

**ESTABLISHING BILATERAL TRADE AGREEMENT WITHOUT
MUTUAL DIPLOMATIC RELATIONS: THE CASE OF THE
REPUBLIC OF CHINA ON TAIWAN**

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I. INTRODUCTION

Since the approval of the United Nations General Assembly Resolution 2758 on October 25, 1971, and the Joint Communiqué on the Establishment of Diplomatic relations of January 1, 1979 between the United States and the People's Republic of China (PRC), the Republic of China (ROC) on Taiwan has suffered tremendous and consecutive setbacks in its diplomatic relations with other nations in the world.¹ Currently, ROC maintains full diplomatic relations with 20 countries² and the Holy See (Vatican City). With the increasing recognition of PRC since the 1970s, about 50 state entities have ceased their formal diplomatic relations with ROC, including the recent case of Sao Tome and Principe in 2016.

Embedded in such diplomatically harsh environment, ROC on Taiwan has established eight bilateral trade agreements with El Salvador, Guatemala, Honduras, Nicaragua, New Zealand, Singapore, and China (PRC). Among these eight nations, ROC does not maintain diplomatic relations with New Zealand and Singapore, while holding a "special relations" with PRC under the famous "1992 Consensus."³ Establishing economic trade agreement with other states normally requires formal diplomatic relations with such states, and apparently, ROC manages to stand as an outlier in the international arena. To achieve this type of bilateral trade agreements, ROC has to employ the World Trade Organization nomenclature as the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu, instead of its official name, the Republic of China.

Besides bilateral trade agreements that ROC currently holds, ROC has also participated in several global and regional economic

1. For details, please see <http://www.un.org/documents/ga/res/26/ares26.htm> (assessed at January 1, 2017) and http://photos.state.gov/libraries/ait-taiwan/171414/ait-pages/prc_e.pdf (assessed at January 1, 2017).

2. These countries are Belize, Burkina Faso, Dominican Republic, El Salvador, Guatemala, Haiti, Honduras, Marshall Islands, Nauru, Nicaragua, Palau, Panama, Paraguay, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and Grenadines, Solomon Islands, and Swaziland.

3. The 1992 Consensus refers to a semi-official meeting between ROC and PRC in 1992. An unofficial conclusion of the meeting is the recognition of the One China Principle by both sides. For an extensive discussion of the 1992 consensus, see Yu-Shan Wu, "Taiwan in 2001: Stalemated on All Fronts," *Asian Survey*, Vol. 42, No. 1 (January/February 2002), pp. 29-38.

organizations, such as the World Trade Organization (WTO) and Asia-Pacific Economic Cooperation (APEC).⁴ In addition, ROC has shown a strong interest in joining the Trans-Pacific Partnership (TPP), a comprehensive trade agreement between 12 nations, including the United States. Nevertheless, the current President of the United States, Donald Trump, signed a presidential memorandum to withdraw from TPP, which shadows the potential feasibility of TPP in the future and discourages ROC from engaging with the TPP.⁵ On the one hand, participation in international organizations, regardless the nature of the organizations, improves the international recognition of ROC on Taiwan, given the fact that ROC is only acknowledged by roughly 10% of the sovereign states in the world. On the other hand, participation in economic international organizations shows an active engagement in the current trend of globalization and hopes to facilitate further economic growth through trade and financial openness. In the case of ROC on Taiwan, similar to the difficulties in establishing bilateral trade agreements, with the absence of formal diplomatic relations and the existing diplomatic pressure from PRC on these international organizations and their member nations, it is not only difficult but, to a certain degree, impossible for ROC to join these international organizations without the approval from PRC.

Nonetheless, scholars have articulated the benefits of trade and financial liberalizations through bilateral and multi-lateral trade agreements and participations in economic international organizations.⁶ In

4. ROC is represented by a ministerial-level official as “Chinese Taipei” in APEC.

5. For the details regarding the United States’ withdrawal of TPP, see “Withdrawal of the United States From the Trans-Pacific Partnership Negotiations and Agreement,” *Federal Register* (January 25th, 2017), <https://www.federalregister.gov/documents/2017/01/25/2017-01845/withdrawal-of-the-united-states-from-the-trans-pacific-partnership-negotiations-and-agreement> (assessed March 15th, 2017).

6. See David Dollar and Aart Kraay, “Growth is Good for the Poor,” *Journal of Economic Growth*, Vol. 7, No. 3 (September 2002), pp. 195-225; David Dollar and Aart Kraay, “Trade, Growth, and Poverty,” *The Economic Journal*, Vol. 114, No. 493 (February 2004), pp. F22-F49; L. Alan Winters, “Trade Liberalisation and Economic Performance: An Overview,” *The Economic Journal*, Vol. 114, No. 493 (February 2004), pp. F4-F21; L. Alan Winters, Neil McCulloch and Andrew McKay, “Trade Liberalization and Poverty: The Evidence So Far,” *Journal of Economic Literature*, Vol. 42, No. 1 (March 2004), pp. 72-115(44); Francisco Alcalá and Antonio Ciccone, “Trade and Productivity,” *The Quarterly Journal of Economics*, Vol. 119, No. 2 (May 2004), pp. 613-646; Geert Bekaert, Campbell R. Harvey, and Christian Lundblad, “Does Financial Liberalization Spur Growth?” *Journal of Financial Economics*, Vol. 77, No. 1 (July 2005), pp. 3-55; Romain Wacziarg and Karen Horn Welch, “Trade Liberalization and Growth: New Evidence,” *The World Bank Economic Review*, Vol. 22, No. 2 (June 2008), pp. 187-231; and Ariel Burstein and Javier Cravino, “Measured Aggregate Gains from International Trade,” *American Economic Journal: Macroeconomics*, Vol. 7, No. 2 (April 2015), pp. 181-218(38). Some scholars also find little evidence of the relationship between economic liberalization and growth; see Francisco Rodríguez and Dani Rodrik, “Trade Policy and

general, economists have found evidence supporting a positive correlation between trade and financial liberalization and economic growth through increasing productivity,⁷ eliminating poverty gap,⁸ and overall economic growth indicators.⁹ That is, with increasing accretion on trade liberalization through various means, including bilateral, multi-lateral trade agreements and joining economic international organizations, citizens and their governments can expect a higher economic return and benefits. These trade agreements and organizational participations can effectively lower the trade barriers through minimizing tariffs, deregulations, or increasing quotas on certain goods, and through increasing accessibility for foreign investors and corporations, which create more employment opportunities and market competition in prices.

As a sovereign state entity, which actively seeks international recognitions, ROC on Taiwan has to sustain endless threats and pressures from PRC under the "One China Policy," acknowledged and enforced by both PRC and the United States. PRC, as the winning camp of the Second Chinese Civil War between 1945 and 1950, after it "untied" with the Soviet Union mid Cold War (the 1950s and 1960s), became a viable alliance option for the United States to balance power against the Soviet Union. The rapid economic development of PRC after the Communist government decided to marketize its economy, the trend of globalization since late the 1970s, and the potential profits for foreign investors that can be generated through its consumer market and comparative advantages (e.g., low-wage labor), have incentivized other nations to establish stronger diplomatic ties with PRC. By creating stronger diplomatic ties, these nations unavoidably have to decrease or even cease their existing foreign relations with ROC on Taiwan. To date, PRC is the second largest

Economic Growth: A Skeptic's Guide to the Cross-National Evidence," *NBER Macroeconomics Annual*, Vol. 15 (2000); Barry Eichengreen, "Capital Account Liberalization: What Do Cross-Country Studies Tell Us?" *The World Bank Economic Review*, Vol 15, No. 3 (October 2001), pp. 341-365; Halit Yanikkaya, "Trade Openness and Economic Growth: A Cross-Country Empirical Investigation," *Journal of Development Economics*, Vol. 72, No. 1 (October 2003), pp. 57-89; and Gwendolyn K. Hallsmith, "Do We Really Know That the WTO Increases Trade?" *The American Economic Review*, Vol. 94, No. 1 (March 2004), pp. 98-114(17). pp. F22-F49.

7. Francisco Alcalá and Antonio Ciccone, "Trade and Productivity" and Ariel Burstein and Javier Cravino, "Measured Aggregate Gains from International Trade."

8. David Dollar and Aart Kraay, "Growth is Good for the Poor;" David Dollar and Aart Kraay, "Trade, Growth, and Poverty;" and L. Alan Winters, Neil McCulloch and Andrew McKay, "Trade Liberalization and Poverty: The Evidence So Far."

9. Geert Bekaert, Campbell R. Harvey, and Christian Lundblad, "Does Financial Liberalization Spur Growth?"; Romain Wacziarg and Karen Horn Welch, "Trade Liberalization and Growth: New Evidence;" and Ariel Burstein and Javier Cravino, "Measured Aggregate Gains from International Trade."

economy and the second highest military spending state in the world, as well as one of the permanent members of the United Nations Security Council. Thus, its international influences are not negligible.¹⁰ As a result, the territorial and sovereign dispute between PRC and ROC constrains ROC's capability in breaking through its diplomatic hardship in seeking international recognition and constructing formal diplomatic relations with other nations and international organizations.

The United States, on the other hand, passed and signed the Taiwan Relations Act (TRA) in 1979 after ceasing its diplomatic relations with ROC in 1978. TRA regulates the non-diplomatic relations between citizens of the United States and citizens of ROC on Taiwan and authorizes de facto diplomatic relations between the United States and ROC. Due to its geographical location the resulting strategic position, ROC on Taiwan has been recognized as one of the important partners with the United States. Therefore, the second point of the second article in section 2 states that TRA is the policy of the United States "to declare that peace and stability in the area are in the political, security, and economic interests of the United States, and are matters of international concern."¹¹ Later in 1982, to ensure peace and stability in this area, the United States agreed to the Six Assurances proposed by Kuomintang (KMT), the ruling party of ROC at that time, which provide a stronger warranty to TRA.¹² As the Cold War ended in 1991, the United States resumed its hegemonic position in the world. However, the emerging power, PRC, has become the number

10. According to the International Monetary Fund, China's nominal gross domestic product (GDP) was 11,391.619 billion US dollars in 2016, and according to the Stockholm International Peace Research Institute, its military spending was 214,787 million current US dollars in 2015.

11. See <https://www.ait.org.tw/en/taiwan-relations-act.html> (assessed March 1st, 2017).

12. The Six Assurances proposed in 1982 were: 1. The United States would not set a date for termination of arms sales to Taiwan; 2. The United States would not alter the terms of the Taiwan Relations Act; 3. The United States would not consult with China in advance before making decisions about United States arms sales to Taiwan; 4. The United States would not mediate between Taiwan and China; 5. The United States would not alter its position about the sovereignty of Taiwan which was, that the question was one to be decided peacefully by the Chinese themselves, and would not pressure Taiwan to enter into negotiations with China; and 6. The United States would not formally recognize Chinese sovereignty over Taiwan. Later in 2016, several changes were made to the original Six Assurances and engrossed by both chambers of the Congress of the United States. The revised assurances were: 1. " * * * [W]e did not agree to set a date certain for ending arms sales to Taiwan"; 2. " * * * [W]e see no mediation role for the United States" between Taiwan and the PRC; 3. " * * * [N]or will we attempt to exert pressure on Taiwan to enter into negotiations with the PRC"; 4. " * * * [T]here has been no change in our longstanding position on the issue of sovereignty over Taiwan"; 5. "We have no plans to seek" revisions to the Taiwan Relations Act; and 6. the August 17 Communiqué, "should not be read to imply that we have agreed to engage in prior consultations with Beijing on arms sales to Taiwan". For more detail, see <https://www.congress.gov/bill/114th-congress/house-concurrent-resolution/88/text> (assessed January 1st, 2017).

one potential challenger to its hegemonic status since the late 20th century. Thus, it is of great interest that the United States maintain benign formal and informal diplomatic relations with ROC. Nevertheless, similar to many other nations, the United States also needs to consider and maintain its economic ties and interests with PRC, resulting in a diplomatic dilemma for the United States in handling the cross-strait relations between ROC and PRC.

With the constant threat from PRC and the United States' diplomatic dilemma in its relations with ROC, ROC has struggled to find a loophole to gain more diplomatic and economic opportunities with other nations and international organization. To address this puzzle, we develop a theory to assess the possibility of ROC establishing trade agreements with other nations while lacking formal diplomatic relations.

The theory predicts that the likelihood of constructing a bilateral trade agreement with a state, which maintains balanced foreign relations with both PRC and the United States, is higher. In addition, the likelihood of establishing a bilateral trade agreement with the nation that aligns with the interest of PRC or the United States, when ROC's relations with PRC or the United States, is stronger, respectively, assuming that the PRC and the United States maintain the status quo. The theory also predicts that ROC may have more or less opportunities in developing bilateral trade agreements with other nations when foreign relations between PRC and the United States are worsened or strengthened, respectively, given the state that establishes the bilateral agreement with ROC is leaning neither to the United States nor China (e.g. maintains a balanced relations with these two nations). To participate in a multi-lateral trade agreement, an explicit or implicit approval from PRC or the United States must be given in unchanged foreign relations between PRC and the United States. When such relations are strengthened or worsened, the possibility for ROC to join in any form of multi-lateral trade agreements would be minimized. To examine our theory, we review two bilateral trade agreements, the Agreement between Singapore and the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu on Economic Partnership (ASTEP) and the Agreement between New Zealand and the Separate Customs Territory of Taiwan, Penghu, Kinmen, and Matsu on Economic Cooperation (ANZTEC).

This research consists of six sections. The first section introduces the framework, research question, theoretical predictions, and outlines of research. The second section includes an extensive review of the literature regarding the pros and cons of trade liberalization through bilateral or multi-lateral trade agreement. The third section provides the theoretical assessment of the feasibility for ROC to establish bilateral and multi-

lateral trade agreements without formal diplomatic relations under the current US-China power struggle. The fourth section reviews ASTEP, as an example demonstrating how ROC achieved a bilateral trade agreement when both ROC and Singapore were leaning toward PRC. The fifth section reviews ANZTEC and demonstrates the emergence of a trade agreement between ROC and New Zealand when foreign relations between the United States and PRC were aggravated due to increasing trade deficit from China to the United States. The last section provides concluding remarks, future research orientations, and policy implications to the government of ROC.

II. LITERATURE ON ECONOMIC LIBERALIZATION

A. Toward Globalization: A Stimulation to Economic Growth

The concept of globalization first appeared in English literature around 1960, as researchers started to study the shrinking constraints of geography and the process of global interconnectedness.¹³ One of the most phenomenal changes is the growth of international trade. After the World War II, the world trade volume maintained exceptional growth rate, averaging 6% annually while the total merchandise exports in the beginning of the 21st century was more than 22 times the level of 1950.¹⁴ The World Bank and the International Monetary Fund (IMF) were founded and have been aiding in the socio-economic development of least developed countries (LDCs). The General Agreement on Tariffs and Trade (GATT) and the successor World Trade Organization (WTO) were created “to help trade flow smoothly, freely, fairly and predictably.”¹⁵ In this trend, many countries adopted liberalized trade policies, removing trade barriers and stimulating export industries, which further facilitate the process of globalization. As a result, economic globalization has become “the most powerful force to have shaped the post-war world.”¹⁶

The burgeoning global socio-economic exchanges are not easy achievements. Although the idea of free trade, based on the concept of comparative advantages, can be traced back to Adam Smith during the 20th Century, most developing countries embraced protectionist views, devoting much effort to maintain import substitution strategies and limited

13. Malcolm Waters. 1995. *Globalization*. New York: Routledge.

14. The World Trade Organization (WTO), “WTO in Brief.” <https://www.wto.org>. Accessed: 4/9/17.

15. IBID.

16. Jeffrey Frankel. “What Do Economists Mean by Globalization? Implications for inflation and monetary policy.” (2006) *Academic Consultants Meeting*, Organized by the Board of Governors of the Federal Reserve System, Washington, DC, September 28.

degree of openness.¹⁷ It wasn't until the 1980s that economists who studied least developed countries began to shift their focus to development strategies based on principles of market-oriented reforms, including an essential element of reduction of trade barriers and opening of international trade.¹⁸ With the routine requirements from the World Bank, IMF, and many other multilateral institutions, trade openness becomes a core factor to structural adjustments in many places. The East Asian economies that experienced rapid economic growth are especially drawing attention to trade openness.¹⁹ Furthermore, the collapse of the Communist system in Eastern Europe in the late 1980s added more momentum to the economic and trade liberalization reforms.

Empirical evidence shows that the global trade system to remove trade barriers significantly improves member countries' economic performances. There is a consensus on this issue.²⁰ Under the trend, the multi-lateral trade regimes play an essential role. For example, Martin et al.²¹ found that during the 1950-2000 period, Asian economies with GATT/WTO membership traded 380 percent more than they would have been outside of the GATT/WTO system. Even for country pairs that include one non-member, the trade volume is found to be 30 percent more with each other than if both were non-members. The expansion of multilateral trade regimes advanced trade-driven globalization by lowering tariff and non-tariff barriers and by inducing more Foreign Direct Investment (FDI) through trade and investment negotiations.

B. Trade Liberalization

There is a strong consensus amongst economists of the benefits of free trade over time.²² Most of the empirical analyses show a positive relationship between trade openness and economic growth, as it increases

17. Sebastian Edwards. "Openness, Trade Liberalization and Growth in Developing Countries." *Journal of Economic Literature*, (September 1993), pp. 1358-1393; Robert E. Baldwin, "Openness and growth: What's the empirical relationship?." In Robert E. Baldwin and L. Alan Winters eds, *Challenges to Globalization: Analyzing the economics*. University of Chicago Press, 2004. 499-526.

18. IBID.

19. World Bank, *The East Asian Miracle : economic growth and public policy*. Washington DC : World Bank Group.

20. Dan Fuller, and Doris Geide-Stevenson. "Consensus Among Economists— An Update." *The Journal of Economic Education* Vol. 45, Issue. 2 (2014), pp. 131-146.

21. Will, Kym Anderson, and Cong S. Pham, "Effects of GATT/WTO on Asia's Trade Performance", in Shiro Armstrong and Thanh Tri Vo eds, *International Institutions and Economic Development in Asia*, London: Routledge (2010).

22. Dan Fuller and Doris Geide-Stevenson. "Consensus Among Economists— An Update." *The Journal of Economic Education* Vol. 45. Issue. 2 (2014), pp. 131-146.

productivity,²³ eliminates poverty gap,²⁴ and leads to positive effects on overall economic growth indicators.²⁵ These researchers and international organizations all suggest the developing countries speed up the process of trade liberalization from the growth perspective. The process of liberalization includes various policy means, such as joining international economic organizations and establishing bilateral or multi-lateral trade agreements with other countries. These arrangements, including trade agreements and organizational participations, help the economies to remove the trade barriers by decreasing tariffs and deregulations, and through increasing availability to foreign direct investments that bring in more resources and business opportunities. However, opponents of trade liberalization exist²⁶ because trade liberalization may have side effects, such as widening the socioeconomic gaps between different sectors, countries, and regions.²⁷ Considering the implementation of trade liberalization, scholars argue that it is necessary to combine several essential policies, e.g., encouragement of investments and promoting human capital accumulation, to achieve a long-lasting effect of liberalization on economic growth.²⁸

1. Trade Openness and Economic Growth

Economists find that growth can be generated not only by increasing aggregate levels of labor and capital but also by efficiently allocating resources from the less productive sectors to higher efficient sectors. Trade openness plays essential roles in this process. On the one hand, the outward-oriented economy makes it possible to use external resources, including the capital and technologies that accelerate technological

23. Francisco Alcalá and Antonio Ciccone, "Trade and Productivity" and Ariel Burstein and Javier Cravino, "Measured Aggregate Gains from International Trade."

24. David Dollar and Aart Kraay, "Growth is Good for the Poor;" David Dollar and Aart Kraay, "Trade, Growth, and Poverty;" and L. Alan Winters, Neil McCulloch and Andrew McKay, "Trade Liberalization and Poverty: The Evidence So Far."

25. Geert Bekaert, Campbell R. Harvey, and Christian Lundblad, "Does Financial Liberalization Spur Growth?"; Romain Wacziarg and Karen Horn Welch, "Trade Liberalization and Growth: New Evidence;" and Ariel Burstein and Javier Cravino, "Measured Aggregate Gains from International Trade."

26. For example, see Francisco Rodríguez and Dani Rodrik, "Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence"; Barry Eichengreen, "Capital Account Liberalization: What Do Cross Country Studies Tell Us?"; and Gwendolyn K. Hallsmith, "Do We Really Know That the WTO Increases Trade?"

27. Adrian Wood. North-south trade, employment and inequality: Changing fortunes in a skill-driven world. Oxford: Clarendon(1994); Robert H. Frank and Philip J. Cook. "The Winner Takes-all Society. (1995). New York: Free Press; United Nations Development Programme (UNDP), *Human Development Report* (1999). New York: Oxford University Press.

28. L. Alan Winters, "Trade Liberalisation and Economic Performance: An Overview."

advancements in developing economies. It also leads to exploitation of economies of scale and greater capacity utilization. Thus, trade openness contributes to growth in productivity and employment.²⁹

On the other hand, trade liberalization results in resource re-allocation according to principles of comparative advantage. In an economy, marginal factor productivities are not equal in different sectors. For example, the export and non-export sectors of the economy have various sizes and functions in each country. Openness leads to significantly higher marginal factor productivities in the export sector and inter-sectoral beneficial externalities generated by the export sector. Economic growth can be achieved by reallocation of existing resources from the less efficient non-export sector to the higher productivity export sector.³⁰ Empirical studies find robust evidence of this argument, as trade openness is seen as an essential factor to explain different economic outcomes across regions.

Early literature has found that promoting free trade is essential for economic development and there is a positive relationship between exported sectors and economic growth. One of the pioneering cross-national studies is from Little, Scitovsky, and Scott.³¹ They illustrate that the structure of protection, measured by Effective Rates of Protection (ERPs), impedes the manufacturing value added process. By protecting domestic industries, there are fewer incentives for allocating resources to develop export-oriented industrialization from traditional sectors or the agriculture. Thus, they suggest developing countries greatly reduce the degree of trade protection and open up to international competition in order to achieve industrialization and economic growth.

Balassa³² generalizes the argument that export-orientation policies foster growth, especially in developing countries. Balassa finds that, had some rapid-growth countries adopted policies that equal to the mean of all of the cases without extra efforts to boost export, the GNP would have

29. Bela Balassa, "Exports and Economic Growth: Further Evidence," *Journal of Development Economics*, Vol. 5 (June 1978), pp. 181-89; Micky Nishimizu and Sherman Robinson, "Trade Policies and Productivity Change in Semiindustrialized Countries," *Journal of Development Economics*, Vol.16 (September-October 1984), pp.177-206; David Dollar and Kenneth Sokoloff, "Patterns of Productivity Growth in South Korean Manufacturing Industries, 1963-1979," *Journal of Development Economics*, Vol.33 (October 1990), pp. 309-27.

30. Gershon Feder. "On exports and economic growth." *Journal of Development Economics* 12.1-2 (1983): 59-73. Hadi Salehi Esfahani, "Exports, imports, and economic growth in semi-industrialized countries." *Journal of Development Economics*, Vol. 35, Issue. 1 (1991), pp. 93-116.

31. Ian M. Little, Tibor Scitovsky, and Maurice F. Scott., *Industry and Trade in Some Developing Countries A Comparative Study* (1970), Cambridge: Oxford University Press.

32. Bela Balassa, "Exports and Economic Growth: Further Evidence".

been decreased significantly. For example, Korean GNP would be down 37%, Taiwan 25%, Chile 14%, and India 12% would decrease respectively if there were no export-oriented policies during the period 1966-1973.

Krueger³³ uses time-series and cross-section data to confirm the previous findings on the relationship between GNP and exports, adding more cases of developing countries. She points out positive cases such as Turkey, the Philippines, Ivory Coast, Colombia, and Malaysia, where export promotion led to economic growth. While the negative cases include India, Argentina, and Egypt, where trade restrictions retard the growth of exports and thus harm the economy, she concludes that there is "little doubt about the link between export performance and growth rates."

Sachs and Williamson³⁴ examine Asian and Latin American cases and they conclude, "The more important differences seem to center on exchange rate management and the trade regime." The Asian economies often use the foreign borrowings to develop industries for tradable goods, especially export industries. In contrast, Latin American countries often use the fund to finance private sectors and did little on increasing export capacity. This is one of the key factors to explain why Asian countries achieved a higher level of economic growth led by export sectors, whereas the Latin American counterparts were more vulnerable to the external shocks in the 1980s.

Dollar³⁵ measures trade liberalization by constructing an index of outward orientation consists of two indices (real exchange rate distortion index and real exchange rate variability). He finds that Asian countries have lower price levels and real exchange rate distortion than Latin American and African counterparts. These two indices reflect relatively modest tariff protection and incentives oriented to external markets. In a broad sample of 95 developing countries in the period 1976-85, the analysis shows that his outward orientation measure is highly correlated with per capita GDP growth. The per capita growth rate in the most open quartile of countries is 2.9%; the second quartile, 0.9%; the third quartile, -0.2%; and the most closed quartile, - 1.3%.

33. Anne Krueger, "Trade Policy as an Input to Development."

34. Jeffrey D. Sachs and John Williamson, "External Debt and Macroeconomic Performance in Latin America and East Asia," *Brookings Papers on Economic Activity* 2 (1985), pp. 523-64, quote on 525.

35. David Dollar, "Outward-oriented Developing Economies Really Do Grow more Rapidly: evidence from 95 LDCs, 1976-1985." *Economic Development and Cultural Change* Vol. 40, Issue. 3 (1992), pp. 523-544.

Sachs and Warner (1995)³⁶ also provide substantial evidence about the positive trade-growth relationships, as they show that developing economies with open trade policies have grown at 4.49 percent per year while the openly developed economies grow at 2.29 percent per year. On the other hand, developing and developed economies that adopt closed trade policies have grown at 0.69 and 0.74 percent per year respectively. In particular, those that employed aggressive import substitution policies suffered the most in the economic crisis during the 1980s and 90s, while export-led policies mitigate the downsides of crisis.

2. Trade Openness: More Recent Evidence

Similar evidence on the advantages of trade liberalization is quite abundant. For example, Edwards,³⁷ Frankel and Romer,³⁸ and Bhagwati and Srinivasan,³⁹ all find that open trade regime is a key factor for economic growth and other economic indices, such as poverty reduction. However, criticisms do exist, such as the early works of Rodríguez and Rodrik.⁴⁰ Rodríguez⁴¹ argues that standard measures of trade policy are not associated with growth. These criticisms are more about methodological issues, especially the measurement of trade openness and economic growth, as Rodríguez points out that the relationship between trade policy and growth may be significant but they are not simply linear and the data cannot reflect it. Therefore, recent evidence turns to multiple research methods to confirm the positive relationship between trade liberalization and growth, where scholars specify the policies needed for economic growth.

First, recent studies have similar and consistent findings that international trade is positively associated with economic growth and related economic performance indices. For example, Brückner and

36. Jeffrey D. Sachs, Andrew Warner, Anders Aslund, and Stanley Fischer, "Economic Reform and the Process of Global Integration." *Brookings Papers on Economic Activity* 1995.1 (1995), pp. 1-118.

37. Sebastian Edwards. "Openness, Trade Liberalization and Growth in Developing Countries," *Journal of Economic Literature*, Vol. 31 (1993), pp. 1358-1393.

38. Jeffrey A. Frankel and David Romer. "Does Trade Cause Growth?" *American Economic Review*, Vol. 89, No. 3, (1999): pp. 379-399.

39. Jagdish Bhagwati and Thirukodikaval Nilakanta Srinivasan. "Trade and Poverty in the Poor Countries." *The American Economic Review*, Vol. 92, Issue. 2, (2002), pp. 180-183.

40. Francisco Rodríguez and Dani Rodrik (2001). Trade Policy and Economic Growth: A skeptic's guide to the cross-national evidence. In Ben S. Bernanke and Kenneth Rogoff eds, *NBER Macroeconomics Annual 2000*. Cambridge: National Bureau of Economic Research.

41. Francisco Rodríguez. "Openness and growth: what have we learned." (2006). DESA Working Paper No. 51.

Lederman⁴² examine the African countries and found that a one percent increase in openness leads to 0.5% short-run economic growth and 0.8% long-run growth per year respectively.

Besides the direct linkage of trade liberalization and economic growth, the literature shows that it can be linked to various aspects of economic performances,⁴³ especially on poverty reduction. Dollar and Kaaray⁴⁴ find that trade and increase in growth rates help the “rapid globalizers,” one-third of the developing countries, to experience rapid income growth and poverty reduction over the past two decades. The effect is significant in countries such as Bangladesh, India and Sri Lanka in South Asia, as they increase trade volume and reduce the tariff and non-tariff barriers. In contrast, the remaining two-thirds of the developing countries that lack sufficient outward orientation performed badly in terms of growth and poverty reduction. Berg and Krueger,⁴⁵ using various methods and data to overcome potential measurement issues, also show that trade policy can be beneficial to economic development and poverty reduction. Taken together, from a meta-analysis viewpoint, Lopez⁴⁶ examine the evidence in both micro and macro levels and he concludes that the empirical research shows that trade liberalization enhances productivity and economic growth, reducing poverty in economies across different regions.

Second, more and more scholars illustrate the importance of complementary policies to trade that combine to enhance economic developments in the long run. Mendoza⁴⁷ points out that the relationship between trade openness and economic growth is conditional on related economic policies such as investments and employments, as poor management or implementation of economic policies could hinder growth. Stone and Strutt (2010)⁴⁸ argue that infrastructure is a necessity of trade, as well as the productivity. Also, economic policies that link trading

42. Markus Brückner and Daniel Lederman. “Trade Causes Growth in Sub-Saharan Africa.” (2012).

43. Winters, L. Alan. “Trade Liberalisation and Economic performance: an overview.” *The Economic Journal* Vol. 114 Issue. 493 (2004), pp. F4-F21.

44. David Dollar and Aart Kraay. “Trade, Growth, and Poverty.”.

45. Andrew Berg and Anne Krueger. “Trade, Growth, and Poverty: a selective survey.” *IMF Working Papers* 2003.30 (2003), pp. 1-50.

46. Ricardo López. Trade and Growth: Reconciling the Macroeconomic and Microeconomic Evidence. *Journal of Economic Surveys*, Vol. 19, Issue 4, (2005), pp. 623-648.

47. Ronald Mendoza. “Trade and Growth in the Post-2008/2009 Crisis World.” *World Economics* Vol. 11, Issue.4 (2009), pp.29-36.

48. Susan Stone and Anna Strutt. “Transport Infrastructures and Trade Facilitation in the Greater Mekong Subregion.” in Douglas H. Brooks and Susan F. Stone eds, *Trade Facilitation and Regional Cooperation in Asia*, New Hampton: Edward Elgar (2010), pp. 156-192.

sectors with other sectors of the economy are necessary for a country to carry out growth led by the export sector. Chang et al.⁴⁹ illustrate that a higher investment in human capital is necessary for growth, as the availability of infrastructure is also a key factor to developing different sectors of economy. Vohra⁵⁰ finds that some countries employ restrictive and regulatory policies for the labor market, which might counterbalance the beneficial effects of trade. Cuadros et al.⁵¹ argue that appropriate policies towards foreign direct investment must be considered because it is one of the essential driving forces for the trade-led developments, as we will show in the next section. These policies must work together to ensure that a country can be beneficial from trade openness.

To conclude the relationship between trade liberalization and economic growth, Panagariya sums up that the empirical evidence and experience from the last fifty years both provides significant support to the case of free trade.⁵² In particular, in the developing world, a majority of the mass economic growth cases occurred when the government adopts strategies to remove trade barriers. Taken together, although there are debates on the measurement issues and causality issues, the baseline is that the literature is certain that trade restriction is not a stimuli for economic growth⁵³ and the trade openness has a positive relationship with economic growth, poverty reduction, and other indices for developments. This view seems to be widely accepted by policy makers worldwide.

C. The Impacts of Foreign Direct Investment and Portfolio Investment

According to the International Monetary Fund (IMF), Foreign Direct Investment (FDI) is defined as 10% ownership or more of a foreign party

49. Roberto Chang, Linda Kaltani, and Norman V. Loayza. "Openness can be good for growth: The role of policy complementarities." *Journal of Development Economics* 90.1 (2009): 33-49.

50. Rubina Vohra. "Export and economic growth: Further time series evidence from less-developed countries." *International Advances in Economic Research* Vol. 7, Issue. 3 (2001), pp. 345-350.

51. Ana Cuadros, Vicente Orts, and Maite Alguacil. "Openness and growth: Re-examining foreign direct investment, trade and output linkages in Latin America." *Journal of Development Studies* 40.4 (2004): 167-192.

52. Arvind Panagariya, "Miracles and Debacles: In Defence of Trade Openness." *World Economy*, Vol. 27, Issue 8 (August 2004), pp. 1149-1171.

53. Ignacio Fiestas, "The Effects of Trade Liberalization on Growth, Poverty and Inequality." *CILAE Nota técnica NT/04/05* (2005); Rodríguez and Dani Rodrik. "Trade Policy and Economic Growth: A skeptic's guide to the cross-national evidence. "

in a domestic corporation. Basu and Guariglia⁵⁴ point out that the FDI flows across the world and is one of the most significant signs of world economy globalization over the past 20 years. In the era of globalization and trade liberalization, the volume of FDI has been growing even faster than the volume of international trade. For example, the aggregate level of FDI stock worldwide doubled during 1975 to 1995, substantially exceeding the growth of trade sectors.⁵⁵ FDI has been proved as one of the most important factor that leads to improvements for various economic performance such as economic growth, higher wages, total employment, and productivity, especially in the developing host economies. However, it also has side effects on rising income inequality between different sectors, or displacing domestic firms. Scholars also find some necessary conditions in the host country if one expects to observe the best economic outcome caused by FDI.

In a nutshell, FDI is an important vehicle for the transfer of technology and productivity, helping to accumulate human capital and contributing relatively more to economic growth than local investment in the host country. FDI also helps to create new job demand and hence increase employment. The effect is especially significant in developing countries. Borensztein et al.⁵⁶ trace the FDI flows from industrialized countries to 69 developing countries for over the two decades starting from 1970. The result is consistent with previous ones. Cuadros et al.⁵⁷ use Latin American cases to show FDI is key for economic growth. Levine and Renelt⁵⁸ parcel out various factors that may have an effect on economic growth and they show a robust relationship between economic growth, FDI and human capital. In particular, share of investment in GDP, FDI, and the trade volume in GDP all have positive effects. De Gregorio⁵⁹ studies 12 Latin American countries and uses the panel data to show that factor productivity growth led by investment is one of the main

54. Parantap Basu and Alessandra Guariglia. "Foreign Direct Investment, Inequality, and Growth." *Journal of Macroeconomics*, Vol.29, Issue. 4 (2007), pp. 824-839.

55. Ray Barrell and Nigel Pain. "Foreign Direct Investment, Technological Change, and Economic Growth within Europe." *The Economic Journal*, Vol. 107 (1997), pp. 1770-1786.

56. Eduardo Borensztein, Jose De Gregorio, and Jong-Wha Lee. "How Does Foreign Direct Investment Affect Economic Growth?" *Journal of International Economics*, Vol. 45, Issue 1 (1998), pp. 115-135.

57. Ana Cuadros, Vicente Orts, and Maite Alguacil. "Openness and Growth: Re-examining foreign direct investment, trade and output linkages in Latin America." *Journal of Development Studies*, Vol. 40, Issue. 4 (2004), pp. 167-192.

58. Ross Levine and David Renelt. "A Sensitivity Analysis of Cross-country Growth Regressions." *The American Economic Review* Vol. 82, Issue. 4(September 1992), pp. 942-963.

59. José De Gregorio. "Economic Growth in Latin America." *Journal of Development Economics*, Vol.39, Issue. 1, (1992), pp. 59-84.

determinants of growth and FDI is about three times more efficient than domestic investment. Blomstrom et al.⁶⁰ also find a significant effect of FDI on economic growth in least developed countries (LDCs). Taken together, Wacziarg⁶¹ argues that FDI is the principal route in which trade liberalization has been effective for economic performance.

FDI contributes to economic development through several mechanisms. The channels include stock of human capital, transferring and diffusion of technology, and a higher degree of efficiency due to the combination of foreign advanced management skills with domestic labor and inputs. These mechanisms are highlighted by an Organization for Economic Cooperation Development (OECD) study of both OECD and developing countries.⁶²

First, foreign investors contribute to economic growth because they tend to be more productive than local firms are. An analysis of 282 pairs of foreign and domestic firms of similar size drawn from 80 manufacturing industries in Brazil concluded that foreign firms have a significantly higher ratio of value-added to output than domestic firms.⁶³ The FDI and newly established manufacturers are thus leading the economic growth.

Second, FDI affect growth by generating productivity spillovers. FDI brings in a process of competitive interaction, as well as technological accumulation between foreign and domestic firms, which raises the overall productivity. Blömstrom and Persson⁶⁴ and Kokko⁶⁵ find evidence that FDI led to significant positive “spillover effects” on the level of labor productivity and growth of domestic productivity in Mexico. Besides the technology, FDI and foreign investors stimulate knowledge transfers in terms of labor training, skill acquisition, alternative management practices, and better organizational arrangements. These new methods of production further stimulate the competition between local firms and FDI-

60. Magnus Blomstrom, . Robert E. Lipsey, and Mario Zejan. *What Explains Developing Country Growth?*. No. w4132. National Bureau of Economic Research, (August 1992).

61. Romain Wacziarg,. “Measuring the Dynamic Gains From Trade.” *The World Bank Economic Review* Vol.15, Issue.3 (2001), pp. 393-429.

62. OECD (1991) *Technology and Productivity: The Challenge for Economic Policy*. Paris.

63. Larry N. Willmore, “The Comparative Performance of Foreign and Domestic Firms in Brazil.” *World Development*, Vol. 14, Issue 4 (1986): 489-502.

64. Magnus Blomström and Håkan Persson. “Foreign Investment and Spillover Efficiency in an Underdeveloped Economy: evidence from the Mexican manufacturing industry.” *World Development*, Vol. 11, Issue. 6 (1983), pp. 493-501.

65. Ari Kokko. “Technology, Market Characteristics, and Spillovers.” *Journal of Development Economics*, Vol. 43, Issue. 2 (1994), pp. 279-293.

related sectors, prompting the existing actors to be more efficient to adapt to the new markets.⁶⁶

Nevertheless, there are necessary policies for a host country to maximize the FDI-led growth. Researchers find that the positive effect of FDI on economic growth is neither universal nor unconditional. In general, the host country must have a sufficient absorptive capacity to realize economic growth triggered by FDI. First of all, the FDI is beneficial when the host country has stable macro-economic frameworks and is open to trade.⁶⁷ This include, for instance, a better financial systems and financial market regulations,⁶⁸ and the property rights protections.⁶⁹ If there is no such necessary environment, FDI may be harmful to economic growth because it only serves to enhance the private rate of return to investment from foreign firms, while offering little on social rates of returns in the host country.⁷⁰

Second, human capital is an essential condition, as the adoption of new technologies and management skills requires a certain level of inputs from the labor. Empirical works find that technological spillover is possible only when the host country reaches a certain “threshold” level of human capital.⁷¹ The technological and human capital gaps between local firms and foreign investors cannot be “too great” because a large gap

66. Luiz R. de Mello. Foreign Direct Investment, International Knowledge Transfers, and Endogenous Growth: Time Series Evidence (1996). Canterbury: University of Kent Dept. of Economics; Beata Smarzynska Javorcik. “Does Foreign Direct Investment Increase the Productivity of Domestic Firms? In search of Spillovers Through Backward Linkages.” *The American Economic Review*, Vol. 94, Issue. 3 (2004), pp. 605-627.

67. Maite Alguacil, Ana Cuadros, and Vicente Orts. “Inward FDI and Growth: The role of macroeconomic and institutional environment.” *Journal of Policy Modeling* Vol. 33, Issue. 3 (2011), pp. 1-496.

68. Laura Alfaro, Arcendam Chandab, Sebnem Kalemli-Ozcan, and Selin Sayekd. “FDI and Economic Growth: the role of local financial markets.” *Journal of International Economics*, Vol. 64, Issue.1 (2004), pp. 89-112; J. Benson Durham, “Absorptive Capacity and the Effects of Foreign Direct Investment and Equity Foreign Portfolio Investment on Economic Growth.” *European Economic Review*, Vol. 48, Issue. 2, (2004), pp. 285-306.

69. Beata Smarzynska Javorcik, “The Composition of Foreign Direct Investment and Protection of Intellectual Property Rights: Evidence from Transition Economics.” *European Economic Review*, Vol.48, Issue.1, (2004), pp. 39-62.

70. Venkataraman N. Balasubramanyam, Mohammed Salisu, and David Sapsford. “ Foreign Direct Investment and Growth in EP and IS Countries.” *The Economic Journal*, Vol. 106, No. 434 (Jan., 1996), pp. 92-105.

71. Eduardo Borensztein, Jose De Gregorio, and Jong-Wha Lee. “How Does Foreign Direct Investment Affect Economic Growth?”

hinders the spillover effects.⁷² Kokko et al.⁷³ examine FDI in Mexico and Uruguay and find that in industries where the foreign affiliates have much higher productivity levels than local firms, the spillover effects are difficult to identify. Taken together, FDI is one of the primary factors that contribute to economic growth under the trend of globalization,⁷⁴ while literature also illustrate the importance of infrastructure, skills, macroeconomic stability, and human capitals in developing countries.

D. The Function of Bilateral and Multi-Lateral Trade Agreement

Regional trade agreements (RTA, or the Preferential Trade Agreement, PTA) have been the most popular form of trade liberalization in the past two decades.⁷⁵ In the 1990s, some people consider PTAs as one of the main threats to the global trading system, while the concern has been shifting towards the Bilateral Trade Agreement (BTA) because of its rapid proliferation.⁷⁶ In the Asia-Pacific region, BTAs became popular in the late 1990s with Japan, Singapore, South Korea and New Zealand as the early promoters. By 2000, the United States joined the regional trend, along with Australia, Thailand, and the PRC. One can observe that every country in the world today is a member of at least one PTA or BTA, while most are members of multiple BTAs. As of March 2017, there are 270 RTAs in force and 647 cumulative numbers of RTAs, as notified to WTO/GATT.⁷⁷ In the GATT era, the period of 1948-1994, 124 notifications of RTAs were sent to the Secretariat. Since the establishment of WTO in 1995, there were over 400 arrangements related to trade in goods or services signed and notified to the WTO.

PTAs are popular for several reasons. The trend is partly due to the stalemates of multilateral trade negotiations of the WTO. Free trade agreements (FTA)—the most common types of PTA⁷⁸—between smaller

72. Ari Kokko. "Technology, Market Characteristics, and Spillovers."

73. Ari Kokko, Ruben Tansini, and Mario C. Zejan. "Local technological capability and productivity spillovers from FDI in the Uruguayan manufacturing sector." *The Journal of Development Studies*, Vol. 32, Issue. 4 (1996), pp. 602-611.

74. İlhan Öztürk. "Foreign Direct Investment-Growth Nexus: A Review of Literature." *International Journal of Applied Econometrics and Quantitative Studies*, Vol. 4, Issue. 2, (2007), pp. 79-98.

75. Caroline Freund and Emanuel Ornelas. "Regional Trade Agreements." *Annual Review of Economics*, Vol. 2 (2010), pp. 139-166.

76. Jayant Menon. "Bilateral Trade Agreements." *Asian-Pacific Economic Literature*, Vol. 2, Issue. 12 (2007), pp. 29-47.

77. Source from WTO Secretariat, https://www.wto.org/english/tratop_e/region_e/regfac_e.htm. Accessed: 4/16/17.

78. BTA can also take the form of Customs Union (CU) or a services agreement, which is often followed by a FTA.

numbers of economies may be easier to negotiate and be signed. The WTO Doha Round reinforced the sentiment, as many countries claim that the WTO fails to deliver proper results. Thus, many countries started to pursue their own trade liberalization agendas.⁷⁹ However, scholars have been debating the effects of FTAs and some trade-offs between bilateral and multilateral trade regimes.

First, from a purely economic self-interest view, researchers find that FTA has positive effects on members' trade flows. Baier and Bergstrand⁸⁰ find that FTA approximately *doubles* two members' bilateral trade after ten years, on average. Caporale et al.⁸¹ examine the effects on trade flows of signing FTAs (European agreements) between the European Union (EU-15) and the Central and Eastern European countries (Bulgaria, Hungary, Poland and Romania). They illustrate a significantly positive impact of FTAs on trade volume and the export sector. When adding control group samples that did not sign an FTA with the EU members, specifically Belarus, the Russian Federation and the Ukraine, one finds a significant impact of FTAs for the trade deal member states. These positive effects are results of the tariff changes, as well as the PTA-induced unobservable actions that effectively reduce trade costs, providing further incentives for investment and trade with partners.⁸²

Second, one of the fundamental principles of the multilateral trading regime is the most favored nation (MFN) treatment, which requires all members of the WTO to provide all other members with equal treatment in terms of trade. However, the PTA allows the partners to provide each other with better market access and trade conditions than MFN.⁸³ For the developing countries, signing BTAs mean that they can receive increased market access for traditional and non-traditional exports. These regional-based agreements encourage further specialization and pursuit of competitiveness. Indeed, there are trade-offs for the countries involved in BTAs. For example, countries receive more market access in exchange for

79. Jayant Menon. "Bilateral Trade Agreements."

80. Scott L. Baier and Jeffrey H. Bergstrand. "Do free trade agreements actually increase members' international trade?" *Journal of international Economics*, Vol. 71, Issue. 1, (2007), pp. 72-95.

81. Guglielmo Maria Caporale, Christophe Rault, Robert Sova, and Anamaria Sova. "On the bilateral trade effects of free trade agreements between the EU-15 and the CEEC-4 countries." *Review of World Economics* Vol. 145, Issue. 2, (2009), pp. 189-206.

82. James E. Anderson and Yoto V. Yotov. "Terms of trade and global efficiency effects of free trade agreements, 1990-2002." *Journal of International Economics*, Vol. 99 (March 2016), pp.279-298.

83. Kenneth C. Shadlen, "Exchanging Development for Market Access? Deep integration and industrial policy under multilateral and regional-bilateral trade agreements." *Review of International Political Economy*, Vol.12, Issue. 5, (2005), pp. 750-775.

making significantly deeper concessions regarding the management of inward investment and intellectual policy.⁸⁴ There will be new constraints regarding the management of FDI, the intellectual property, and the countries have to relinquish more regulatory instruments under the FTA rules.

Third, some PTAs are designed for one or more key sectors, focusing on expanding the trade liberalization into specific sectors or areas that may be ignored or too sensitive to deal with in multilateral levels. A FTA can concentrate on rules for investment, intellectual property rights, or just for the service sector. For example, many of the FTAs pursued by the US with developing countries belong to this type.⁸⁵ Involving only two or a small number of parties for agreement, a FTA faces fewer difficulties than a regional or multilateral pact that include multiple players and sectorial interests. Thus, BTAs may have the potential to achieve deeper levels of economic integration, driven by specific sectors.

Fourth, in contrast to the PTA that focuses on specific sectors, there are sector-excluding PTAs, especially for agriculture, the most sensitive sector under the trend of liberalization. It is relatively easier in the PTA negotiations than in multilateral settings to manipulate rules to limit liberalization of sensitive sectors. For example, the Japan-Mexico FTA was designed to achieve further economic integration without the involvement of the agriculture in both countries.⁸⁶

On the other hand, PTAs have various consequences. One of the most important characteristics of PTAs is that there are competitions among countries to access certain markets, where country's decision of entering such trade deals is conditional on other countries' decision. In particular, the competition for foreign investment and market share is more significant for neighboring countries, as PTAs help to gain more advantages over the competitors. Signing PTAs lead to exclusive status of market access to another economy, triggering a snowballing or domino effect.⁸⁷ For example, in the Asian Pacific region, the number of BTAs was doubling between 2002 and 2004, and the number has more than doubled again in 2007. Baldwin⁸⁸ predicts that:

84. Ibid.

85. Jayant Menon. "Bilateral trade agreements."

86. John Ravenhill. "The political economy of the new Asia-Pacific bilateralism: benign, banal, or simply bad?," in Vinod Agrawal and Shujiro Urata eds, *Bilateral Trade Agreements in the Asia-Pacific*, London: Routledge, 2006, pp. 27-49.

87. Richard Baldwin. "Multilateralising regionalism: spaghetti bowls as building blocs on the path to global free trade," *World Economy*, Vol.29, Issue. 11 (2006), pp. 1451-518.

88. Richard Baldwin. "Managing the noodle bowl: The fragility of East Asian regionalism." *The Singapore Economic Review*, Vol.53, Issue 3 (2008), pp. 449-478.

“[i]f history is any guide, the domino effect in East Asia will spread to many, many more countries in the neighborhood. In Europe, for example, the playing out of several waves of domino effects has left the EU with preferential trade deals with every WTO members except nine. It is therefore conceivable that the 13 members of the ASEAN+3 group will end up signing a very large number of bilaterals in the coming years.”

Similarly, Gruber⁸⁹ argues that economically weaker countries may participate in plurilateral institutions that have little benefits for national interests simply because other countries' participation raises the costs of not participating in regional institutions. Guzman⁹⁰ uses cases from least developed countries and argues that fear of a neighboring country entering into an agreement with the US and other major economies is a primary factor that least developed countries sign treaties that may bring side effects. For example, they fear the potential loss on the economic market share and exclusion from regional affairs.

These competition effects and the exclusive nature of PTA may hinder economic liberalization and the general welfares. Economists find that the loss of the non-member partners could outweigh the gains to partners, reducing the overall efficiency of the world economic system.⁹¹ Although BTAs may enhance the economic performance of the member countries, Scollay and Gilbert,⁹² for instance, found that all BTAs in the Asia Pacific region harm the welfare of particular non-member countries. They also find that the New Zealand–Singapore agreement is an exception, having little negative effects on others because they have already adopted MFN tariff rates that are close to zero, which minimize the distortion introduced by PTAs. However, most of the PTAs still biased economic liberalization towards the member countries.

PTAs have negative impacts on the broad-based multilateral liberalization via several mechanisms. From the viewpoint of political economic analyses, PTA results in disproportionate gains to certain groups with different factor endowments.⁹³ These groups may be powerful

89. Lloyd Gruber. *Ruling the World: Power politics and the rise of supranational institutions*. Princeton University Press, 2000.

90. Andrew T Guzman “Why LDCs sign treaties that hurt them: Explaining the popularity of bilateral investment treaties.” *Virginia Journal of International Law*, Vol 639 (1997).

91. James E. Anderson and Yoto V. Yotov. “Terms of Trade and Global Efficiency Effects of Free Trade Agreements, 1990–2002.”

92. Robert Scollay and John Gilbert. *New Regional Trading Arrangements in the Asia Pacific*. Washington, DC: Institute for International Economics, May 2001.

93. Philip I. Levy, “A Political-Economic Analysis of Free-Trade Agreements.” *The American Economic Review*, Vol. 87, No. 4 (Sep., 1997), pp. 506-519.

enough to prevent further liberalization of trade because it will destroy the rents created by the PTAs.⁹⁴

From an economists' view, PTAs may have side effects as well. For example, McLaren⁹⁵ finds that the expected regionalism and PTAs create its own demand for the main economic actors in each country, as it diminishes the ex-post demand for multilateral free trade based on negotiating costs and sector-specific sunk investments. The expected trading bloc motivates the major economic actors and private agents in each member country to invest in specialized sectors vis-à-vis the member states but become less interested in trading with non-members. Therefore, PTAs can be harmful to a global free trade regime.

Taken together, the PTAs between a small number of countries are beneficial to trade liberalization in a partially manner. The "remedies for multilateral trade regime" in response to the proliferating PTAs do exist,⁹⁶ but there may be lacking incentives to do so, as the expected cost of being excluded in the PTAs is high for individual countries.

III. THEORETICAL ASSESSMENT TO ESTABLISHMENT OF TRADE AGREEMENT WITHOUT FORMAL DIPLOMATIC RELATIONS

To better address various difficulties of the ROC establish bilateral or to join multi-lateral economic agreements, it is important to understand the balance of power between the United States and PRC. After the end of the Cold War, PRC has managed to become the second largest economic and military entity while maintaining an authoritarian regime. Though the United States and PRC maintain high volumes of trade and financial investments, the power transition theory argues that PRC's role as an emerging power may create potential military conflict in the future.⁹⁷ Under the context of the power transition theory, ROC then becomes a potential bargaining chip utilized by both PRC and the United States. For

94. Pravin Krishna, "Regionalism and Multilateralism: A political economy approach." *The Quarterly Journal of Economics*, Vol. 113, Issue. 1 (1998), pp. 227-251.

95. John McLaren, "A theory of insidious regionalism." *The Quarterly Journal of Economics*, Vol.117, Issue. 2, (2002), pp. 571-608.

96. Jayant Menon. "Dealing with the Proliferation of Bilateral Free Trade Agreements." *The World Economy*, Vol. 32, Issue. 10 (2009), pp. 1381-1407.

97. See Douglas Lemke and William Reed, "Regime Types and Status Quo Evaluations: Power Transition Theory and the Democratic Peace," *International Interactions*, Vol. 22, No. 2 (1996), pp. 143-164; Douglas Lemke and Ronald L. Tammen, "Power Transition Theory and the Rise of China," *International Interactions*, Vol. 29, No. 4 (2003), pp. 269-271; and Steve Chan, *China, the US and the Power-Transition Theory: A Critique*, Routledge (2007).

example, in a December 11, 2016 television interview with Fox News, the president-elect Donald Trump expressed:

I fully understand the One-China policy. But I don't know why we have to be bound by a One-China policy unless we make a deal with China having to do with other things, including trade. I mean, look, we're being hurt very badly by China with devaluation, with taxing us heavy at the borders when we don't tax them, with building a massive fortress in the middle of the South China Sea, which they shouldn't be doing. And, frankly, they're not helping us at all with North Korea. You have North Korea, you have nuclear weapons, and China could solve that problem. And they're not helping us at all.

So, I don't want China dictating to me. And this was a call put into me. I didn't make the call. And it was a call, very short call, saying, "Congratulations, sir, on the victory." It was a very nice call. Short. And why should some other nation be able to say, I can't take a call? I think it would have been very disrespectful, to be honest with you, not taking it.⁹⁸

However, after Donald Trump was inaugurated as the 45th President of the United States on January 20, 2017, in a telephone call conversation in February with the President of PRC, XI Jinping, he reversed his position and stated that he would honor the One China policy. This exemplifies ROC's role within the tension between PRC and the United States. Such event also reveals the tangible struggle for ROC to achieve any foreign relations without approaching or receiving explicit or implicit approval from the United States and PRC.

We develop several theoretical scenarios to demonstrate how ROC would be able to manage to pursue bilateral or multi-lateral trade agreements without having formal diplomatic relations with other nations by considering the balance of power between the United States and PRC. In our unique spatial models, there exist three parameters: (1) the foreign relations between PRC and the United States, (2) the foreign relations between ROC, PRC, and the United States, and (3) the foreign relations of the targeted nation (the potential state to establish a bilateral trade agreement with ROC) with ROC. Among these three parameters, there are four strategic actions: (1) the foreign relations between ROC and the targeted States move closer or more distant, (2) the foreign relations between PRC and the United States move closer or more distant, (3) ROC

98. Shelley Rigger, "Donald Trump is No Friend of Taiwan," *Foreign Policy Research Institute* (March 16th, 2017), <http://www.fpri.org/article/2017/03/donald-trump-is-no-friend-of-taiwan/> (assessed March 20th, 2017).

changes its position along the relations between PRC and the United States, and (4) the foreign relations between the targeted nation and the United States or PRC move closer or more distance.

In these spatial models, we have three assumptions. The first assumption is that the diplomatic interests of the targeted nation toward ROC are aligned with its foreign relations with the United States or China. This means, if the targeted nation has stronger foreign relations with the United States and ROC also has stronger foreign relations with the United States, its relationship ties with ROC will be stronger, and vice versa. The second assumption is that given the targeted nation maintains balanced relations with PRC and the United States (not leaning to neither actors), when the targeted nation changes its foreign relations with ROC, its foreign relations with PRC and the United States will remain unchanged. The last assumption is that an increase of the targeted nation's ties with PRC or the United States is a direct loss of its ties with the other nation. That is, for the targeted nation, its foreign relations with PRC and the United States are a zero-sum game.

The logic behind these assumptions is that, as the power balance between the United States and PRC becomes more intense along with the unavoidable economic globalization, it is difficult for any existing states to completely isolate itself and resist establishing foreign ties with either state. In addition, both the United States and PRC have incentives to increase their influence on existing state entities to gain advantage over their competitors. Therefore, under the context of the power competition between the United States and PRC, a state cannot gain better alignment with PRC or the United States without costing foreign relations with the other. ROC, on the other hand, has to balance its relationship between the United States and PRC, given its international status. A signal to change the status quo from another state to ROC is also a signal to the United States and PRC.

To better present our models, we visualize the relationships between ROC, PRC, the United States, and the targeted nation in Figure 1. The distances between ROC to the United States and PRC indicate the foreign relations between them: the closer the distance, the stronger the relations are between the pair of states. The distance between the targeted nation and ROC represents the likelihood of establishing a bilateral trade agreement between them: the closer the distance, the higher likelihood it is to establish such trade agreement.

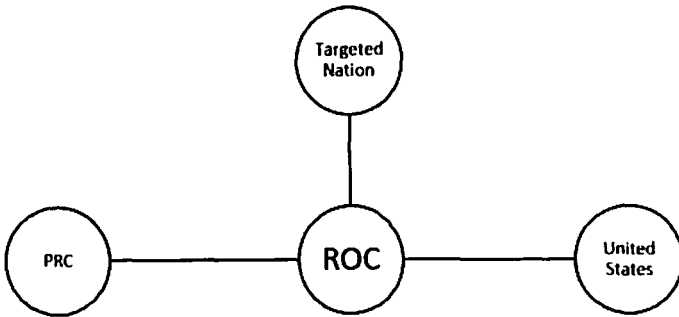


Figure 1: The Basic Model

Figure 1, then, is the basic model where the distance between each pair of the states are moderate and the targeted nation maintains neutral relations with both the United State and PRC. To begin, let first move the relations between ROC and the targeted nation closer while holding all other relations constant, as shown in Figure 2. In this scenario, the targeted nation is a relatively independent state within the power balance between the United States and ROC in which such state does not take a clear stance along with PRC nor the United States. Because of its independent status, this nation will be minimally influenced by both states. Once the targeted nation is immune to both the major powers, then formal or informal diplomatic approaches become a viable option for both states to engage in negotiation for economic cooperation with further possibility of a bilateral trade agreement.

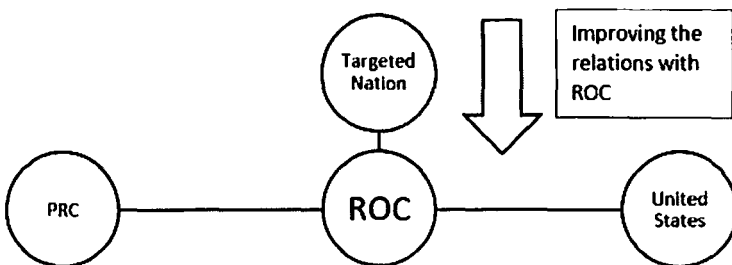


Figure 2: A Closer Foreign Relations between ROC and the Targeted Nation

That is, once the targeted nation is capable of resisting the influences from both PRC and the United States, the likelihood of a bilateral trade agreement to emerge between ROC and the targeted nation will be higher. Therefore, it leads to the first proposition:

Proposition 1: The likelihood of establishing a free trade agreement between ROC and the nation which maintains balanced foreign relations with PRC and the United States is high.

Based on Figure 2, there exist two more potential variations. First, as shown in Figure 3, when the foreign relations between PRC and the United States are worsened, meaning that the power completion between these two nations is escalated and the potential conflict between them is more likely, ROC and the targeted nation will have a better chance of making diplomatic or trade arrangements with each other. To begin, when United States and China alienate each other, it results in severe competition. Under such circumstance, each side has incentive to maintain the status quo with ROC to avoid potential aggravation between each other. If the status quo between US-China relations were changed due to the change of the status of ROC, a potential conflict could emerge. In addition, in such circumstance, as a state holding independent relations with the United States and PRC, the potential influence imposed by these two major states will be lower as they will aim to increase diplomatic ties with existing allies to strengthen its power. It is difficult to alter the relations of the targeted nation with both the United States and China by both actors since, by doing so, they will unavoidably cause a change in the status quo and lead to instability. For the targeted nation, it is also wise to stay independent to avoid being dragged into the conflict. This mechanism leads to the second proposition:

Proposition 2: The likelihood of establishing a free trade agreement between ROC and the nation which maintains balanced foreign relations with PRC and the United States is high when the US-China relations are worsened.

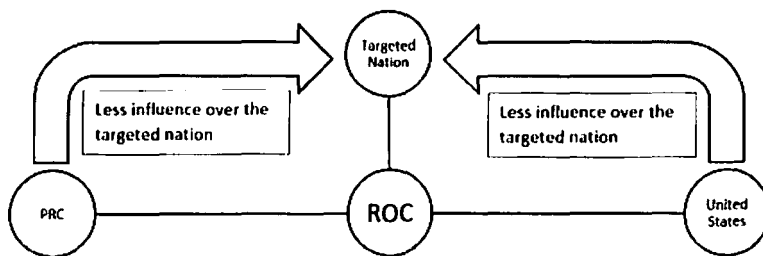


Figure 3: A Polarized US-China Relation

Second, when the US-China relations improves, both nations will have stronger diplomatic and economic ties with the targeted nations since the

distances between the targeted nation and PRC and the United States are closer. That is, under a world system with polarized US-China relations, the targeted nation will face more difficulties in maintaining its independent relations and in seeking opportunities of cooperation with any of these two major states. Benign US-China relations enable the targeted nation to improve its foreign relations without sacrificing its independent status. In addition, as the US-China relations improves, the diplomatic space of ROC will nonetheless diminish and its international status and sovereignty may be sacrificed by PRC and the United States, although trying to maintain its independence with both PRC and the United States. As a result, an improved US-China relation will suppress ROC's potential in coordinating and further establishing any forms of bilateral trade agreement with the targeted nation, as well as other states. Figure 4 then visualizes this mechanism and leads to the third proposition:

Proposition 3: The likelihood of establishing a free trade agreement between ROC and the nation, which maintains balanced foreign relations with PRC and the United States, is low when the US-China relations are improved.

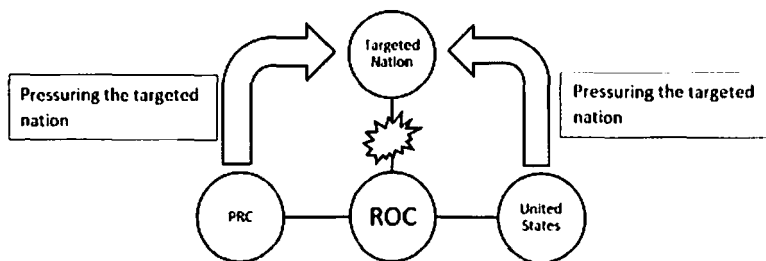


Figure 4: A Closer US-China Relation

The previous spatial models and their associated propositions assume ROC's foreign relations with PRC and the United States are independent. Now, let assume ROC's position within the US-China relations is mobile, meaning that ROC can choose to improve its diplomatic relations with either PRC or the United States. Since the model assumes that ROC's position within the US-China relations is a zero-sum game, an increasing tie between ROC and PRC or the United States is a direct loss for its relations with the United States and PRC, respectively. On the one hand, when ROC's relations with PRC are improved, PRC then will be more willing to allow its allies to form a stronger economic tie with ROC, as such diplomatic and economic relations are most likely, given the

condition that ROC and PRC's allies all embrace the One China Policy and are fully aware of the boundary that PRC has agreed with. On the other hand, when ROC's relations with the United States are improved, it unavoidably results in a hostile environment for US-China relations as the new US-ROC relations are flowing into a direction against PRC's irredentism for ROC on Taiwan. As for the United States to maintain its ties with ROC, approaching allies of the United States that disagree with PRC's international status or other sociopolitical positions, such as human rights violation and its authoritarian features, then becomes a viable route for ROC to establish bilateral trade agreements. Accordingly, the likelihood of a bilateral trade agreement between ROC and the targeted nation is higher given the following two conditions: (1) the ROC-PRC or the ROC-US relations are improved, and (2) the targeted nation has a stronger diplomatic tie with PRC or the United States, respectively. Figure 5a and 5b demonstrate this scenario along with the fourth proposition of the model:

Proposition 4a: The likelihood of establishing a free trade agreement between ROC and the nation, which maintains closer foreign relations with PRC, is high when ROC improves its foreign relations with PRC.

Proposition 4b: The likelihood of establishing a free trade agreement between ROC and the nation, which maintains closer foreign relations with the United States, is high when ROC improves its foreign relations with the United States.



Figure 5a: A Closer Foreign Relation between ROC, the United States, and the Targeted Nations



Figure 5b: A Closer Foreign Relation between ROC, PRC, and the Targeted Nations

Proposition 1 to 5 describe how ROC can establish bilateral trade agreements with other nations within the existing US-China framework and the struggle from the One China Policy. One of the major theoretical mechanisms is that it is possible for ROC to initiate a bilateral trade agreement, which can further improve its economy. Nevertheless, it requires the ROC government to acknowledge and accurately calculate its position within the current US-China relations and diplomatic relations between the targeted nation and the United States and China.

With regard to ROC's participation in multi-lateral trade agreements, again, given the current international framework and the major consensus to the One China Policy by both PRC and the United States, such participation requires strong approval by PRC, the United States, or both. This is difficult to achieve as PRC will utilize its influences over other nations to suppress any international recognition of ROC, while the United States also lacks the incentive to promote ROC by raising a potential conflict with PRC. In addition, any drastic changes along with the current US-China relations may create unpredictable consequences to their position on ROC's future. Thus, an explicit or implicit agreement by the United States or PRC is needed to warrant any forms of ROC's participation in multi-lateral trade agreements, given the current US-China relations.

The following section reviews two bilateral trade agreements that ROC established without having formal diplomatic relations. The Agreement between Singapore and the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu on Economic Partnership (ASTEP) demonstrates how ROC achieved a bilateral trade agreement with Singapore by improving its relations with PRC (*Proposition 4a*), and the Agreement between New Zealand and the Separate Customs Territory of Taiwan, Penghu, Kinmen, and Matsu on Economic Cooperation (ANZTEC) demonstrates how ROC established a bilateral trade agreement with New Zealand when the US-China relations were worsened (*Proposition 2*).

IV. CASE STUDY: AGREEMENT BETWEEN SINGAPORE AND THE SEPARATE CUSTOMS TERRITORY OF TAIWAN, PENGHU, KINMEN, AND MATSU ON ECONOMIC PARTNERSHP (ASTEP)

The Agreement between Singapore and the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu on Economic Partnership (ASTEP) took force on April 19, 2014. This agreement is a comprehensive trade agreement with 17 chapters on economic cooperation, dispute settlement, trade liberalization, trade in goods and services, and WTO-

plus⁹⁹ provisions on competition, e-commerce and investment.¹⁰⁰ According to the Taiwan WTO and Regional Trade Agreement (RTA) Center at the Chung-Hua Institution for Economic Research (CIER), ASTEP removes 81.03 percent of tariffs from Singapore upon implementation; the remaining 16.45 percent of tariffs will be minimized to zero in 15 years.¹⁰¹ In addition, within these 15 years, ASTEP will increase Taiwan's exports to Singapore by \$782 million US dollars and imports by \$719 million US dollars.¹⁰²

Singapore and ROC have maintained long-term benign diplomatic relations since their early times. Singapore was independent in 1965. As a former British colony, the initial plan for merging Malaysia and Singapore was unsuccessful due to the political conflict between the first Malaysian Prime Minister, Tunku Abdul Rahman, and the founding father of Singapore, LEE Kuan Yew (LKY). Since then, Singapore has constructed itself as a non-race-based state in Southeast Asia.¹⁰³

After Singapore's independence, due to the irreconcilable tensions with Malaysia and communist threats from Southeast Asia, constructing a sustainable defense force was one of the major challenges for Singapore to maintain its sovereign state status. In the 1960s and 1970s, seeking a reliable military assistance from major powers was difficult. On the one hand, the United States was trapped in the Vietnam War. On the other hand, the United Kingdom was unable to provide such assistance because of its relations with Malaysia, one of the potential hostile states to Singapore yet another former British colony. ROC on Taiwan then became a viable option for Singapore, with its military preparedness and experiences of warfare against Japan and the Communist insurgency.

Since 1967, ROC has sent military officers to Singapore. In 1975, during the meeting between LKY and CHIANG Chin-kuo, the former President of ROC, ROC and Singapore materialized the signing of the

99. WTO-plus indicates a bilateral trade agreement that goes over and above existing WTO commitments.

100. The legal text of ASTEP can be found here: <https://www.icsingapore.gov.sg/Trade-From-Singapore/ASTEP/Legal-Text> (accessed March 1st, 2017).

101. Taiwan WTO and RTA Center, CIER, "The Economic Impact Analysis of the ASTEP Agreement" (In Chinese), commissioned by the Ministry of Economic Affairs, Taipei (2013), http://www.moea.gov.tw/CWS/tsc/content/SubMenu.aspx?menu_id=5536 (accessed March 1st, 2017).

102. Taiwan WTO and RTA Center, CIER, "The Economic Impact Analysis of the ASTEP Agreement" (In Chinese).

103. Stephan Ortmann, "Singapore: The Politics of Inventing National Identity." *Journal of Current Southeast Asian Affairs*, Vol. 28, No. 4 (2009), pp. 23-46.

Training Protocol.¹⁰⁴ As a result, military personnel from the Singapore Armed Forces came to Taiwan and received military training. Such military cooperation is unusual in international relations, as Singapore terminated its diplomatic relations with ROC in 1990. A defense cooperation between two non-diplomatic states is rare. Nevertheless, the stable military cooperation is evident by the positive foreign relations between ROC and Singapore.

With the establishment of formal diplomatic relations between PRC and Singapore, Singapore's relations with PRC have since been greatly improved. Nevertheless, an increasing tie between Singapore and PRC does not seem to hinder its military cooperation with ROC on Taiwan. This is largely due to the post-Cold War international environment when PRC wanted to reshape its international image as an icon of peace and improve its relations with the Association of Southeast Asian Nations (ASEAN). While PRC has tried to reframe its international image since the 1990s, Singapore under LKY also aimed to serve as the bridge within the cross-strait negotiations. Statistically, LKY made 25 trips to ROC and 33 trips to PRC during his term, indicating an equal emphasis on both nations regarding its foreign relations.¹⁰⁵ To facilitate the improvement of the cross-strait relations, LKY played a critical role in materializing the first meeting between both PRC and ROC through the Strait Exchange Foundation (SEF) and the Association of Relations Across the Taiwan Straits (ARATS) established in 1991.¹⁰⁶ Worth noticing, SEF and ARATS also materialized the 1993 "Koo-Wang meeting" between the chairpersons of both organizations, KOO Chen-fu and WANG Daohan, which led to four general agreements that provide the legal grounds for future negotiations and coordination, where the meeting was, nonetheless, held in Singapore.

As evident, Singapore has long been an effective bridge between PRC and ROC since its independence. LKY's and his successor, LEE Hsien Loon's position on maintaining peaceful and stable cross-strait relations and supporting the One China policy clearly is welcome by PRC and Kuomintang's (KMT) government. Though the Ma-Xi meeting in 2015 at Singapore between the President of ROC, MA Ying-jeou, and the President of PRC, XI Jinping, occurred after the ratification of ASTEP, it

104. Kuan Yew Lee, *From Third World to First: The Singapore Story: 1965-2000*, Singapore: Marshall Cavendish Editions (2000).

105. Shuhei Yamada, "Who's Right, the Late Lee Kuan Yew or Taiwanese?", *Nikkei Asian Review* (2015), <http://asia.nikkei.com/Politics-Economy/International-Relations/Who-s-right-the-late-Lee-Kuan-Yew-or-Taiwanese> (accessed March 1st, 2017).

106. Pasha L. Hsieh, "Legitimacy of Taiwan's Trade Negotiations with China: Demystifying Political Challenges," *Political Science*, Vol. 68, No. 1 (January 2016).

indicates the importance of Singapore in the cross-strait negotiations. One of the prior conditions of the Ma-Xi meeting was the reaffirmation of the 1992 consensus (the One China policy), where all three key actors, PRC, ROC under KMT's administration, and Singapore, agreed to it.

Applying Proposition 4b, the likelihood of establishing a free trade agreement between ROC and the nation that maintains closer foreign relations with the United States is high when ROC improves its foreign relations with the United States, Singapore could clearly fit itself into the role of the target nation. Compared to the triangular relations between ROC, PRC, and Singapore in the early 2000s, where ROC on Taiwan was under CHEN Sui-bian's DPP administration, both ROC and Singapore had greatly improved their relations with PRC through the reaffirmation of the 1992 consensus during MA Ying-jeou's KMT administration. On the one hand, ROC during Ma's administration between 2008 and 2016 had dramatically altered the cross-strait relations during Chen's administration. CHEN Sui-bian, as the former President of ROC whose political ideology clearly leans toward independence of Taiwan, proposed "Four Wants and One Without" in 2007: Taiwan wants independence, Taiwan wants the rectification of its name, Taiwan wants a new constitution, Taiwan wants development, and Taiwanese politics is without the question of left or right, but only the question of unification or independence. This proposal altered the cross-strait relations and led to a hostile attitude from PRC, as in the earlier time. Chen's speech in his inauguration ceremony was the "Four Noes One Without" in 2000, where he stated that his administration would not declare Taiwanese independence, change the national title from "the Republic of China" to "the Republic of Taiwan," include the doctrine of special state-to-state relations in the Constitution of the Republic of China, or promote a referendum on unification or independence.

KMT won the presidential election of 2008, which was marked as the third power alternation in ROC's road toward democratic consolidation. MA Ying-jeou had served as the President of ROC between 2008 and 2016 (reelected in 2012). His cross-strait policy was significantly different to Chen's. Ma's administration was leaned heavily towards PRC. During his administration, ROC and PRC established a preferential trade agreement, the Economic Cooperation Framework Agreement (ECFA), which was signed by CHIANG Pin-kung, the chairman of SEF, and CHEN Yunlin, the President of ARATS, during the fifth round of SEF-ARATS talk on June 29, 2010 in Chongqing, China. Approved by ROC's Executive Yuan (the executive branch) on July 2, 2010 and ratified by the Legislative Yuan (the legislative branch) on August 17 of the same year, it came into force in January 1, 2011. Under the framework of ECFA, two major negotiations

have spurred across Ma's administration, including the Cross-Strait Goods Trade Agreement (CSGTA) and the Cross-Strait Service Trade Agreement (CSSTA). The former has been through 12 rounds of negotiations but is currently inactive due to the power alternation from KMT to Democratic Progressive Party (DPP) under the new President TSAI Ing-wen. The latter was signed on June 21, 2013 but not ratified by the Legislative Yuan due to the Sunflower Student Movement in March 2014.¹⁰⁷

All these negotiations and moves are evidence of ROC's improved relations toward PRC during Ma's administration that helped Singapore, a nation state that holds benign relations with both countries in the past interactions, mature a bilateral trade agreement with ROC in 2014. Without Ma's endless efforts in sending positive signals to PRC's government, it would have been difficult for PRC to allow a third party state to engage in trade conversations with ROC. Similarly, without the PRC's implicit approval, ROC would not have had the opportunity to initiate trade conversations with Singapore. The case analysis of the triangular relationship between PRC, ROC, and Singapore implies that the maturation of ASTEP was largely due to an improving tie between these three nations under the 1992 consensus (the One China policy).

To further elaborate on the case of ASTEP, once the cross-strait relations between PRC and ROC is improved, a friendly country of both PRC and ROC becomes a relatively easy target for ROC to develop a bilateral trade conversation, as PRC would lessen its influence and pressure on the country. This can be interpreted as a friendly signal from Beijing's administration to Taipei. As long as the non-negotiable 1992 consensus (the One China policy) is firmly acknowledged by both the country and ROC, PRC will provide certain diplomatic spaces for ROC to improve its visibility and international cooperation in the global political arena. This signal is important to PRC since it provides stronger incentives for the ROC government to keep increasing its diplomatic and economic ties with PRC, which leads to a relatively unilateral dependency of ROC on PRC. This is definitely a welcomed scenario from PRC's perspective. The ultimate goal of PRC in dealing with the cross-strait issue is to seek a peaceful reunification with ROC. Nevertheless, the domestic sentiment

107. The Sunflower Student Movement is a protest against the ratification of the Cross-Strait Service Trade Agreement (CSSTA) by the Legislative Yuan in ROC on Taiwan. For details, please see Cindy Sui, "Will the Sunflower Movement change Taiwan?", *BBC* (April 9th, 2015), <http://www.bbc.com/news/world-asia-32157210> (accessed March 1st, 2017); Jin Kai, "Hong Kong and Taiwan: Populism or Democracy?", *The Diplomat* (April 16th, 2015), <http://thediplomat.com/2015/04/hong-kong-and-taiwan-populism-or-democracy/> (accessed March 1st, 2017); and Shang-su Wu, "Opposition Ascendancy Won't Release Taiwan from China's Grip," *The Diplomat* (December 8th, 2014), <http://thediplomat.com/2014/12/opposition-ascendancy-wont-release-taiwan-from-chinas-grip/> (accessed March 1st, 2017).

toward PRC in ROC on Taiwan has been hostile since the 2000s. Thus, a friendly signal from PRC to ROC, through its implicit agreement for ROC to improve its international spaces, then is crucial as an attempt to alter Taiwan's domestic perception toward PRC.

Though a bilateral trade agreement under the scenario of Proposition 4b, as exemplified by the Agreement between Singapore and the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu on Economic Partnership (ASTEP), may in the long run damage ROC on Taiwan's sovereignty, its potential in creating mutual economic gains for both participants, ROC and Singapore, are foreseeable. In addition, the signing and ratification of ASTEP is also marked as one of the diplomatic breakthroughs after the UN Resolution 2758 within ASEAN states. ASTEP also demonstrates an optimistic future for ROC to increase its economic development under the current rapid globalized world. As ROC has been struggling with significant economic improvement, both the achievements in diplomacy and economy are essential to ROC because it allows a possible reentry to international society. The future impact of ASTEP will be shown in the following years and it may greatly advance ROC's relations with other ASEAN countries, even generating more possible bilateral trade agreements through the New Southern Bound Policy under Tsai's administration.

V. CASE STUDY: AGREEMENT BETWEEN NEW ZEALAND AND THE SEPARATE CUSTOMS TERRITORY OF TAIWAN, PENGHU, KINMEN, AND MATSU ON ECONOMIC COOPERATION (ANZTEC)

The Economic Cooperation Agreement between New Zealand and the Separate Customs Territory of Taiwan, Penghu, Kinmen, and Matsu (ANZTEC), a bilateral comprehensive trade agreement between ROC and New Zealand, was signed at Victoria University of Wellington on July 10, 2013 by Elliott Charng, Representative of the Taipei Economic and Cultural Office (TECO) in Wellington, and Stephen Payton, the director of the New Zealand Commerce and Industrial Office (NZCIO) in Taipei.¹⁰⁸ ANZTEC is designed to reduce all tariffs to zero over the course of 12 years. ROC agreed to reduce the tariffs of 99.88 percent of New Zealand's imports to zero, and New Zealand agreed to reduce the tariffs of 100 percent of ROC's import to zero. ANZTEC was ratified by the Legislative Yuan of ROC on October 29, 2013.

108. The full text of ANZTEC can be found here: <http://www.nzcio.com/taiwan/relationship-between-new-zealand-and-taiwan/anztec-economic-cooperation-agreement> (accessed March 1st, 2017).

According to the Chung-Hua Institution for Economic Research (CIER), ANZTEC is expected to generate ROC's gross domestic product (GDP) by \$303 million US dollars and create 6255 job opportunities.¹⁰⁹ In addition to the potential economic benefits to both nations, ANZTEC also marks Taiwan's first bilateral economic agreement with a country lacking formal diplomatic relations. Since ROC and New Zealand do not have diplomatic relations, the negotiations had to be delegated by a private non-governmental negotiator from the New Zealand side.¹¹⁰ Surprisingly, the negotiation and signing process was generally welcomed by PRC government.¹¹¹

Unlike the ROC-Singapore relations, New Zealand does not play a crucial role in the cross-strait negotiations, nor does it have military training programs with ROC government. Jason Yang contends that the economic reason is the main driving force of ANZTEC, as he states:

Taiwan is New Zealand's eight-largest goods export market, taking NZ\$850 million in the year to May 2013. The benefits of ANZTEC for New Zealand exporters are substantial. Phasing out current tariffs of 5 to 20 per cent in Taiwan's dairy industry on New Zealand trade of US\$242 million is estimated to lead to annual savings of US\$20 million. Taiwan tariffs of 6 percent on beef and 15 percent on sheep meat on an annual trade of NZ\$208 million cost New Zealand exporters NZ\$18 million annually. These will be phased out within two to four years. New Zealand horticulture exporters will enjoy immediate elimination of a 20 per cent tariff on apple exports valued at NZ\$21 million. The economic rationale is, therefore, the primary driver for New Zealand entering the agreement.¹¹²

But we argue that the realization of ANZTEC can also be understood under the context of the changing dynamics of the US-China relations.

In the early years of Obama's administration, some positive interactions were evident. For example, during a phone conversation between Barack Obama and HU Jintao on November 8, 2008, both parties emphasized the further development of the US-China relations in the

109. Taiwan WTO and RTA Center, Chung-Hua Institution for Economic Research (CIER), "The Economic Impact Analysis of the ANZTEC Agreement" (Chinese), commissioned by the Ministry of Economic Affairs, Taipei (2013), <http://www.moea.gov.tw/CWS/tnc/home/Home.aspx> (accessed March 1st, 2017).

110. Jason Yang, "Space for Taiwan in Regional Economic Integration: Cooperation and Partnership with New Zealand and Singapore," *Political Science*, Vol. 66, No. 1 (2014), pp. 3-22.

111. Jason Yang, "Space for Taiwan in Regional Economic Integration: Cooperation and Partnership with New Zealand and Singapore," p. 15.

112. Jason Yang, "Space for Taiwan in Regional Economic Integration: Cooperation and Partnership with New Zealand and Singapore," p. 13.

interest of both nations and the world.¹¹³ Moreover, the Strategic Economic Dialogue,¹¹⁴ which was initiated by the former US president George W. Bush and the former President of PRC, HU Jintao, was designed to discuss mutual economic relations and issues between PRC and the United States in 2006, was broadened to the US-China Strategic and Economic Dialogue (S&ED). The format of these dialogues is to have high-level representatives of both countries and their associated delegations to meet annually at capitals alternating between the two countries. To date, S&ED has materialized eight rounds of talks, with the last one held in Beijing on June 6-7, 2016. S&ED provides opportunities for PRC and the United States to bridge their preferences and interests regarding various global issues and negotiate some potential resolutions toward these issues. These interactions evidence the formation of the Group of Two (G2) by PRC and the United States.

Though there were signs indicating a brighter future of the US-China relations, some unresolvable issues worsened their relations within Obama's administration. The first confrontation, which challenges the US-China relations, is trade deficit. According to the United States Census Bureau, the trade deficit with PRC raised from \$227 billion US dollars to \$347 billion dollars from 2009 to 2016.¹¹⁵ To further elaborate this problem with Obama's administration, Congressman Paul Ryan states:

Free trade is a powerful tool for peace and prosperity, but our trading partners need to play by the rules. This challenge focuses on China. They steal our intellectual property rights, they block access to their markets, and they manipulate their currency. President Obama said he would stop these practices. He said he'd go to the mat with China. Instead, they are treating him like a doormat. We're not going to let that happen. Mitt Romney and I are going to crack down on China cheating and we're going to make sure that trade works for Americans.¹¹⁶

113. "Chinese President, Obama Discuss Relations, Int'l Issues on Phone," Xinhua Net (November 9th, 2008), http://news.xinhuanet.com/english/2008-11/09/content_10328375.htm (accessed March 1st, 2017).

114. During 2006 to 2008, there were five meetings: 1. December 14-15, 2006 (Beijing); 2. May 22-23, 2007 (Washington, DC); 3. December 12-13, 2007 (Beijing); 4. June 17-18, 2008 (Annapolis, MD); and 5. December 4-5, 2008 (Beijing). For details, see Bill Powell, "Paulson in China: The Monster Under the Bed," *Time* (December 5th, 2008), <http://content.time.com/time/world/article/0,8599,1864669,00.html> (accessed March 1st, 2017).

115. For details, please see <https://www.census.gov/foreign-trade/balance/c5700.html#2008> (accessed March 1st, 2017).

116. Sabrina Siddiqui, "Paul Ryan: China Is treating Obama 'Like a Doormat'," *The Huffington Post* (August 16, 2012), http://www.huffingtonpost.com/2012/08/16/paul-ryan-china_n_1790453.html (accessed March 1st, 2017).

In addition, Wayne Morrison in his Congressional Research Service piece also provides a general concern about the trade deficit:

Some analysts contend that the large U.S. merchandise trade deficits with China indicate that the trade relationship is somehow unbalanced, unfair, and damaging to the U.S. economy. Others argue the large U.S. trade deficit with China is more of a reflection of global shifts in production as well as the emergence of extensive and complex supply chains, where China is often the final point of assembly for export-oriented multinational firms that source goods from multiple countries.¹¹⁷

Perhaps the most astonishing critique regarding trade deficit from PRC was Obama's closing speech at the Asia-Pacific Economic Cooperation summit in 2011, where he expressed that the United States was fed up with PRC's trade and currency practices and demanded China to behave like a "grown up."¹¹⁸ The United States pursued the Trans-Pacific Partnership (TPP) under Obama's administration, which, if ratified, would empower the United States to strengthen its economic and diplomatic ties with other allies and serve as the balancer against the Regional Comprehensive Economic Partnership, where PRC has played an important role. The realization of TPP will reduce the economic dependency of the United States on PRC; however, it is currently terminated by the current President Donald Trump's administration.

Aside from trade deficit, the difference in "values" is another major obstacle challenging the US-China relations. The United States has long been the fighter for democratic norms and practices since the end of the Cold War, while PRC has remained as an authoritarian regime under the control of the Chinese Communist Party (CCP) since its birth in 1950. One of the major confrontations between the United States and PRC is human rights. During the meeting between Barack Obama and HU Jintao in 2011, Obama questioned Hu on China's human rights records.¹¹⁹ PRC's mistreatments against Tibetans, Uyghurs, and Mongols in the Inner Mongolia were well known in the world. Stresses and concerns from other nations and international human rights organizations demanding PRC to

117. Wayne M. Morrison, "China-U.S. Trade Issues," *Congressional Research Service* (March 2017), p. 9.

118. Matt Spetalnick and Doug Palmer, "Obama to China: Behave like a "grown up"," *Reuters* (November 14th, 2011), <http://www.reuters.com/article/us-apec-idUSTRE7AB12920111114> (accessed March 1st, 2017).

119. See "Hu Jintao Questioned by Barack Obama on China's Human Rights Record," *The Guardian* (January 19th, 2011), <https://www.theguardian.com/world/2011/jan/19/hu-jintao-human-rights-obama> (accessed March 1st, 2017).

improve its human rights also pressure the United States to take necessary actions. According to Dave Boyer's report from *The Washington Times*:

"The president reiterated America's unwavering support for upholding human rights and fundamental freedoms in China," the White House said in a statement about the meeting, which took place Thursday afternoon on the sidelines of a nuclear security summit in Washington. Administration critics had been urging Mr. Obama to get tougher with China on human rights. Rep. Chris Smith, New Jersey Republican and a leading voice on Capitol Hill on human rights issues, said this week that Mr. Obama has failed to use either the power of the presidency or his status as the 2009 Nobel honor to push back against the communist Chinese regime, which holds some 1,500 political prisoners."¹²⁰

Without a doubt, these signals would push a stronger anti-US sentiment from Beijing.

Lastly, security issues such as territorial disputes in the South China Sea and the East China Sea has led the United States to pressure PRC during and after Obama's administration. The South China Sea disputes involve several sovereign states within the region, including Brunei, PRC, ROC, Malaysia, the Republic of Indonesia, the Republic of the Philippines, and the Socialist Republic of Vietnam, while the East China Sea disputes involve PRC, ROC, Japan, and South Korea. Obama had expressed concerns and warnings toward PRC regarding its maritime strategy that may generate regional instability in East and Southeast Asia several times during his administration.¹²¹ More importantly, PRC has raised concerns and critiques over Obama's defense strategy in East Asia, as well as the continuation of arms sales to ROC on Taiwan. Perhaps this various security concerns can be summarized by the Chinese Ministry of Defense spokesman GENG Yansheng's speech to the new US defense plan:

"We hope that the United States will flow with the tide of the era, and deal with China and the Chinese military in an objective and rational way, will be careful in its words and actions, and do more that is

120. Dave Boyer, "Obama Raises Human Rights, Cyberattacks with Chinese President," *The Washington Post* (April 1st, 2016), <http://www.washingtontimes.com/news/2016/apr/1/obama-raises-human-rights-cyber-attacks-xi-jinping/> (accessed March 1st, 2017).

121. For example, see "G20: Obama Warns Beijing against South China Sea Aggression," *The Guardian* (September 3rd, 2016), <https://www.theguardian.com/world/2016/sep/03/g20-obama-warns-beijing-against-south-china-sea-aggression> (accessed March 2nd, 2017); and "Obama Forced Xi to Back Down over South China Sea Dispute," *Financial Times* (July 12th, 2016), <https://www.ft.com/content/c63264a4-47f1-11e6-8d68-72e9211e86ab> (accessed March 2nd, 2017).

beneficial to the development of relations between the two countries and their militaries.”¹²²

While the US-China relations might start with a positive future, various unavoidable confrontations and challenges have pushed the relationship in the opposite direction during Obama’s administration. The case of ANZTEC shows support for *Proposition 2*, in which the likelihood of establishing a free trade agreement between ROC and the nation, which maintains balanced foreign relations with PRC and the United States, is high when the US-China relations are worsened. With the evidence provided above, US-China relations are clearly challenged and worsened during the time when ANZTEC was under negotiation and finally approved with the signing and ratification. Demands from New Zealand to increase its economic cooperation with ROC, of course, is one of the conditions of facilitating the realization of ANZTEC. But without the conflicting US-China relations, New Zealand would have had to take its relations with PRC and the United States into consideration before making this move.

In particular, such US-China relations left plenty of room for New Zealand and ROC to engage in a series of semi-diplomatic interactions, without raising concerns from both PRC and the United States, as there were bigger and more critical issues for PRC and the United States to consider at the time. Moreover, New Zealand’s benign but neutral relations with PRC and the United States further nurtured the likelihood of this bilateral trade agreement because this action would not be considered as a change of the balance between the United States and PRC. As the result, the maturation of ANZTEC was due to various factors, and it is strongly aligned with the prediction of our models.

VI. CONCLUDING REMARKS

Finding international space for ROC on Taiwan has been a long challenge after the UN Resolution 2758 because most of the nation states do not hold formal diplomatic relations with ROC. With the absence of diplomatic relations, it is nonetheless difficult for ROC to initiate negotiations and interactions with other countries, since ROC should not be treated and recognized as a sovereign state. On the top of sovereignty and recognition, pressures from PRC also has served as one of the most critical factors deterring any international interactions with ROC.

122. MJ Lee, “China Fires at New U.S. Defense Plan,” *POLITICO* (January 1st, 2012), <http://www.politico.com/story/2012/01/china-fires-at-new-us-defense-plan-071233> (accessed March 1st, 2017).

However, ROC also needs to fight for further development to gain domestic legitimacy and improve the welfare of its citizens. Thus, we question how ROC can establish a bilateral trade agreement without formal diplomatic relations with other states. Bilateral trade agreements are important venues in the current globalized international economy, where lower tariffs and associated regulations encourage trade and investment across different states. We provide an extensive review of the literature regarding the pros and cons of trade liberalization. Borrowing from the concept of spatial modeling with the assumption of the zero-sum game within the US-China relations, we then developed four theoretical models and derived five propositions from these models. The model predicts that the likelihood of establishing a bilateral trade agreement is higher when (1) the US-China relations are worsened, (2) when the ROC-PRC relations are improved and the potential country that shows interests in establishing a bilateral trade agreement with ROC also holds benign relations with PRC, and (3) when the US-ROC relations are improved and the potential country that shows interests in establishing a bilateral trade agreement with ROC also holds benign relations with the United States. To examine the validity of our theory, we analyze the only two bilateral trade agreements with nations that do not have diplomatic relations with ROC, the Agreement between Singapore and the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu on Economic Partnership (ASTEP) and the Economic Cooperation Agreement between New Zealand and the Separate Customs Territory of Taiwan, Penghu, Kinmen, and Matsu (ANZTEC), and find support for two of our propositions: ASTEP was established due to benign relations between the triangular, PRC, ROC, and Singapore, and ANZTEC was materialized because the US-China relations were worsened under that international environment.

This research also yields some limitations. First, with the current available cases, we can only find support for two of the five propositions we proposed and we cannot predict whether other propositions will ever be evident. Second, similar to the first limitation, with limited available cases, we can only find evidence in support of two propositions without repetition. There are chances to refute our supportive propositions with new evidence in the future. Third, our theory provides a simplification of the realpolitik, and the real diplomatic interactions may involve more considerations and factors we did not incorporate in our research. Lastly, our theory may not be generalizable to other states, as ROC on Taiwan is a peculiar existence in both the history and the current international world. These limitations do not dispute the validity of our theory, but do raise caution for readers who intend to extend and generalize our research.

The implications of this research is threefold. First, we provide theoretical foundations for ROC government to determine which state to approach for a potential bilateral trade agreement. Diplomatic personnel and government agency need to consider various factors including the current state of the US-China relation and the relationship between the potential country with PRC and the United States together. More importantly, with limited resources in hand, our research helps ROC government to distribute its resources with a higher efficiency and to direct the New Southbound Policy. Second, we also provide guidelines for any nations, which have interests in improving its trade and other economic interactions with ROC. In particular, we address the timing and factors that will affect the possibility of a bilateral trade agreement for those nations to take into account. Lastly, we also provide insights to international observers who have paid tremendous amount of attention to ROC on Taiwan, cross-strait issues and the triangular relations between ROC, PRC, and the United States. The triangular interactions are historically, politically, and internationally complicated, and our research warrants a relatively simple angle in viewing these interactions.

We also aim to contribute to the literature of trade liberalization and international relations in general. As shown in the literature review section, most existing research focuses on the consequences of bilateral or multilateral trade agreements but not on the formation and realization of these agreements. ROC on Taiwan stands as an international puzzle in which its survival depends largely on the dynamics between the US-China relations. Nevertheless, ROC on Taiwan, as a vibrant state hosting over 23 million population within about 14 thousand square miles (36 thousand square kilometers), has urged to break its diplomatic deadlocks imposed by PRC and to increase its international recognition for a better future. Sadly, ROC's diplomatic strategies unavoidably have to face the challenges and pressures from Beijing but this does not mean that ROC on Taiwan will not be able to gauge potential economic allies in the current world system.

GLOSSARY OF SELECTED ABBREVIATED TERMS

ANZTEC	Agreement between New Zealand and the Separate Customs Territory of Taiwan, Penghu, Kinmen, and Matsu on Economic Cooperation
APEC	Asia-Pacific Economic Cooperation
ARATS	Association of Relations Across the Taiwan Straits
ASTEP	Agreement between Singapore and the Separate Customs Territory of Taiwan, Penghu, Kinmen, and Matsu on Economic Partnership
BTA	Bilateral Trade Agreement
CIER	Center at the Chung-Hua Institution for Economic Research
CSGTA	Cross-Strait Goods Trade Agreement
CSSTA	Cross-Strait Service Trade Agreement
DPP	Democratic Progressive Party
ECFA	Economic Cooperation Framework Agreement
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GATT	General Agreement on Tarrifs and Trade
IMF	International Monetary Fund
KMT	Kuomintang
LDC	Least Developed Countries

MFN	Most Favored Nation
NZCIO	New Zealand Commerce and Industrial Office
OECD	Organization for Economic Cooperation Development
PTA	Preferential Trade Agreement
RTA	Regional Trade Agreement
S&ED	US-China Strategic and Economic Dialogue
SEF	Strait Exchange Foundations
TECO	Taipei Economic Cultural Office
TPP	Trans-Pacific Partnership
TRA	Taiwan Relations Act
WTO	World Trade Organization