The Chinese Economies in Global Context: The Integration Process and Its Determinants

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Summary

The integration of the People's Republic of China (PRC) into the world economy has preoccupied business leaders and policy makers alike. There is a plethora of evidence that flows of capital and goods to and from the PRC are increasing. This study undertakes a price-based (prices of goods, prices of assets) assessment of the linkages between the People's Republic of China and the other Greater China economies of Hong Kong and Taiwan. The linkages are assessed, and compared against those of the PRC with the economies of Japan and the United States. Specifically, we first characterize the time series behavior of three criteria of integration, namely real interest parity, uncovered interest parity, and relative purchasing power parity. The empirical results indicate that these parity conditions tend to hold over longer periods between the PRC and all other economies, although they do not hold instantaneously. Overall, the magnitude of deviations from the parity conditions is shrinking over time. However, there is no substantial evidence that the integration among the Greater China economies is stronger than that between the PRC and the non-Greater China economies. In general, Hong Kong appears to have an advanced level of integration with the PRC. On the other hand, the PRC's link with Taiwan, another Greater China economy, is not stronger than the links with Japan and the US. The differential results from Hong Kong and Taiwan suggests that, during the sample period, integration with the PRC is not necessarily an intrinsic characteristic of a Greater China economy. In addition, we find that a *de facto* fixed exchange rate arrangement is associated with strong evidence of integration while weak integration tends to occur with a flexible rate arrangement. We then turn to examining the determinants of the degree of integration. Regression results suggest that the degree of financial and real integration depend upon the extent of capital controls, foreign direct investment linkages as well as exchange rate volatility.