

Comment on “Two meanings of cooperation between Japan and Taiwan in China Market,”

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This paper investigates potential cooperation between Taiwan and Japan in two fields in relation to China.

- 1. Linkage strategy between aid and trade policies and national security.**
- 2. Cooperation of Taiwanese and Japanese multinationals in Chinese markets.**

Since the paper covers broad coordination issues, it is a good kick-off paper for this conference on Asian economic integration.

1. Linkage strategy between aid and trade policies and national security issues.

Using a “signaling model” of a non-cooperative game between two countries, the paper shows that by linking aid or trade policies with national security issues, Country *A* can reduce Country *B*'s threat to peace. Basic assumptions are:

- Country *B*'s ability to develop a new weapon, θ , is not known to Country *A*.
- Country *B*'s imports of some raw material for the production of the weapon, W , plays the role of a signal.
- Country *A* links its aid or trade policy T with W ; $T=T(W)$.

Liu shows that if development of the new weapon is costly ($\alpha > 1$), there exists a pooling equilibrium. In this equilibrium, Country *B* will not develop the new weapon even when it has the ability to do so ($\theta = 1$) in order to ensure Country *A* stays favorable.

Although I basically agree with the logic behind the main result, the model depends on some implausible assumptions:

- Why does Country *A*'s payoff depend on θ ; $U_A = -(T(W) - \theta)^2$? It is more plausible to assume that U_A depends on Country *B*'s development of the weapon, not θ .**
- Why does Country *B*'s payoff not depend on the development of the weapon; $U_B = T(W) - \alpha W / \theta$? In the present model, Country *B* does not have an incentive to develop the new weapon, if Country *A* commits itself to never adopting a favorable policy toward Country *B*; $T(W) = 0$ for $W = 0, 1$.**

I think that the essence of the linkage strategy can be explained by a simple three-stage model without signaling.

Stage 1: Country *A* sets aid or trade policy, which is conditional on country *B*'s future behavior.

Stage 2: θ is determined by nature.

Stage 3: Country *B* decides whether to develop the weapon or not.

If Country *A* can offer a policy that is very favorable to Country *B* or the cost of developing the weapon, α , is large, Country *A* can stop Country *B* from developing the weapon.

Questions:

- The Chinese economy is already large and prospering. Can Taiwan and Japan offer sufficient incentives?**
- China can threaten Taiwan and Japan with retaliation, if the two countries terminate favorable aid or trade policies.**

2. Cooperation of Taiwanese and Japanese multinationals in Chinese markets

Liu argues that Taiwan and Japan have no incentive to pursue Strategic Trade Policies (promotion of domestic firms' exports or R&D in order to shift excess profits from foreign rivals to home country firms) today; reasons mentioned include the international division of labor and fierce price competition.

I think that there are more factors which reduce governments' incentive to pursue STPs:

- Foreign investors own 30 or 40 percent of the stocks of large Japanese machinery manufacturers.**
- A substantial part of Taiwanese and Japanese firms' production is conducted abroad. New employment might be created in other countries.**

Liu also argues that during the early stage of a direct investment in China, Japanese firms can reduce risks and benefit from expertise on the local market by cooperating with Taiwanese firms.

I think that the importance of cooperation is not limited to the early stage of entry. As the Chinese market expands, Japanese affiliates in China are beginning to shift their focus from exports to the local market. To reduce intermediate input costs, they are also trying to raise local procurement ratios. Taiwanese firms' expertise on Chinese markets and suppliers is becoming more and more important for Japanese firms.