Two Levels of Strategic Thinking in Chinese Market

1. Introduction

After the economic liberalization taken place in late 70s, China has gradually become one of the new manufacturing factories in the world. Thanks to abundant production resources and decreased barriers of international factor movement, the rapid economic growth of China has brought prosperity to its Eastern Coast region and improved standard of living in several metropolitan areas. Although China's per capita GDP is still far away from making itself a country with strong consumption demand, the general consensus believes that China's optimistic economic growth in the next decade will lead to a growing population of middle class earners. Hence, China's domestic markets in capital and durable goods are expected to be growing if this trend goes on. Upon this expectation, large multinational corporations from developed economies such as the United States, Japan and EU countries concurrently aim at Chinese market as the next fast growing market in the future and therefore accompanied with their strategies of manufacturing outsourcing, marketing strategies aiming at this seemingly lucrative market is also pivotal to their continuous success in hi-tech industries.

When a new foreign market emerges, the barriers of entry are often subject to a relatively high level due to local market accessibility, regulations and information asymmetry and therefore an oligopoly often prevails. The market structure dynamics and interaction between potential entrants are then determined by the timing and modes of entry which are subject to firms' global strategies or their capability of breaking through the barriers. In terms of entry modes, risk and control are central considerations for different strategies. Low intensity modes of entry prevent long term capital commitment and therefore reduce risk in both local market demand and political environment. Various derived costs on sales personnel, marketing campaigns

and tangible facilities for distribution are also minimized. However, in exchange to low risk and costs, these entrants adopting low intensity of market participation also lose control of the local market in terms of pricing strategies, marketing plans and accurate market information that requires long time and high intensity of market participation. Hence, risk premium are paid from the market entrants adopting low intensity entry modes to the local distributors in the form of losing bargaining position in division of excess profits. Although international oligopolies selling differentiated products may be different in the edge of information and costs and therefore adapt different entry modes, oligopolies often adapt complement strategic on entry modes for fear of rivals' exploitation of information edges and pricing wars. This means if an oligopolistic firm chooses to enter a new market via a high intensity mode of market participation, its potential rivals will tend to do the same in response. An obvious example is that Japanese automakers have launched more FDI in the resent years after American and German automakers have entered Chinese automobile markets trough joint-venture companies with Chinese automakers.

In a practical world where different entry modes and structures of ownerships are present, complexity and challenges for effective government interventions devoted to export promotion and domestic welfare improvement are also increasing. The purpose of this discussion is then to review the justifications for implementing conventional strategic trade policies when foreign oligopolies choose to go behind low intensity of market participation. In addition to policy instruments at government level, potential opportunities of cooperation between Japanese and Taiwanese firms are also present as we discuss what the entry modes are to enter an emerging market like China.

2. Reviews on Strategic Trade Policy

Tax revenue, employment and other political considerations (interests groups formed by industries) creates a stake for domestic governments to promote exporting industries where the firms are international oligopolies. The typical intervention implemented by governments is via strategic trade policies (STP) which refer to the trade policy that affects the outcome of strategic interactions between firms in an actual or potential international oligopoly (Brander, 1995). In particular, the STP literature conventionally refers the outcome to monetary term and the strategic interactions to a Cournot quantity setting game (Brander and Spencer, 1983, 1985；Krugman, 1984；Dixit, 1984) or a Bertrand price setting game (Eaton and Grossman, 1986). To understand the essence of strategic trade policy and restrictions of the model, a simple review of the canonical STP model developed in Brander and Spencer (1985) may be helpful.

The main objective of strategic trade policy is to shift excess profits from foreign rivals to the home country firms (Brander and Spencer, 1983). Since STP is often implemented through exports or R&D subsidies which all require public financing, there is no incentive for a government to implement strategic trade policy in a competitive market with zero excess profits or in a monopolistic market where no rival exists. Hence only oligopolistic markets with increasing return to scale production breed strategic interactions and provide incentives for government interventions.

Under such market environment, each government would then have incentives to promote its domestic firm to expend market share at the other’s expense if the strategic interaction between firms is in terms of quantity but not price. That means firms react to each other by changing their production decisions that generate maximum profits. A conventional and simple setting describing this strategic

interaction is Cournot Duopoly where two firms selling differentiated products set complement strategies on quantity. Given that firms have symmetric information about market demand and production technology (cost functions). The equilibrium market price and profits for firms are then determined by their simultaneous quantity decisions. The way of expending market share could then be done by directly subsidizing domestic firm or indirectly subsidizing development of cost-reduction technology.

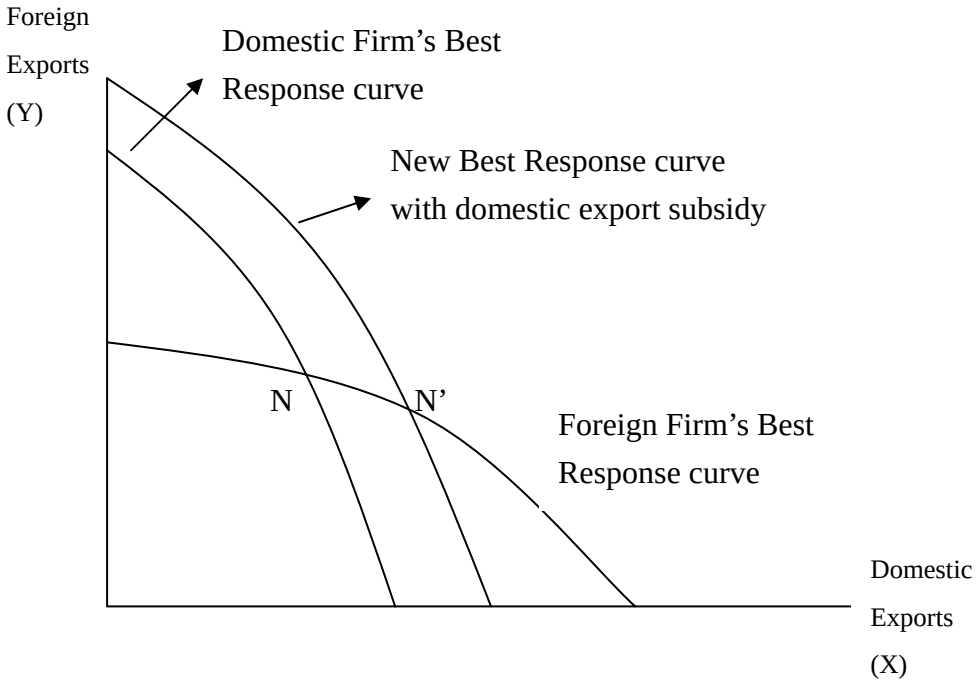

Figure 1: A domestic export subsidy

The effect of the export subsidy could be shown in Figure 1. Through deduction in marginal cost, the domestic exports increase for any given level of foreign exports. As a result, the strategic export subsidy successfully shifts the Cournot equilibrium from N to N' meaning an expansion of market share for the subsidized domestic firm.

There are several critical requirements for an environment in which STP could work effectively.

(1) Two completely indigenous firms from different countries compete in a third country and they have no vertical relationship in production.
(2) Strategic interactions are taken in form of quantity but not price.
(3) Firms must possess information on market demand, production technology of their rivals and even capability of foreign governments to implement STP.
(4) Firms compete in a one shot game which means no retaliation and intertemporal strategic considerations in this environment.
(5) No social cost of public fund. That means to domestic welfare, one dollar of public fund is equivalent to one dollar of extra profit earned from foreign market.

3. Why STP doesn't work?

Those requirements previously stated could be very restrictive in practical sense. Hence whether STP could effectively promote domestic firms on expanding market shares in the third market is questionable. In general, there are several aspects for governments to review when they consider STP.

(1) High degree of vertical disintegration is one of the features for highly developed industries nowadays. Moreover, this vertical disintegration is often taken place internationally and that means two firms from different countries selling differentiated final products may import the intermediate goods from the other country. This vertical relationship between competing countries complicates the decision making process in implementing STP. Ishikawa and Spencer (1999) pointed out that domestic export subsidies may end up with helping the

intermediate-good firms from the competing country and raise its social welfare. Whether the optimal STP would reverse from subsidies to taxes depends on the vertical structure of the industries. However, this leaking issue regarding domestic welfare is very likely to weaken government's incentive to implement STP.

(2) One key feature for justifying export subsidies is strategic complementarity in quantity between competing countries. In a two-country Cournot model as previously introduced, it means the subsidized domestic firm can gain larger market share by forcing the foreign competitor to limit its output. However in a practical world where firms often adapt aggressive price competition and marketing promotion to fight for larger market share, implementing STP could trigger worse price competition and lead both countries to welfare-inferior outcomes.

(3) STP requires that governments can commit to its policies. In other words, government must be firstly given enough incentives to commit to its policies before firms take any business actions. Also, governments must persuade firms that they will not default and subsequently change it policies. However, democratic governments often face political pressure from different interest groups in industries. With limited budgets, committing a long term subsidy to one particular industry is often not political feasible and viable. Even WTO has explicitly banned any direct export subsidy to the home firms, it is still difficult for governments to commit R&D support to one particular project or industry in a considerable long period of time.

(4) The "one shot game" assumption is highly unrealistic. In the practical world,

unless the third country grant the right of Monopoly to the firm which earns majority of the market or satisfies certain set of requirements after the trial period, the first mover implementing STP must consider possible retaliation from the rival government. Depending on the market demand and production technology, the outcome of the policy game may lead to a Prisoner Dilemma. Therefore even if one government or firm has the first mover advantage, as long as the interaction between players is a multiple-period repeated game, governments from both countries have to consider intertemporal strategies taking account the possible retaliation. Hence, as pointed out by Spencer and Brander (1983), one means of cooperation would be to negotiate a trade agreement that entices the countries to choose free trade but not intervention. This cooperation may be sustainable if all countries are willing to do the same in face of creditable punishment from multilateral parties. Each country although faces a unilateral incentive to use activist trade policy but all can benefit if they can collectively agree to abandon such policies.

(5) From government's point of view, the transaction cost of implementing STP is also important because most of government instruments require financial support from public budgets. Since welfare cost of public funds for implementing STP may not be the same under different market or social conditions, it is possible that the opportunity cost of public funds exceeds the extra profits gained from implementation of STP. In the simple model from Brander and Spencer (1985), that means when we calculate domestic welfare W, the marginal welfare cost of the publicly funded subsidies (λ) may not be equal to 1. A mathematic representation denoting net domestic welfare could be expressed as follows,

$W = \Pi(x, y, s) - \lambda s x(s)$ and $\lambda > 1$

In this expression, $\Pi(x, y, s)$ denotes the profit for the domestic firm at the Cournot equilibrium. x and y are quantity decisions for the domestic and foreign firms, respectively. s is the level of export subsidy imposed by domestic government and λ is social cost of public fund. It is obvious to see that if social cost of public funds is significantly large such that $\lambda > \Pi_{xs}$, then the optimal s may even become negative which means the government should instead impose the unlikely export tax.

With regard to the justification of implementing STP, we have demonstrated why in the practical world, STP is often not as effective as the model suggested. In fact, when facing emerging Chinese market, Japanese and Taiwanese governments have very low incentive in engaging zero-sum game competition since two countries have a very long history of cooperation in both industry and firm level. In some highly developed industries such as ICT and Automobile industries, Japanese and Taiwanese firms are vertically related in high end products and their positioning in the value chain of these industries tend to be complementary. Hence, both governments should consider what the best strategy is to enhance the performance of their corporations in Chinese market. The previous discussion suggests that implementing STP, even through R&D support, may be ineffective and could lead to Prisoner Dilemma. Hence alternative means devoting to cooperation and creation of a win-win situation, such as FTA or EPA, should be seriously reviewed and considered. Of course, a sound mechanism of cooperation should be built on mutual incentives and credible threats and so STP could still play a role of punishment to refrain both governments from default.

Having pointed out some basic principles that both governments should consider when forming trade and investment polices in promoting exports and exploration of foreign emerging markets, we shall take one step further and look at what the better strategies are for firms to successfully operate in an emerging market like China.

4. The market entry strategies in an emerging market

(1) Flawed marketing strategies

Some valuable lessons could be learned through the marketing strategies adopted by western companies when they started to enter emerging markets in 90s. The literature shows that the type of entry model and level of entry intensity are core strategies that multinational corporations (MNCs) are concerned. However, those types of decisions are often made given a belief that the success of MNCs in developed markets can pass on to other emerging markets by simply replicating the previous market strategies without adjusting to local conditions. To be more concise, firms often follow the business paradigm that keeps their global pricing strategies by breaking down demand in an emerging market into several well-defined segments. MNCs then apply their global competitive advantages targeting at generating maximum profits like they execute in developed markets. Firms are reluctant to adjust their pricing strategies and provide more suitable and affordable goods and services to meet domestic needs because their previous competitive edge may not immediately and appropriately apply to new products and pricing strategies.

However, this global price consistency has led to a loss of pricing flexibility and therefore their products may end up being priced at levels at which only a small part of population can afford them. Although arguments regarding managerial and menu costs have been made to justify uniform pricing and marketing strategies, the fundamental tenet of marketing such as cultural approximation and local market

responsiveness are ignored and violated in this business strategy. Hence, MNCs in an emerging market often compete against each other for serving only small wealthy population and unilaterally hope that demand and taste of consumers in an emerging market will gradually converge to consumers in developed market through economic growth. Even the convergence does happen, it will most likely to take a rather long period of time.

Moreover, MNCs also tend to rely on large distribution system which they are familiar with and they are reluctant to invent on more traditional, complex and domestic-oriented wholesale and retailing system to raise coverage of distribution. As results, a lot of firms failed to meet their original goals on market penetration and profits. This flawed strategy has been commonly observed as one reason for many evident failures or on-going struggles of MNCs. The fierce competition and prisoner dilemma shows up since most of firms inherit a similar strategy and do not adjust their strategies to accommodate local conditions.

Observing the success of some local entrants also tells us why some foreign firms fail. It is the segmentation strategy that gives local firms the scope to develop their own brands and mass marketing strategies targeting at ordinary consumers with moderately growing demand. Some local firms which quickly imitate their international competitors are growing faster and more successful than foreign firms. Hence even foreign firms have competitive edge in resources, technology and managerial skills in an emerging market, adapting flawed marketing strategy may cost them to lose market shares and even the first-mover advantage in the future.

However, it is worth noting that the marketing strategies that the MNCs adapted may be self-enforcing decisions rather than forgetfulness. Some studies argue that, mass marketing is not yet economic viable for the MNCs in most emerging markets because the infrastructure such as distribution systems on which such strategies

depend, are not yet soundly built. This indicates that local firms' edge on distribution is what is harder for foreign firms to catch up in a short amount of time. Nonetheless, the discussion thereinafter will provide gradual steps for MNCs to engage in high intensity of market entry intended to develop mass-marketing practice with higher localization.

(2) Three phases of market entry strategies for mass-marketing

The process of market penetration in a foreign country consists of a series of business actions dedicated to different stages of challenges. These actions often would not be appropriately implemented if marketing strategies and organizations do not change accordingly to satisfy the development needs. This series of actions was conventionally described through three principal phases proposed by Douglas and Craig (1989) as follows.

a. In the first phase, a low-commitment market entry mode should be adapted to test the market potentials and collect local market information from the local distributors.
b. In the second phase where MNCs start to face price competition and seek to develop differentiated marketing strategies and associated services, intensified marketing activities and facility investment should be undertaken to develop competitive edge in the targeted market and maximize performance within the country.
c. In the third phase, when a firm have established sound marketing mechanism and gained deep marketing experience in the region, the consolidation of a country-specific system into an integrated and efficient global marketing organization becomes essential.

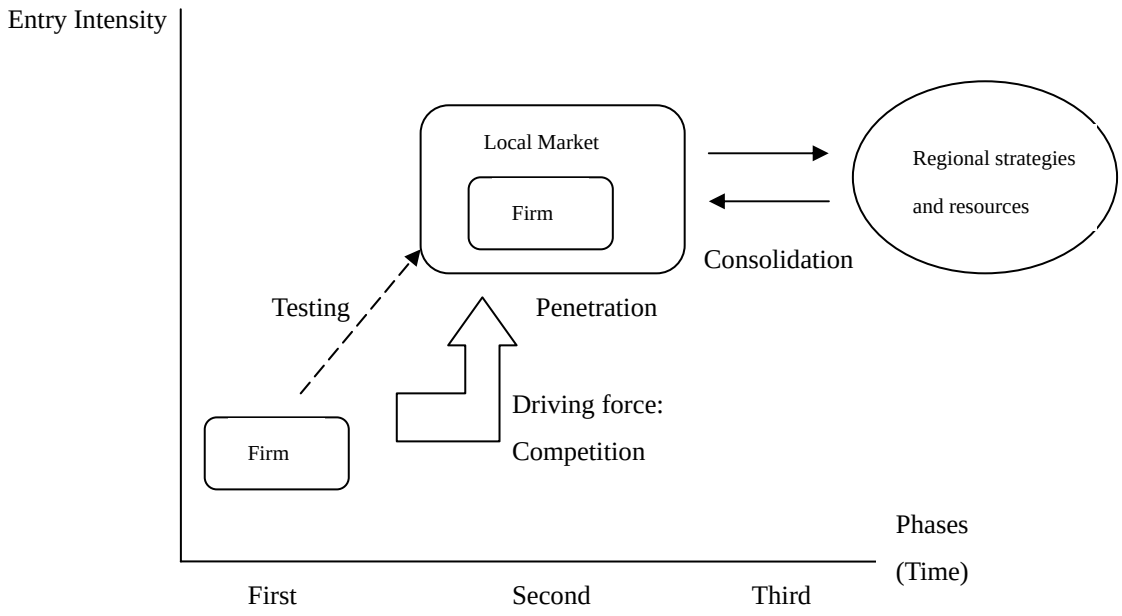

Figure 2: Three Phases of Market Entry

The speed of this process of course depends on firms' international experience, financial capability, and managerial capability of consolidating local resources and knowledge to form a more flexible mechanism suitable for their global objectives.

(3) Possible market entry modes

A. Agency

In the first phase, doing business in an emerging market through local agents may be attractive to foreign firms due to both low financial risk and access to local operating knowledge. It is particularly suitable for firms with little information since almost operating functions are delegated to the agent. However, in addition to the low level of control in terms of pricing and marketing strategies, some additional drawbacks should be noted. From local agents' point of view, their best interests are to operate on the basis of economies of scope, seeking to act as intermediaries for as

many foreign firms as possible. Hence, local distributors often possess superior bargaining power on grasping excess profits as they only devote their greatest resources to the firm that offers the greatest profit margin.

Advantages	Disadvantages
1. Low risk 2. No huge fixed costs incurred 3. High elasticity of adjustment to political and demand shocks in local market	1. Low control to pricing and marketing activities 2. Low market penetration 3. Less responsive to customers' needs and inadequate customer services 4. Little access to local market knowledge

Table 1: Advantages and disadvantages of agency mode

B. Co-marketing by piggybacking

In the BRIC countries, barriers to build up a local distribution network are still high in many aspects such as languages and cultural norms, geographic segmentation, access to political authorities and required adjustments to regulations. Breaking all these barriers often requires a considerable amount of time and resources and therefore some firms may choose to enter an emerging market though an rather opportunistic way by so call "piggybacking" other firms or distributors in the first phase. A common way of piggybacking is to serve or to cooperate with firms that have better distribution network in the market. However, notice that the necessary conditions for piggybacking are that firms must have no conflicts in marketing

objectives and their products are not close substitutes so that the firm with better network would then have incentive to share the network in exchange to cost compensation. In general, firms that are vertically related have better incentives to create a platform of cooperation and use the same distribution channel for differentiated and non-substitute products. For example, a jointly-ventured 7-11 could provide both Taiwanese and Japanese manufacture and non-manufacture firms a distribution network in major regions of China. Recently, Taiwanese banks have integrated with major chain-retailers to successfully expand their service network. Such a piggybacking strategy could conceivably apply to Chinese market as Japan and Taiwan continue to establish differentiated networks in China based on their industrial comparative advantage and create more opportunities of forming strategic alliance.

C. Strategic alliances

Firms in the second phase of marketing strategies may be self-motivated by objectives of development or forced by competition to go beyond simple export of goods and services. In this phase, a higher intensity of entry mode such as joint ventures, franchising or licensing could be considered. The common feature of these entry modes is that the foreign firms often engage in cooperation of production and marketing with either domestic firms in the target country or foreign firms from different countries. Although these three modes are different in the structure of obligations and rights between bilateral entities, choosing strategic partner usually involves in four dimensions of consideration, the so called 4Cs (Austrade):

1. Complementary skills
2. Cooperative cultures
3. Compatible goals

4. Commensurate risk

Among these criteria, complementary skills and compatible goals are relatively not restrictive since firms are generally well-informed about the technical capability and objectives of their prospective partners before forming the strategic alliance. However, cooperative cultures and commensurate risk are relatively restrictive if a foreign firm chooses to form a strategic alliance with a local firm. Since the local firm is generally better informed than the foreign firm about the local tastes and business models, information asymmetry may affect their attitude toward risk and therefore may result in conflicting strategies and actions. Moreover, if the foreign firm controls the vital factor that empowers its bargaining position and the local firm primarily plays the role of execution, the strategic alliance will be more like a principal-agent problem. The need for a well-functioned incentive design will be a challenge to the foreign firm as the local firm with superior information may engage in rent-seeking behavior by mimicking its effort level on either quality or costs.

5. Why Japanese and Taiwanese firms? The reasons supporting cooperation between the two countries in China Market

(1) The vertical relations between Japanese and Taiwanese firms can prevent both governments from engaging ineffective STP.

Ishikawa and Spencer (1999) pointed out that export subsidies that tempt to shift excess profits from foreign competitors to domestic firms of a final good may not be welfare improving if production process is not fully indigenous. When an intermediate input is supplied by foreign firms, implementing export subsidies may also serve to shift excess profits to foreign suppliers if they are able to bargain over the division of excess profits. Hence, the incentive for export subsidy will be

weakened. In case of Taiwan and Japan, the level of vertical integration in ICT, machinery and optical products has been historically high as Taiwan imports upstream electronic and mechanical parts for downstream appliance and exports intermediate or final goods back to Japan. When this vertical relation in production carries to China, the two countries should have even less incentive to engage in STP since there is one more player in the value chain to divide excess profits.

(2) Positive assortative matching in production:

According to the famous "O ring" model developed by Kremer (1993), industries that behave high degree of vertical disintegration must cautiously choose their production partners, as the value of a final product crucially depends on productivity of every task in the production process. If production function exhibits supermodularity,[1] then firms that are vertically related will mutually sort themselves positively which means a world-class brand company with more advanced technology will be willing and able to outbid its inferior rivals for better outsourcing manufactures. Taiwan has been a long time production partner to Japan in various manufacturing industries. For instance, the cluster effects in ICT industries developed throughout years of specialization in OEM has made Taiwanese ICT firms the most cost efficient, quickly respond and quality assuring manufactures in the world. Moreover, since mid-90s, Taiwan has been developing its ICT manufacturing bases and cluster effect in China. If Japanese ICT firms wish to reduce time and trade costs by directly outsourcing production or ordering products within China, cooperating with Taiwanese ICT firms can strengthen their competitive edge not only on cost-saving but also on knowledge of local demand and taste.

[1] In verbal terms, supermodularity in production refers to a production relationship in which marginal productivity of one factor is non-decreasing with another incremental factor. In mathematical language, supermodularity means no-negative cross derivatives.

(3) Transaction costs of cooperation between two countries are also relatively lower than other combinations of partner nations.

According to Kobayashi (2006), he pointed out that Japanese firms in China continue to struggle on fighting for better investment conditions with Chinese governments due to fear of retaliation. On the other hand, Taiwanese firms are relatively more aggressive in appealing their needs and have better assessment on risk of local business operation. Moreover, Taiwanese firms' networking and experience with local authorities are advantages that Japanese firms need. In some cases, a joint venture formed by the two countries can potentially bypass some counterproductive bureaucratic hoops and downplay certain social or political issues such as "anti-Japanese sentiments" that may have effects on business operation. At least, the experience which Taiwanese firms have gotten throughout years of struggle can provide Japanese some valuable information on how to appropriately respond to local market demand and potential risks. Although this is not certain that this advantage would reveal, especially for the large MNCs, but for SMEs seeking to operate in the regional market, cooperation between firms from the two countries may contribute to mutual success.

6. Conclusion

The economic rise of China and the multilateral trade and investment relations in northeast Asia are dynamically changing social, economic, political, and military interaction among countries in the region. Especially, this is affecting the tactical balance and the basic interests and policies of China, Japan, and Taiwan. Since its economic boom, the spotlighted China has launched a "Candy Wrap strategy" in which it attempts to embrace the interests of neighboring countries through trade and investment and downplays its military threats to every neighbor country but Taiwan.

China has also recently demonstrated itself to be a responsible partner striving for regional peace by openly opposing the North Korean nuclear testing. As the close relation in trade and investment keeps developing, China will have a growing stake in the regional stability. Hence in the first essay, I pointed out that having a warm economic relation with China is essential for Japan and Taiwan to prevent potential conflicts within the region. A win-win situation could be reached if the multilateral trade and financial dependency between tri-nationals can provide them significant incentives to maintain stability that serves everyone's best interests.

In addition to the consideration of regional stability, the growing opportunities for mutual economic gains have also been attracting businesses from Japan and Taiwan to enter Chinese market in forms of trade or FDI. From the viewpoint of regional stability, Japan and Taiwan may share the common interests, but the two countries might be competitors in fighting for economic benefits in Chinese market. In the second essay, I briefly cast the competitive relations into two levels. At government level, although governments are often forced by political considerations to implement strategic trade policies but the literature has proven its ineffectiveness in improving social welfare. I also pointed out reasons why STP may not serve both countries' best interests and suggested that governments should refrain themselves from intervention that stems from unilaterally strategic thinking.

At firm level, the characteristics of Japanese and Taiwanese firms make them complement each other and depend on each other for technology, human resources, manufacturing expertise and marketing channels in Chinese market. More importantly, since two countries share the common concerns regarding economic and non-economic friction with China such as the rampant piracy problem, the bureaucratic corruption and the disregard of WTO commitments. Fostering cooperation between Japanese and Taiwanese business communities can also

strengthen the collective voice to express these common issues.

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