefit Taiwan, they would; but the cross-Strait gains are disproportionately large given the sheer magnitude of China's economic growth and the unique abnormalities between Taiwan and China.

Finally, our modeling offers insights for other economies from the ECFA and ECFA+ scenarios.³ For China, the net

3. In our forthcoming book, our analysis goes well beyond this policy brief to examine sectoral effects, trade versus other welfare effects, and other dimensions.

results of ECFA are positive, though far less so than for Taiwan in value terms and of course as a share of GDP. For other economies in the region, including those that have enjoyed an intermediary role in lieu of direct China-Taiwan economic links, the impact of ECFA is modest (in some cases positive); in no case do we foresee economic grounds for concern among the other players in the region. Even Hong Kong, which has been the main entrepôt between China and Taiwan, has little to be concerned about from China-Taiwan normalization.

In the case of the United States, our model shows a very modest positive result from ECFA (though statistically marginal), but a more negative impact as the scenarios incorporating further Asian integration (ASEAN+3) unfold. Several insights arise from this component of our analysis. First, if the US objective is to maximize Taiwan's economic prospects and hence its freedom of independent action, then ECFA is highly desirable, and Taiwan's involvement in further Asian deepening is to be supported. Second, however, we should be mindful of what the models are telling us: US economic interests per se erode as Asia draws tighter together without US inclusion. That is an econometric reality. More significant still is the geoeconomic, qualitative implication of even long-standing nemeses China and Taiwan drawing together in a free trade pact while the United States watches, unable to ratify already negotiated Asian trade agreements like the US-Korea free trade agreement.

POLICY CONCLUSION

Our economic projections of the effects of a China-Taiwan economic liberalization agreement point to the significant benefits of cross-Strait economic reform, especially for Taiwan. Modeling the impacts on other economies helps illuminate the importance of US engagement in Asian economic integration. Washington and Taipei can add to the balance in geoeconomic momentum centered on China by reinvigorating their ongoing Trade and Investment Framework Agreement (TIFA) talks and by considering other opportunities for transpacific bridge building that *includes* the United States. In that context, the Trans-Pacific Partnership (TPP), which the United States is pursuing with others in the region, may present an attractive test of Taiwan's ability to engage in additional economic liberalization, once ECFA is agreed (and assuming TPP moves ahead in a meaningful way).

Taiwan has more limited experience in negotiating serious trade liberalization than most other Asian economies, and in ECFA talks Beijing's underlying political motives may cause it to restrain its trade negotiators from pushing for maximum

benefits. Going beyond ECFA, if Taiwan wants to capitalize on the opportunity to build more economic links, it will need to catch up quickly in terms of the skills to negotiate and then ratify and *implement* at home its external commitments. That Taiwan should encounter some missteps in implementation given its relative isolation in the past is understandable; but if Taipei is to make use of any greater opportunity to conclude agreements externally in the future it will have to do better. Whether the challenge is executing a product-specific import agreement, implementing ECFA itself, or

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convincing the populace that going through WTO dispute resolution procedures is a mark of maturity, not an indication of weakness, Taiwan's leaders have political challenges at home that Beijing's officials are not constrained by.⁴ This should be good news—an aspect of commonality with more advanced democracies, not a source of misgiving about Taiwan's ability to deliver on its trade commitments.

As with any preferential trade agreement, the ECFA now moving closer to conclusion between Beijing and Taipei will take time to complete and then to enact. Its ultimate worth will depend on the fidelity with which it is enforced and the competence with which the private sectors and bureaucracies on both sides facilitate the commerce that should be empowered by it. While the details, including myriad sectoral and industrial codicils, remain to be seen, our modeling makes clear that the aggregate implications of ECFA are very important economically and thus will likely have an impact on the larger relationship between China and Taiwan, between those two and the region, and between that region and the United States. While modest in its global economic effects, we believe the geoeconomic implications are significant enough to demand strategic attention from the United States and underscore as well as anything the importance of securing US economic engagement of the first order in Asia.

4. We are mindful that China's leadership, while not constrained by an electorate, has its own limitations at home: the complexity of managing the world's largest population, epic inequalities between rich and poor, a weak legal system for enforcing trade obligations, and developmental challenges that tempt local officials to circumvent national commitments, to name just a few.