

China, Hong Kong, and Taiwan: A Quantitative Assessment of Real and Financial Integration

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Summary

Despite its growing economic importance and increasing trade and financial ties with other countries, China has been perceived to be a rather distinct market, with a limited degree of integration with the world economy. The theme of the current exercise is to study the degree of integration between China, Hong Kong, and Taiwan, thereby determining whether this perception has been accurate. Specifically, we consider three parity conditions in this exercise. They include real interest parity as an indicator of "real" capital mobility, uncovered interest parities for assessing financial capital mobility, and deviations from relative purchasing power parity for measuring goods market integration.

In spite of the fact that China and Taiwan have implemented different types of trade barriers and capital controls, it is found that, to varying degrees, there is evidence of real and financial integration of these economies even though these markets are not completely efficient. During the sample period, China and Hong Kong appear to experience increasing real and financial integration while Hong Kong and Taiwan show no substantial gain in the integration process. Further, the evidence indicates the integration of markets for goods and services is stronger than that for financial assets.

Even though the statistical results offer some evidence of integration, we recognize that there are non-negligible restrictions on both physical and financial flows between the Greater China economies. With scheduled removal of barriers associated with joining the WTO, it is expected that the ascendant Chinese economy will be increasingly integrated with those of Hong Kong and Taiwan. We conjecture that the increasing degree of integration will make the costs associated with the remaining impediments to the free flow of goods and capital more obvious and costly. Hence, we envision this process of integration continuing, and to the extent that this process requires even more political engagement, we believe the prospects for cooperation along a variety of dimensions are promising.