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Relative Gains Problem and Case Studies of Economic Cooperation in East Asia

Ping Deng

Old Dominion University

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RELATIVE GAINS PROBLEM AND CASE STUDIES
OF ECONOMIC COOPERATION IN EAST ASIA

by

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ABSTRACT

RELATIVE GAINS PROBLEM AND CASE STUDIES OF ECONOMIC COOPERATION IN EAST ASIA.

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Relative gains problem basically means unequal cooperative payoffs disproportionately favoring partners. With the relative gains problem widely accepted as a serious impediment to international cooperation, some scholars have theoretically argued or modeled several conditions that are most likely to foster a state’s sensitivity to relative gains and thus substantially affect the prospects for cooperation. But little empirical work has been done to date. The central objective of this dissertation is to test whether those theoretical propositions can be supported by empirical evidence. For this purpose, we have deducted three hypotheses: 1) If a state faces military threat and zero-sum political competition from another state, then it will be extremely sensitive to relative gains, thereby restricting economic interactions favoring the rival state; 2) If a state believes that its partner is a rising power in a changed system, then it will show increasing sensitivity to relative gains and seek for its bargaining power; and 3) If a cooperative arrangement is likely to put a state in a competitive disadvantage and hurt its long-term growth, then it will be acutely sensitive to such relative losses and will not cooperate. The hypothesized causal relationships are tested via three cases: Taiwan’s restriction of its economic interactions with China since 1979, Japan’s reduction of its ODA commitment to China in the fourth loan package, and China’s rejection of the flying geese model since the mid-1980s.
The hypotheses in both Taiwan and ODA cases are strongly supported by the evidence, while the evidence for actual policy outcomes (i.e., non-cooperation) in the flying geese model is mixed. Therefore, the relative gains approach has a formal deductive logic and parsimonious power in analyzing cooperation barriers in East Asia. The study has also three policy implications. First, largely because of "defensive cooperation," relative gains concerns do not always jeopardize or eliminate cooperation. Second, even high relative gains concerns may not be fully reflected in policy outcomes, since the extent to which they are ultimately translated into policy is constrained by many other factors. And third, due to strong relative gains concerns, no formal economic bloc in East Asia could be created in the near future, and the continuation of US military presence in the region is highly necessary.
I wish to express my heartfelt gratitude to my dissertation chair, Dr. Carl Boyd, and to the other members of the dissertation committee, Drs. Xiushi Yang, Steven A. Yetiv, Jie Chen and Qiu Jin, for their encouragement, guidance, and constructive criticism during my work leading to this dissertation. I am also very grateful to Drs. Regina Karp, Kidane Mengisteab, Usman Qureshi, and Professor Aaron Karp for their invaluable comments on parts of the dissertation and precious advice and support of this study. I would especially like to thank Old Dominion University for indispensable financial assistance during my graduate studies at the university since August 1993. Without such generous financial support, this dissertation could not have been completed. In addition, the late Ms. Elizabeth Thornton, Program Coordinator, since the inception of Graduate Programs in International Studies, was of enormous administrative assistance during my studies at Old Dominion University.

Deep appreciation is also extended to Drs. Simon Serfaty and John Q. Zhao for their guidance at the early stage of the dissertation research. Furthermore, I would like to extend my thanks to my friends Jack Kalpakian and Janet Lewis for their skillful proofreading of the earlier drafts of my work. I also acknowledge my gratitude to Drs. Kae H. Chung, John A. Doukas, Charathi P. Rao and Wayne K. Talley for their insightful comments on the dissertation from their business perspectives, which were especially useful to my analysis in Chapter 5. Finally, I wish to express my warmest appreciation to my wife, Changyun Nie, and my parents for providing me with enduring comfort and support during the several years of research, writing, and sometimes frustration.
NOMENCLATURE

APEC  Asia-Pacific Economic Cooperation
ARATS Association of Relations Across the Taiwan Straits
ASEAN Association of South East Asian Nations
CCP  Chinese Communist Party
DAC  Development Assistance Committee
DPP  Democratic Progressive Party
EC  European Community
EPA  Economic Planning Agency
FAIR Foundation for Advanced Information and Research
FDI  Foreign direct investment
GATT General Agreement on Tariffs and Trade
IISS Institute of International Studies and Strategy
IMF  International Financial Fund
IPE  International political economy
ISDF Japan Self-Defense Forces
JETRO Japan External Trade Organization
JFOIR Japan Forum on International Relations
KMT Kuomintang (Nationalist Party)
LDP  Liberal Democratic Party
MFA  Ministry of Foreign Affairs
MFN Most-favored-nation (treatment)
MITI Ministry of International Trade and Industry
MOF  Ministry of Finance
MOFTEC Ministry of Foreign Trade and Economic Cooperation
NETs Natural Economic Territories
NICs  Newly industrialized countries
NIEs Newlly industrialized economies
NPC National People’s Congress
ODA Official Development Assistance
OECD Organization for Economic Cooperation and Development
PD  Prisoners’ Dilemma
PLA People’s Liberation Army
PRC  People’s Republic of China
ROC Republic of China
SEF Straits Exchange Foundation
SEZs Special Economic Zones
UN  United Nations
US  United States
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CHAPTER I
INTRODUCTION: THEORETICAL FOUNDATION
AND HYPOTHESES

Relative gains essentially refer to gaps in payoffs favoring partners in an otherwise mutually beneficial cooperation. Because of a state's concern for relative gains, the prospects for cooperation would be substantially affected. However, before 1988 when Joseph Grieco published a now classic article, entitled "Anarchy and the Limits of Cooperation" (1988a), relative gains concerns had been rarely thought of as an important impediment to international cooperation and particularly economic cooperation. Since then, the relative gains problem and its constraint on international cooperation have become the centerpiece of the growing debate between neorealism and neoliberalism, the two most influential approaches to contemporary international relations theory.1 Some well-known scholars have published a number of articles on the issue in leading academic journals as well as influential books.2

The relative gains problem has now been widely accepted by both sides as a serious inhibition to international cooperation. That is, the willingness of a state to be engaged in cooperative ventures will be affected not only by whether and how much the state believes it will gain in absolute terms, but by its perception and assessment of whether and how much the other state(s) will gain more in relative terms. Neoliberals and neorealists disagree only over the extent to which relative gains concerns are likely to be dominant in issues of cooperation and make it more difficult (Grieco 1988a, 501; Snidal 1991a). However, a

The model used for the references and citations in the entire dissertation is American Political Science Review.
conspicuous problem is a relative lack of empirical studies on the very important issue.

While theorizing alone can tell us when states should be more or less sensitive to relative gains, it can not provide the empirical references needed to establish the significance of relative gains concerns in the real world. Moreover, almost no theoretical approach can be deemed truly valid or useful without testing its congruity and pertinence to real life and circumstances. Furthermore, theory can not meaningfully be understood in a vacuum, devoid of empirical context. That is why both neorealists such as Joseph Grieco and Kenneth Waltz, and neoliberals such as Robert Keohane and Duncan Snidal, believe that theories should be systematically tested with evidence (Keohane 1993, 297). After all, “if theory does not successfully enhance our understanding of complex ‘real-world’ phenomena, it remains a purely intellectual exercise” (Underhill 1994, 24). Finally, while neoliberals and neorealists surely compete on many dimensions, the relative gains approach can help us in our quest to understand the politics of economic cooperation among nations (Grieco 1993, 335; Keohane 1993, see also Chapter 2).

RESEARCH PURPOSE

As will be further discussed later, a most valuable outcome from the neorealist-neoliberal debate on the relative gains problem is to show under what conditions state concerns for relative gains will be severe and dominate a chance for cooperation (Keohane and Martin 1995, 44-5; see also Grieco et al. 1993, Matthews 1996, Niou and Ordeshook 1994). Moreover, many scholars have theoretically argued or modeled various conditions under which impact of relative gains on cooperation may be significant, but little empirical work has been done so far. Therefore, the central objective of this dissertation is to test
whether those theoretical propositions on the conditions that are most likely to foster state concerns about relative gains and thus substantially affect the prospects for cooperation have empirical evidence.

In so doing, we expect to find out when and why relative gains concerns will make international cooperation in an empirical world such as East Asia more difficult, if not impossible. Such empirical investigation would also help us to examine whether relative gains approach has a formal deductive logic and parsimonious power in analyzing and accounting for barriers to international cooperation generally and economic cooperation in East Asia particularly. As the “theoretically informed” empirical study focuses on the key conditions that are likely to trigger state concerns for relative gains, we do not intend to answer whether relative gains matter or to study all aspects of the constraining effects of relative gains problem for cooperation.3

To serve the purpose of this study, three important economic cooperative breakdowns or setbacks in East Asia will be analyzed in detail. The three cases covered the economic relations among three major Asian powers during the last decade or so. They are: Taiwan’s restrictions on economic interactions with China since 1979, Japan’s reduction of the ODA commitment to China particularly in the fourth loan package beginning in the 1990s, and China’s rejection of the flying geese model of economic development led by Japan since the mid 1980s.4

These cases were selected mainly because at least one side in each case perceived that the other was achieving or would achieve disproportionate economic gains and possibly political gains, thereby sharply limiting its commitment to the cooperative arrangement or bargaining hard for its relative power in the deal. In addition, there are several other reasons
that make the three cases suitable to test the explanatory power of relative gains approach in the real world.

First, East Asia is typically characterized by international anarchy, where weak institutions, fear of Japan, the rise of China and further reduction of the US military presence have created deep worries about future stability and economic opportunities in the region. In particular, China and Taiwan are political archrivals; China and Japan have a strong sense of rivalry and each worries about the other because of geographic proximity and historical grievances. In this sense, states in East Asia can be at least regarded as defensively oriented. Defensive positionalists mean that states do not necessarily look for opportunities to take advantage of one another, but work to insure that other states do not take advantage of them (Walt 1987, Grieco 1988a, 1988b). In this light, one would expect to see that their economic interactions should be characterized with high levels of relative gains concerns that thwart full cooperation.

Second, as East Asian countries lack the tradition of multilateral institutions, economic exchanges in the region largely depend on bilateral relations, especially between major powers. In analyzing the three cases that basically cover bilateral economic arrangements between those three political entities (i.e., China, Japan and Taiwan) we expect to find typical evidence for the proposition that a state’s concerns for relative gains impede international cooperation in the region.

Third, in the neorealist-neoliberal debate, it is an article of faith that the relative gains problem tends to be more severe in the security realm than in the economic realm; that even in situations where economic agreements have security repercussions, relative gains concerns will also be predominant (Matthews 1996, 115; Grieco 1988a, 487), since wealth is the main
source of military capability and other means of influence. In analyzing those three economic cooperation collapse or setbacks that are to a large extent attributable to security/political considerations, we expect that the relative gains approach will demonstrate a formal deductive logic and parsimonious power for analyzing and accounting for a nation’s unwillingness to participate in an otherwise mutually beneficial cooperative arrangement.

Finally, the three cases provide us with an excellent opportunity to test whether an important neoliberals’ proposition has empirical support. That is, to establish the significance of relative gains motivations, states must have ample reason to believe that the advantaged partner has the opportunities and intentions to use the relative gains to its own advantage and to the disadvantage of the other (Powell 1991, 1315; Keohane 1993, 281-3). Neoliberals appear to strongly argue that anarchy, which is characteristic of international affairs in general and international relations of East Asia in particular, will not by itself mandate a significant concern for relative gains and thus inhibit cooperation. As Robert Keohane argues, if a state is motivated by relative gains concerns, "there must be some plausible way by which one's partner could use advantages gained from the international agreement to hurt oneself in a future period, and a significant prospective motivation for it to do so" (1993, 281; emphasis original).

METHODOLOGICAL APPROACH

The literature on the relative gains problem is, in essence, theoretical in nature. There is a dearth of empirical work to test the relative gains question. Indeed, a comprehensive literature review strongly indicates that a serious weakness of the debate on the relative gains problem for cooperation is a relative lack of empirical investigation (see Chapter 2). Although
in his original article (1988a) Joseph Grieco has called for empirical tests of the two approaches, empirical analysis of the very important issue and particularly conditions that are most likely to foster a state's concern for relative gains is surprisingly lacking. For this reason, many scholars such as Grieco (1993), Keohane (1993), Keohane and Martin (1995), and Liberman (1996) have called again that much more empirical research is needed to test the explanatory power of relative gains problem. Moreover, the very few existing empirical works, including those case studies to serve as a plausible testing of hypotheses, focus either on economic relations among the U.S., Japan and the EC (European Community) in order to explore prosperity-based relative gains, or security negotiations between the U.S. and former Soviet Union for security-based relative gains analysis.

So far, none of the existing empirical work on the issue of relative gains has dealt with North-South relations and their economic interactions, let alone international political economy (IPE) in East Asia. However, the neglect of the economic or security arrangements outside of the developed countries will result in a serious limitation on understanding of the literature on international cooperation. Indeed, some scholars (e.g., Stephen 1991) have argued that an empirical analysis of Third World collaboration or alliance with advanced countries may bring about the most fruitful payoffs for understanding of the international relations. More surprisingly, although the relative gains approach has been widely credited with a strong explanatory power in identifying, analyzing and accounting for impediments to international cooperation, no one has ever applied it into empirical exploration of economic cooperative issues in East Asia in particular. However, if the theoretical approach cannot be used as a useful guidance to analyze the real world like East Asia which is typically characterized with international anarchy, its empirical significance would be greatly reduced.
Precisely for those reasons, this research is structured as a “theoretically informed” empirical analysis. The empirical cases which will be systematically examined in Chapters 3-5 have been selected, with the purpose of taking full advantage of the major outcomes from the recent debate on the relative gains problem, while at the same time paying attention to the weaknesses of the debate (see Chapter 2). By focusing on the conditions that are most likely to foster a state’s concern for relative gains and thus substantially affect the prospects for cooperation, we purport to find some solid empirical evidence to clarify some still conflictual issues and consolidate some conceptually accepted views in the debate on the relative gains problem, thereby making a valuable and original contribution to the literature of international cooperation in general and economic cooperation in East Asia in particular.

In this light, this dissertation seeks to make a significant contribution to the literature by producing a theory-oriented, empirical analysis of the relative gains question in the Asian context. In order to do so, it uses the deductive case study approach, subjecting the relative gains problem for cooperation to three cases for analysis by focusing on the key conditions that are most likely to foster state concern for relative gains. While deduction entails the development of hypotheses which are then tested with factual data and evidence, the case study method constitutes what Theodore Lowi called “one of the more important methods of political science analysis” (1964, 677; see also Marsh and Stoker 1995). It “permits specific and systematic examination of each component” of a country’s foreign policymaking. Through this method, the interrelations between these components can be analyzed and their effective influence on the decisionmaking more readily gauged (Hellmann 1969, 4-5; see also Lijphart 1971, 691-3; Portis and Levy 1988).

Equally importantly, as Harry Eckstein (1975, 80) argues, case studies “are valuable
at all stages of the theory-building process, but most valuable at that stage of theory building
where least value is generally attacked to them." Eckstein (1975, 123) further argues that:
"Case studies yield methodological payoffs as well. This is in large part due to the fact that
they help avoid difficulties that are hard to reduce or abolish in cross-cultural research."
Therefore, to test whether the relative gains proposition has a parsimonious power for
analyzing a nation’s unwillingness to participate in an otherwise mutually beneficial
cooperation, the case study method is valuable and appropriate. This appears particularly true
given that perceptions of economic relative gains and their security implications are most
accurately studied by qualitative assessment (e.g., Liberman 1996, 155-9; see also Russett
1970). This method discusses each case in detail as a means of testing and illuminating the
theoretical approach as well as demonstrating its applicability to the real world.

Therefore, the case study method is designed to generate in-depth empirical analysis,
 enhancing the ability to make valid inferences about the importance of relative gains in any
given context (on drawing valid inferences, see King et al. 1994). The difficulty of
operationalizing the relative gains question makes the conventional case study method critical.
While it is not an optimal method, it may very well be the best means of attempting to move
the relative gains research question beyond the theoretical dimension, to the level of empirical
exploration (e.g., Lowi 1964, 686-8; see also Lijphart 1971, 693). While future work might
seek to operationalize more systematically the concept of relative gains and on that basis to
test more concretely how it expresses itself in reality, this is a major undertaking which is
beyond the scope of the present work and beyond the extant literature on the subject. Rather,
this dissertation seeks to break ground by offering an in-depth empirical analysis of critical
elements of the relative gains problem in a vital region of the world.
On that score, the present work identifies the conditions under which relative gains are theorized in the literature to be important and then, through case study analyses, inquires as to the extent to which they were present. Peter Evans eloquently captures the role of theory in macro inductive scholarship, "theory helps frame empirical puzzles, and it generates plausible causal hypotheses that are worth examining" (Kohli et al. 1995, 47). As a result, the relative gains approach is expected to act as an effective guidance for the empirical research.

Moreover, in each case we will concentrate on one side's perception and assessment of whether and how its partner would gain more in relative terms, thus resisting or sharply limiting its commitment to the cooperative arrangement. On top of that, in each case, we will also discuss some common alternative explanations for those cooperation collapse or setbacks and explore why they miss some important points that could only be insightfully explained by the relative gains approach.

Finally, to carry out the research, the major strategy of inquiry is the "within-case" analysis, which basically utilizes "within-case" observations to assess the correlation between observed and predicted outcomes as the basis for causal explanations (e.g., George and Smoke 1974, 617; also 1973). It, therefore, helps us derive several hypotheses to predict outcomes on the basis of a specified theoretical framework (George and McKeown 1985, 29-30; George 1979, 61-2). A comparison is made between the actual policy outcomes and those predicted by the hypotheses. If the outcome is consistent with the prediction, then the possibility of a causal relationship is established. Equally significantly, the within-case analysis enables us to identify stimuli to which decisionmakers respond but not need to discuss the complicated policymaking process in detail (George and McKeown 1985, 34-41). Therefore,
it is ideally suited to guiding the empirical analysis especially given the fact that the primary sources of data for the research come from public documents, monographs, and influential media accounts rather than original field studies and interviews with the people involved in the policy process. Nevertheless, although this analytical strategy has provided us with the theoretical support on how the three hypotheses (focus of the following section) will be developed, it will not be directly applied to the empirical cases. Put succinctly, it is the hypotheses that will be directly applied to the cases.

**RELATIVE GAINS PROBLEM FOR COOPERATION**

This study utilizes the relative gains problem for cooperation to analyze and explain why a state resists or sharply limits its commitment to an otherwise mutually beneficial cooperative venture. It focuses on the conditions that are most likely to foster relative gains concerns. In this light, the relative gains approach will provide the theoretical framework for our empirical analysis. It allows us to describe how things happened, explain why they happened in ways they did, and predict the reoccurrence of similar things in a given situation (Singer 1961, 91-2). In the complexity of East Asian economic relations, it helps “find the central tendency among a confusion of tendencies, to single out the propelling principle even though other principles operate, to seek the essential factors where innumerable factors are present” (Waltz 1979, 10).

To analyze and account for international cooperation, various theories have been developed from different perspectives. Three broad theoretical approaches are of particular significance. They are “system-centered, society-centered, and state-centered” approaches, which concentrate on three levels of analysis: international, state, and societal, respectively;
each embraces a body of theoretical literature (Frieden and Lake 1996, Ikenberry et al. 1988, Dougherty and Pfaltzgraff 1990). The system-centered approach emphasizes the power or capabilities of a state relative to other nation-states in the international system (Waltz 1979, Keohane 1980, Lake 1988, Mastanduno et al. 1989). Foreign economic policies are seen from this perspective as a function of the structural constraints of international system or balance of power.

As a crucial part of neorealist theory (an essentially system-centered theory), the relative gains approach emphasizes the importance of the anarchic ordering principle or structure of the international system as a determinant of state behaviors or outcomes in international studies (Underhill 1994, 29; Milner 1992, 471; Nye 1988, 236, 241; Ruggie 1986, 152). In other words, the distribution of power among states and a changing distribution of capabilities under anarchy fundamentally determine what states can do and will do in their quest for self-preservation, security and absolute welfare maximization. This theoretical approach was largely popularized by Joseph Grieco when he utilized it as a powerful tool to challenge the central assumption of neoliberals that cooperation under anarchy is fundamentally preoccupied with absolute gains (Grieco 1988a, 1988b, 1990).

DEFINING RELATIVE GAINS PROBLEM

In essence, the relative gains problem for cooperation is triggered by two factors. The first is that in a cooperative endeavor one partner does better than another and enjoys an advance in relative position over the other. The second is that international anarchy provides opportunities for one state to turn the relative gains to its advantage and to the disadvantage of the other state, thereby sharpening the possible negative effects arising from the first factor,
i.e., gaps in gains. That is, if a state becomes relatively stronger by enjoying disproportionate gains from joint action, it might use that relatively greater power to seek to restrict its partners' independence or to force its partners to accept a progressively less favorable set of terms in future joint arrangements. This insight is well observed by Kenneth Waltz:

When faced with the possibility of cooperating for mutual gains, states that feel insecure must ask how the gains will be divided. They are compelled to ask not 'Will both of us gain?' but 'Who will gain more?' If an expected gain is to be divided, say, in the ratio of two to one, one state may use its disproportionate gain to implement a policy intended to damage or destroy the other. Even the prospect of large absolute gains for both parties does not elicit their cooperation so long as each fears how the other will use its increased capabilities (1979, 105).

As the occurrence of relative gains is predicated upon the prospect of gains that are unequal and lead to a change in relative position among partners, the relative gains problem for cooperation is generally illustrated as, “a state will decline to join, will leave, or will sharply limit its commitment to a cooperative arrangement if it believes that gaps in gains will substantially favor partners. It will so eschew cooperation even if participation in the arrangement was providing it, or would have provided it, with large absolute gains” (Grieco 1990, 44; 1988b, 603). The underlying logic is that states in anarchy are generally defensive positionalists; they are fundamentally concerned about their physical survival and their political independence and thus seek to prevent increases in the others' relative capabilities. As Joseph Grieco puts it, “the fundamental goal of states in any relationship is not to attain the highest possible individual gain or payoffs; instead it is to prevent others from achieving advances in their relative capabilities” (1988a, 498; emphasis original; see also 1990, 10, 44). However, this does not necessarily mean that states may always try to maximize to their
own advantage differences in gains arising from cooperation or that states prefer noncooperation; rather it means that a state would be prepared to accept less benefits in absolute terms, if by so doing it could narrow a gap in benefits that favored its partners (Grieco 1990, 46; 1988b: 614).

CONDITIONS FOR STATE CONCERNS ABOUT RELATIVE GAINS

There is still a considerable disagreement between neorealists and neoliberals over the relative gains problem and especially on how and when it acts as a serious barrier to cooperation. In general, neorealists believe in a broader scope and more sources of state concerns for relative gains than neoliberals, and that relative gains concerns are more likely to dominate a chance for cooperation and make it more difficult (Baldwin 1993b, 5; Grieco et al. 1993). More recently, the two sides have come to some convergence. They agree that relative gains are a major impediment to international cooperation but their importance is conditional on such factors as the number of actors in the system and whether gains in one round will cumulate in future rounds (Baldwin 1993a, 22-4; Berejekian 1997; Grieco et al. 1993; Keohane 1993, 281-3; Keohane and Martin 1995, 44; Matthews 1996). That is, gaps in otherwise mutually positive gains that favor partners may disrupt or jeopardize cooperation, however, the extent to which relative gains matter varies with particular contexts. According to Robert Keohane, a leading neoliberal,

Whether relative gains are important is not a matter of dogma, but is conditional on the opportunity and incentives to use them against others . . . . To make a plausible case for such [relative-gains] motivations, the analyst must show that the state or states resisting cooperation could have reasonably expected to be disadvantaged, in a future period, by the gains made in this current period by its potential partners

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As the debate has increasingly focused not on whether relative gains matter, but on under what conditions they matter, scholars have suggested a number of conditions under which the importance of relative gains would be significant and thus substantially affect the prospects for cooperation. Joseph Grieco has clearly specified state sensitivity to gaps in gains — what he calls the coefficient of relative gains sensitivity, “k,” which can be viewed as a variable, and offered six illustrations of how variation in “k” can make cooperation more or less attractive to a state (1988b, 614-7; 1990, 43-4, 46).

In brief, the conditions under which state concerns for relative gains are usually related to its partners, its own circumstances, and the type of cooperative endeavor to which it has committed itself. A general point is that the more prevalent are conditions to increase a state’s sense of vulnerability, either economically or politically, or both, the more germane will be the relative gains argument. As illustrated by Robert Powell, if the costs of using force in the international system are low, then relative gains concerns will predominate and cooperation is unlikely (1991, 1993, 1994). This is essentially because such situation creates opportunities for states to exploit relative gains to their advantages. And when combined with anarchy (i.e., there is no common government to ensure that states will not exploit these advantages) cooperative behavior is undermined.

1. The most basic condition affecting a state’s sensitivity to relative gains is the degree of military threat by its rival partner (Jervis 1978, 174-5: Lipson 1984, 15-8).8 In general, according to Joseph Grieco, the term representing state sensitivity to gaps in payoffs, “k” “is likely to increase as a state transits from relationships in what Karl Deutsch terms a
'pluralistic security community' to those approximating a state of war" (1990, 46). That is, when a war is probable, states worry more about shifts in relative power in respect to the partner. This is essentially because, as Robert Keohane puts it, "[u]nder conditions of severe competition, which is characteristic of power conflicts and particularly of arms races . . . gains for one side are seen as losses for the other" (1984, 123). Therefore, faced with inevitable threats to their survival, states must concern themselves with relative position as measured by military capability, economic productivity, and the like, thereby attenuating the likelihood of cooperation. However, defensive advantage such as having an assured nuclear-destruction mitigates the security significance of adverse relative gains (Waltz 1993, 74; Glaser 1994, 79; Powell 1991, 1304-6; 1993, 115-7).

Accordingly, a state’s relative gains concerns will vary with the degree to which another state’s relative gains can be turned into military capabilities that threaten the first state. Joseph Grieco argues that “k” depends on the probability that payoff-gaps will be converted into military threats (1990, 45-6; 1988b, 610-1). If relative gains can be readily turned into military capabilities and political leverage, a state’s sensitivity to the gaps in gains will be of more importance. Robert Keohane also argues that “relative gains may be important motivating forces for states and firms, but only when gains in one period alter power relations in another, and when there is some likelihood that subsequent advantages in power may be used against oneself” (Keohane 1993, 275). In addition, Robert Powell (1991) presents a formal model, showing that gaps in gains from cooperation detract from a state’s utility and cause it to choose not to cooperate, if it fears that the advantaged partner could employ the increased capabilities produced by the gaps to be a greater military threat. Powell’s analysis underscores the importance of the potential use of force as the key source of relative gains concern.
Finally, relative gains concerns are likely to be most prominent in the military interactions of potential adversaries, who possess the capabilities and perhaps the motives to destroy or otherwise physically harm each other. Since economic power usually underpins political and military influences, even economic relations among potential adversaries are likely to be influenced strongly by relative gains considerations. East-West trade during the Cold War provides a clear demonstration of security-motivated relative gains policy between Cold War adversaries. Believing that trade would provide greater benefits to the smaller and more backward Soviet economy, the US led trade-embargoes against the Soviet bloc during the 1950s and 1960s, and continued to embargo high-tech exports afterwards (Mastanduno 1992).

2. National security is not the only reason that states are concerned about unequal gains. Interest in prosperity alone leads states to forgo absolute but unequal economic gains, especially when they bring about absolute economic losses in the long run. States are "inherently inclined to strive for relative advantage against like entities on the international scene, even if only by means other than force" (Luttwak 1990, 19). Hence, there are two key sources of relative gains, the pursuit of security and the pursuit of welfare. Strategic trade theory provides a straightforward economic logic for why states should care about relative gains.9

Some scholars have actually found strong evidence for conflicts over economic competitiveness and prosperity-motivated relative gains. Joseph Grieco's findings about the EC and the government procurement and technical barriers codes and Michael Mastanduno's findings about the US and satellites and fighter aircraft clearly demonstrated that national concerns about the strategic economic importance led to relative-gains-seeking behaviors in
the collaborative arrangements of those issue areas. After analyzing two codes on nontariff barriers to trade established during the GATT Tokyo Round in the 1980s, Grieco finds that the EC achieved positive gains but feared that the US might achieve even larger gains. Fear of the disproportionate gains favorable to America underpinned the EC behaviors to resist the US vigorously. In his account, “EC efforts regarding technical barriers and government procurement were viewed in Europe as directly affecting the EC’s lagging technological position vis-à-vis the United States and Japan” (1990, 207). Mastanduno shows that in the later 1980s, US resistance to cooperation with Japan on fighter aircraft co-development and satellite, arises from its opposition to relative Japanese gains. In his words, “the immediate concern was not military security, but economic well-being” (1991, 109). In the same vein, after analyzing efforts at cooperation in different sectors of the international communications industry, Stephen Krasner (1991) found that states were deeply worried about distributions of payoffs in relative economic terms.

Fear about the nonmilitary consequences of gaps in gains is another vitally important source of relative gains concerns. In part, this is because military might is significantly dependent on economic might and gaps in economic gains can be translated into military advantage that can be used for coercion or aggression. More relevantly, immediate relative economic gains can result in greater long-run opportunity costs in a variety of ways such as a better bargain power in the future and economic dependence. Thus, states might forbid transfer of technology or managerial expertise, passing up immediate gains that might result in greater long-run losses (Tucker 1991).

The consequences of the convertibility of gaps in gains into long-term economic advantage or influence are well observed by the concept of “cumulation effects” introduced
by John Matthews (1996). According to Matthews, the importance of relative gains will vary according to whether receiving a higher proportion of gains in one round will have implications for future transactions. If “winning” a current round allows a state to be in a better position to win later rounds, relative gains will be quite important. On the other hand, when gains do not cumulate over time, then relative gains will be less critical. In other words, it is the risk of future losses that motivates state concerns for relative gains. According to Charles Glaser’s assessment (Glaser and Matthews 1997, 186), Matthews’s cumulative framework appears to work extremely well on the economic cases despite the fact that relative gains vary in both economics and security as consequences of the cumulative benefits that a single round of gain can provide. In short, when relative gains in one round increase the probability of additional gains in the future, they will be more important, since from the long perspective joint gains produced in the present can be converted into power sources.

However, before Matthews nicely reformulates the hypothesis and demonstrates the plausibility of the argument with several case studies, other scholars have recognized the cumulation effects. For example, Joseph Grieco argued that “through a cumulative process of converting gaps in gains into better deals, the advantaged partner might also become powerful enough to restrict the capacity of the disadvantaged partners for independent choice and action in the domain in which cooperation is occurring and in others to which that domain is related” (Grieco 1993, 315; Grieco et al. 1993, 734). Similarly, Michael Mastanduno demonstrated that a concern about cumulative shifts in national capabilities arising from unequal cooperative gains disproportionately favoring Japan was an important factor in US economic conflict with Japan over the FX jet fighter and commercial space satellites. In his words,
By the latter half of the 1980s, however, clear signs of relative gains-seeking behavior appeared in the U.S. policy process. The immediate concern was not military security, but economic well-being. Some U.S. officials feared that certain patterns of economic interaction with Japan, even though mutually beneficial in absolute terms, would bring relatively greater economic benefits to Japan and over time work to the detriment of America's competitive position in the development and application of advanced technology (1991,109; emphasis original).

Also, states worry about the consequences of economic interaction for their political autonomy. In essence, asymmetrical interdependence may lead to political vulnerability, providing opportunities for other states and even friendly ones to constrain a nation-state's political choices or exercise leverage over its behavior (Keohane and Nye 1977). As economic dependence is basically the result of cumulative effects of relative gains, Kenneth Waltz argues that states tend to be wary about cooperation out of a fear of becoming dependent on their partners (1979, 106-7; see also Grieco et al. 1993, 734). In the same vein, Robert Keohane contends that concern about dependence is a motivation for seeking relative gains if one's partner could use advantages gained from cooperative agreement to hurt oneself in a future period (Keohane 1993, 282).

3. System structure and its changes are an important determinant of relative gains sensitivity, since it conditions the direction and variability of threats. Robert Keohane states that "under different systemic conditions states will define their self-interest differently . . . . Where survival is at stake efforts to maintain autonomy may take precedence over all other activities; but where the environment is relatively benign energies will also be directed to fulfilling other goals" (1989, 62). Robert Powell shows that a key variable for the relative gains to matter is essentially because "the constraints defining the system creates opportunities
for one state to turn relative gains to its advantage and to the disadvantage of other states” (1991, 1315). Duncan Snidal’s models of the relative-gains problem also demonstrate that as the number of players decrease to two, relative-gains sensitivity increases sharply, thereby transforming situations into and exacerbating prisoners’ dilemma (PD) (1991a; 1991b; see also Grieco 1990, 228). On the other hand, according to Peter Liberman (1996), a state’s sensitivity to relative gains is attenuated in multipolar international systems and when the defense is dominant.

In addition, the presence of external challenges will affect state sensitivity to relative gains. To the degree that there is a common enemy posing clear, immediate threats, a state may actually welcome increases in an ally’s capabilities (Jervis 1978, 175). However, as a common threat becomes less severe, a state’s tolerance for gaps in gains favoring allies tends to sharply decrease (Grieco 1990, 46). This argument is supported largely by empirical work done by Michael Mastanduno, who shows that the United States has been increasingly bargaining for relative economic gains with Japan as their common enemy, the former Soviet Union collapsed with the end of the Cold War (1991, 78-83).

4. The experience with and the character of the partner can affect a state’s sensitivity to gaps in gains. In general, states will fear the relative gains of nearby, powerful, offensively armed, and hostile nations more than those of distant, weak, defensively armed, and friendly ones. Moreover, the level of a state’s sensitivity to gaps in gains will be higher if a state’s partner is a traditional adversary rather than a long-time ally (Grieco 1990, 45-6; 1988b, 611-2). Also, Snidal observes that for any pair of states, “the smaller state will be more concerned with the relative gains consequences” as they interact with larger states. Thus, the larger state may allow the smaller states to achieve disproportionate gains in order to ameliorate their
concerns (1991a, 720). In the same vein, middle-range states may be extremely sensitive to
gaps in gains, "for they must simultaneously fear the strong and aspire to their status and they
must worry that they might slip down into ranks of the weak" (Grieco 1990, 46; emphasis
original).

Finally, "a state's sensitivity coefficient is likely to be higher with respect to partners
which have a reputation for exploiting payoff-gaps or, more generally, for seeking domination
within cooperative arrangements, than in regard to partners whose reputation suggests a less
willingness to press advantages and a higher satisfaction with the status quo" (Grieco 1988b,
612-3). For example, Michael Mastanduno (1991) empirically shows that a key factor
underpinning US increasing sensitivity to relative gains in its economic ties with Japan was
that Tokyo had proven itself to be a formidable competitor in the high-tech industry
development and application and its trade polices tend to be adversarial.

ASSUMPTIONS AND HYPOTHESES

A central assumption for this research is that a state's concerns for relative gains are a
severe impediment to international economic cooperation, especially when it has strong
security/political ties, and that the higher the relative gains concerns, the more difficult it is
for a state to be engaged in cooperation, ceteris paribus. As relative gains problem for
cooperation is essentially regarded as a contextually rich theory of international studies
(Berejekian 1997, Grieco et al. 1993, Keohane 1993), we further assume that high relative
gains concerns occur because of a number of factors or conditions such as competitive
political relationship, chances and incentives for a state to take advantages of others,
international structural changes, and cumulative effects. As discussed above, many
scholars have actually modeled or theoretically argued various conditions under which the impact of relative gains concerns on cooperation may be significant. Therefore, as a "theoretically informed" empirical analysis, it is vital for us to find evidence for the causal relationships between these conditions and state sensitivity to relative gains.

From those two assumptions and the literature review especially on the conditionality of a state's concerns for relative gains, we can deduce three major hypotheses for the empirical investigation. In particular, for each case, one hypothesis has been developed. The hypothesized causal relationships will be tested via the case studies in Chapters 3 through 5.

**Hypothesis 1:** If a state constantly faces military threat and zero-sum political competition from another state, then it will be extremely sensitive to relative gains, thereby restricting economic interactions favorable to the rival state.

In essence, this hypothesis intends to explore whether security-motivated relative gains concerns would establish the plausible way by which Taipei has been constantly restricting economic transactions across the Taiwan Straits and still maintains a ban on direct trade and investment relations with Mainland China, although this has seriously hurt Taiwanese economy in absolute terms. It can also be interpreted as, if Taiwan believes that it is experiencing an economic dependence upon its political archrival and military enemy, China, its relative-gains sensitivity would increase and it will limit the economic cooperation to prevent shifts in relative power favoring China. This is largely because economic dependence is one such trend, which has the potential to reduce the future long-term economic growth, grant China a source of political leverage against Taiwan's core national interests such as
reunification and sovereignty, and strengthen China’s military capabilities to invade Taiwan in the future. In short, the hostile situation pushes Taipei to concern about their physical survival more seriously. In Kenneth Waltz’s words, “in a self-help system, considerations of security subordinate economic gain to political interest” (1979, 107).

Obviously, this hypothesis is mainly derived from the theoretical argument that a state’s sensitivity to relative gains tends to be affected by the degree of the military threat from its rival partner(s). It is also based upon the recent works emphasizing the importance of turning relative economic gains into a real advantage, both politically and militarily (Powell 1991, Keohane 1993, Matthews 1996). Finally, a smaller state will be more concerned with the relative gains consequences (i.e., economic dependence) as it interacts with a larger state in economic areas (Snidal 1991a, 1991b).

**Hypothesis 2:** If a state believes that its economic partner is becoming a rising power in a changed international system, then it will show a greater sensitivity to relative gains favoring the partner, thereby seeking its relative achievements of capabilities in the deal and increasing its bargaining power.

This hypothesis is developed to examine whether state concerns for relative gains vary with the changes of international system and its partner’s power capabilities. The relative gains literature strongly suggests that the importance of relative gains will increase if a common military threat becomes less severe and if the partner is more likely to pose a clear and present danger (Grieco 1988b, 1990, Powell 1991, 1993). Indeed, Michael Mastanduno has found empirical evidence that international structural changes account for the increasing sensitivity of the US to relative gains in the economic collaborations with Japan (1991). The
key is, as Mastanduno quoted, “Japan has replaced the former Soviet Union as America’s most important foreign policy problem” (Johnson 1989, 26).

**Hypothesis 3:** If a state believes that a cooperative arrangement would put it in a disadvantaged position and thus hurt its long-term economic growth and possibly political status, then it will be acutely sensitive to such relative losses and will not be ready to cooperate.

This hypothesis is concerned with whether a state will be willing to cooperate when differential short-run economic gains are more likely to threaten its long-run economic interests. States may be concerned about the consequences of relative gains for their national economic welfare, to the extent that mutually beneficial interaction puts their firms at a competitive disadvantage, leads to a shrinkage of their industrial base, or results in the movement of high value-added activity away from their territory. For those reasons, it can be assumed that states will behave in the logic of relative gains and forgo some of the benefits of cooperation or economic exchange in the short run, in order to assure national security, broadly defined, over the long run.

The theoretical basis of the hypothesis is the concept of “cumulative effects,” which essentially argues that states’ sensitivity to relative gains increases when current cooperation creates advantages that increase the probability of additional gains in the future (Matthews 1996, Keohane 1993, Grieco 1993). More specifically, if China perceives that the flying geese model of regional economic integration is most likely to work over time to the detriment of China’s long-term economic interests and put Japan in a superior position both within the arrangement and across issue-areas, it will be highly sensitive to relative achievements of
gains, possibly leading to the cooperative arrangement failing to ever get under way. On top of that, it is theoretically supported by the argument that degree of state concerns for relative gains varies with the character and record of its partner(s) (Grieco 1988b, 1990, Powell 1991, 1994). If a partner has a reputation for exploiting gaps in gains arising from a cooperative arrangement and seeks to enhance the relative capabilities of its own firms and industry while damaging other partners' interests, then the state has additional impetus to react in accordance with the logic of relative gains.

APPLICATION OF THE HYPOTHESES

As discussed above, the theoretical framework raises a set of hypotheses to test. When we use hypotheses that correspond to what is actually contained in the theory, relative gains arguments provide a firm basis for the empirical analysis of international cooperation in general and economic cooperation in East Asia in particular. Accordingly, this “theoretically informed” empirical analysis tests the three key hypotheses as a way to apply the relative gains approach to the empirical case studies. These hypotheses are employed to highlight the changing dynamics of East Asian economic cooperation as the examined countries consider the possibilities to cooperate or not. They are essentially the tools to interpret the causal relationships between various conditions and state sensitivity to relative gains. Therefore, they should help us understand the essence of complicated issues, ask fundamental questions, and explain the logic of how things develop.

One may wish to push this approach further to illuminate precisely the linkage between the relative gains and the specified contexts. Here, it should be made clear that the conditions that are most likely to foster state concerns for relative gains and thus impede cooperation are
essentially situational and case contingent. They may differ over such variables as time, space, and the particular issue. As Jon Elster points out, in the real world, “the number of possible permutations of conditions is too great for us to be able to establish the characteristic mechanism operating in each of them . . . [A] mechanism is a specific causal pattern that can be recognized after the event but rarely foreseen” (1993, 1-7). More relevantly, the relative-gains problem itself is still under intense debate and numerous important issues such as the conversion of relative capabilities, anarchy and the motivations of states, and how to accurately measure relative gains and their consequences remain a challenge for future work (Grieco et al. 1993, 735-41; Glaser and Matthews 1997, 186; Liberman 1996, 174-5; Keohane and Martin, 1995: 50-1; Niou and Ordeshook 1994, 234).

In this light, the relative gains approach developed for this empirical research is not intended to act as a “general” or “grant” theory to cover every aspect of human activity, and that “is and will always remain an illusory dream” (Elster 1993, 2; see also Dougherty and Pfaltzgraff). Rather, it “aims at explanation of a category of behavior over a prolonged period of time” (Whiting 1992, 507). It only lays out an analytical framework as a starting point to study constraining effects on economic cooperation in the context of East Asia.

Finally, as already mentioned above, this study is not intended to explain every aspect of constraints on international cooperation. Its purpose is more modest, but none the less valuable – namely, to provide a starting framework within which to examine the impact of international environment on an individual state’s unwillingness to cooperate. As a result, these hypotheses are by no means exclusive and exhaustive in terms of qualifying and elaborating the theory and explaining East Asian economic cooperation. Other factors and especially the domestic factors in the involved countries such as institutional arrangements
and the domestic character of states, may also affect the relative gains concerns. These factors may not only pose some initial conditions that have to be taken into consideration, but may influence policy process and outcomes directly. Therefore, the empirical analysis based on the outlined theoretical framework needs to be sensitive to the possible influences of those factors not discussed as well. In the concluding chapter, we will briefly discuss them in the analysis of why relative gains concerns cannot be fully and automatically translated into policy outcomes.

**OVERVIEW AND SUMMARY**

Following this chapter, Chapter 2 provides a comprehensive literature review of the relative gains problem for cooperation. It summarizes the major academic works in the relative gains debate between neorealists and neoliberals. To a large extent, this chapter is an extension of the theoretical outline in Chapter 1. Based upon the detailed literature review, we have identified both the strength and the weakness of the relative gains approach for international cooperation. The strength of the approach essentially provides us with the theoretical foundation to develop the assumptions and hypotheses for the empirical analysis. On the other hand, the weakness of relative gains approach has reminded us that a state's sensitivity to relative gains may be strongly evident in the policy making process but not necessarily fully reflected in the policy outcomes, mainly due to a systematic neglect of domestic factors. As analyzing the weakness of relative gains approach is not the focus of the research, we will only briefly discuss it further in the last chapter.

Part II of the dissertation (Chapters 3-5) applies the relative gains approach presented in this chapter to study three important interstate cooperation breakdowns or setbacks involving
Taiwan, Japan and China over the last two decades. These three cases concentrate on the key conditions that are most likely to foster each country's concern for relative gains and thus its choice and preference not to cooperate or sharply limit its cooperative commitment. In general, in each chapter we start with the basic information about the cooperative arrangement itself and its breakdown or setback, then briefly explain why some common alternative explanations are puzzling and fail to account for some key insights of the cooperative reduction, and on that basis, we introduce the hypothesis, and finally analyze the main sources of relative gains concerns in detail for the purpose of testing and illuminating whether they can justify the hypothesis.

Chapter 3 examines why Taipei officials have struggled to restrict the rapid expansion of the mutually beneficial economic relations with China since 1979. This chapter analyzes not only Taipei's overall restrictive economic policy toward China, i.e., maintaining a ban on direct commercial ties with the mainland, but also why Taipei gradually and cautiously relaxes its economic relations with China. Moreover, it pays a special attention to two “sub-cases.” That is, Taipei’s “go South” investment strategy and its forcing Formosa Plastic Group to cancel its $3.8 billion power plant investment in China, the largest-ever foreign investment project in Chinese history. The two sub-cases are significant in that they will provide us with concrete and vivid examples of why Taipei has performed in the logic of relative gains. Furthermore, it discusses the argument of “hollowing out” as an alternative way to explain Taipei’s restrictive policy.

Chapter 4 studies why Japan sought to shorten its ODA arrangement with China and bargained more toughly over the terms that China could use its government loans especially during the fourth loan package negotiations. Prior to the 1990s, Japan proved to be less
sensitive to relative gains concerns in providing China with huge ODA, and in fact accepted or even encouraged patterns of interaction that worked to the relative economic advantage of China. Beginning in the 1990s, however, clear signs of relative gains-seeking behaviors appeared in the Japanese ODA policy toward China. In this light, this chapter focuses heavily on the external environment that Japan has to face with the international structural changes exemplified by the end of the Cold War, and places an emphasis on the Japanese perception that China is becoming a more powerful, non-status quo country. In addition, the chapter also explores Japan's overall policy changes toward China after the Cold War. Finally, it carefully analyzes the record and incentives that Japan has utilized or would use its foreign aid and particularly ODA as a policy tool to serve both its economic interests and strategic purposes.

China's rejection to participate in the flying geese pattern of economic cooperation dominated by Japan is the focus of Chapter 5. This chapter seeks to explore official Chinese perception that the regional cooperative pattern structured by a three-tiered V-formulation of industrialization which, if allowed to persist, is likely to work over time to the detriment of China's national interests. Toward that end, the chapter analyzes why Japan vigorously advocated the flying geese model especially in the years after the 1985 Plaza Agreement and how the model would serve Japanese firms' international competitiveness and strategic goals. Mainly from the industry-level analysis, we will also examine how the pattern could help Japanese firms to build a production process based on the vertical division of labor, thereby increasing difficulty for the "following geese" like China to obtain high technology, locking them up in the inferior competitive position, and compelling them to run huge structural trade deficits. During these discussions, we will pay a particular attention to the experiences of Asian NICs and ASEAN countries. As their economies are much more integrated with Japan
through the model than the Chinese economy, there is no doubt that China’s unwillingness to participate in the flying geese pattern is to a large extent affected by their experiences. Finally, we will analyze the political implications of the economic cooperation by focusing on how it might hurt China’s nationalist self-image and enhance Japan’s leadership in the region. This analysis is expected to provide an additional impetus for China to react in accordance with the logic of relative gains.

Following the theoretical part and empirical analyses of the three cases mainly at the international level, the final part (Chapter 6) concludes the research and captures the essence of the empirical findings, calling to the attention of the cooperation specialists the severely inhibiting effects of relative gains concerns on economic cooperation in East Asia. In each case, we have found the key factors that underlie the relevant countries’ concerns for relative gains. In Taiwan’s case, Taipei’s deep fear of the political danger of its growing economic dependence upon China constitutes the most important factor to foster Taipei’s relative gains concerns for the cross-strait economic relations. In the ODA case, to counter the rising challenge of China in the post-Cold War era fundamentally underpins Japan’s reconsideration of the ODA to China in more relative gains terms. In the flying geese model, the potential damage to China’s long-term economic growth, nationalistic self-image and international political status is the primary motivation for Beijing to officially resist the otherwise mutually beneficial cooperation. My overall finding is that relative gains concerns matter significantly, but not unconditionally in blocking international economic cooperation in East Asia.

Furthermore, the concluding chapter will highlight two important policy implications which are related with the formation of a formal regional economic bloc in East Asia and the continuation of the US military presence in the region.
Finally, the last chapter will discuss why relative gains concerns tend to be more evident in the policy process than in the policy outcomes. This is essentially because the extent to which relative gains concerns are ultimately translated into policy is shaped by many other factors and particularly domestic factors. The evidence strongly implies that, in fully constructing explanations of relative gains-seeking behaviors, we need to move from the international to the domestic level of analysis and to be attentive to both international and domestic structures as well as the relationship between the two. Along this line, we expect that future research will bring about highly instructive outcomes.

SIGNIFICANCE OF THIS RESEARCH

Understanding relative gains concerns as a serious impediment to economic cooperation in East Asia is of empirical and theoretical significance. Empirically, none of the existing studies has applied the approach to explain why some mutually beneficial economic cooperative arrangements in East Asia suffered breakdown or dramatic setbacks. As the first-ever academic effort in the field, this study seek to empirically confirm that relative gains concerns indeed act as a major corrosive force on the willingness of states to work together even in the face of common interests. Meanwhile, we also hope to provide solid empirical evidence that the changing degree of relative gains concerns varies with particular contexts. As the survival of regional cooperation in East Asia is largely threatened by the perceived unequal distribution of gains among member states, this empirical research strongly suggests that in order to achieve sustainable economic cooperation the relevant countries must pay a high priority to the relative gains problem.

Theoretically, the relative gains approach has been developed and used to analyze
constraints on economic cooperation in East Asia. In so doing, we intend to find out whether the relative gains approach has formal deductive logic and parsimonious power for identifying and explaining the unwillingness of a state to be engaged in cooperative ventures. As a radically different starting point, this approach creates new research agenda for the study of East Asian cooperation. The causal relationships between various factors and relative gains concerns are significantly illustrated by the cases in this study. The findings of the case studies strongly suggest that relative gains approach provide a promising direction for inquiry into barriers to East Asian economic cooperation.

Equally important, the analytical framework in the case studies will serve as a model for future inquiries into the role of relative gains problem in blocking international cooperation. Although the past two decades witnessed a dramatic increase in scholarly monographs on economic cooperation in East Asia, a conspicuous problem is the lack of a widely accepted theory that explains the wellsprings of their behavior in any succinct and persuasive fashion. It is hoped that this study can bridge the gaps by establishing coherent relationships between conditions and relative gains concerns via the case studies. Along this line, similar studies in the future may discover more factors that contribute to or alleviate state concerns for relative gains with the purpose of more accurately detecting the degree to which such concerns jeopardize mutually beneficial cooperative efforts. By so doing, the explanatory power of the relative gains approach will be substantially enhanced.
NOTES

1. The terms such as neorealism, realism and structural realism, and the terms such as neoliberalism, liberalism and (neoliberal) institutionalism are used interchangeably, and there is no conceptual distinction among them, unless otherwise stated. The same logic is applied to the related terms such as neorealists and neoliberals, and realists and liberal institutionalists. This usage essentially reflects the fact that leading scholars in the literature, as will be reviewed in this chapter, have used those two groups of terms alternatively, and do not put any emphasis on their differences. For an alternative view, see Ashley (1984).

The major neorealist works on the topic of relative gains problem and international cooperation include: Grieco (1988a, 1988b, 1990, 1993); Krasner (1991); Mearsheimer (1994); and Waltz (1979). The major neoliberal’s works on this topic include: Axelrod (1984); Axelrod and Keohane (1985); Keohane (1984, 1993); Keohane and Martin (1995); Liberman (1996); Lipson (1984); Oye (1986); and Snidal (1991a, 1991b). Other works which are not easily classified as either neoliberal or neorealist, but have made significant contribution to the debate on the relative gains problem include: Baldwin (1993a, 1993b); Berejekian (1997); Grieco et al. (1993), Keohane (1986a); Glaser and Matthews (1997); Mastanduno (1991); Matthews (1996); Milner (1992); Niou and Ordeshook (1994); and Powell (1991, 1993, 1994).

2. These articles appear in prestigious journals such as American Political Science Review (e.g., Powell 1991, Snidal 1991a, Grieco et al. 1993, Berejekian 1997), International Organization (e.g., Grieco 1988a, Powell 1994), International Security (e.g., Mastanduno 1991, Mearsheimer 1994, Keohane and Martin 1995, Matthews 1996), International Studies Quarterly (e.g., Snidal, 1991b), and World Politics (e.g., Milner 1992, Niou and Ordeshook 1994). In addition, two widely noted books, Neorealism and Neoliberalism (Baldwin 1993a) and Cooperation Among Nations (Grieco 1990) mainly concentrate on the relative gains problem and its negative effect on the willingness of states to cooperate.

3. In this dissertation, the terms such as relative gains concerns, relative gains problem (for cooperation), relative gains approach, the theoretical approach of relative gains, and a state’s sensitivity to relative gains, etc., are used interchangeably, and there is no conceptual distinction among them, unless otherwise stated. This usage essentially reflects the fact that leading scholars in the literature have used those groups of terms alternatively, and do not put any emphasis on their differences.

4. The "flying geese" theory of economic development was first developed by Japanese economist Kaname Akamatsu in the 1930s. (East Asian proper names have been inverted for the convenience of most English readers, that is, the personal name followed by the surname. However, traditional East Asian usage has been adhered to in the case of certain widely recognized proper names; these are Deng Xiaoping, Goh Chok Tong, Hu Yaobang, Jiang Jingguo, Jiang Zemin, Lee Kuan Yew, Lee Tenghui, Li Hongzhang, Li Peng, Lien Chan, Qian Qishen, Sun Yat-sen, Wang Yu-ching, Yang Shangkun, Ye Jianyiling, Zhao Ziyang, and Zhu
Like Vernon's product cycle theory (1971), it spelled out a protracted process, driven by the gradual and international diffusion of technology. In the 1970s and 1980s, Japanese scholars used a modified version of the flying gooses theory to explain what they viewed as a synergistic pattern of economic development and integration in Asia. Japan, of course, is the "lead goose" in this regional economic pattern, followed by the four Asian NICs, then ASEAN and China, and so on.

5. John Mearsheimer believes that states are both offensively oriented and defensively oriented (1994, 11-2). This observation is well applied to the relationship between Taiwan and China.

6. In this dissertation, international political economy (IPE) denotes the issue areas of international economic affairs, and deals with issues of trade, monetary policy, investment, and other economic activities that generally have wealth as the principal goal (Friedman and Lake 1996, Introduction). In this sense, absolute gains are normally regarded more important than relative gains in IPE. However, in some instances IPE and security do overlap and economic interactions produce security results. When this happens, relative gains become more serious and cooperation is more difficult (e.g., Grieco 1990, 45-57; Jervis 1982, Lipson 1984).

7. Peter Evans further argues that theory has been very important because it "helps define what questions are worth looking at and, by extension, provides an external definition of what cases are most interesting to examine. In short, it defines 'big idea' . . . General theoretical perspectives also important as a source of tool and they help describe mechanisms that make the behavior of actors and institutions causally plausible" (Kohli et al. 1995, 4-5).

8. For the argument that relative gains are not a problem in security but in economics, see Glaser (1994) and Glaser and Matthews (1997). In his view of point, security is at best understood in absolute terms and "the relative gains problem essentially ceases to exist" in the security realm (Glaser and Matthews 1997, 186).

9. The most commonly cited reference on the strategic trade literature is Paul R. Krugman (1986a, 1986b). For a short discussion of the subject, see Robert Gilpin (1987, 215-21). Regarding the political economy of the theory, as well as its availability in the Asian-Pacific region, see Richardson (1990, 1994). There are a number of works that have used the strategic trade theory to analyze economic competition, particularly in the realm of high-tech competition among the advanced countries (e.g., Tyson 1992, Luttwak 1990, Tucker 1991).

10. Short-run positive relative gains increase rather than decrease dependence on trading partners (Milner 1992, 487). As many prestigious scholars have demonstrated, power in an interdependent relationship flows from asymmetry: the one who gains more from the relationship is the more dependent (see, for example, Hirschman 1945, Keohane and Nye 1977, Baldwin 1980). According to my reasoning, to regard economic dependence upon a partner as a major source of state concern for relative gains can be well understood in terms
of long-run relative losses as consequences of short-term relative gains cumulate.

11. Prisoner Dilemma (PD) game is the most common game theory model used in international relations. Achieving cooperation under the incentives of a PD is the subject of much of the cooperation literature. The classic works on this subject are Axelrod (1981, 1984). PD is also directly connected to another important means to achieve cooperative arrangements – the effect of the shadow of the future on cooperation. For the general discussion of PD and the shadow of future, see Oye (1985, 12-8); Axelrod and Keohane (1985, 232-4); Rapoport et al. (1976); and Snidal (1985).

12. That China and Japan do not have security concern for each other’s physical survival is essentially because both countries possess large nuclear arsenals and rely heavily on nuclear deterrence for their security. (Please note that Japan is effectively under U.S. ensured nuclear protection umbrella, and that is almost equal to nuclear deterrence.) As nuclear weapons can provide a dominant defense advantage, security-related relative gains constraints are small (e.g., Jervis 1978, Powell 1991, Lynn-Jones 1995, Waltz 1993).

13. The newly industrialized countries (NICs), also called as the newly industrialized economies (NIEs), include Hong Kong, Singapore, South Korea, and Taiwan. The Association of Southeast Asian Nations (ASEAN) was established with U.S. support in 1967, when the Vietnam War stroked fears that Southeast Asian nations would fall like dominoes to Communism. As of July 1997, ASEAN has nine members. They are Brunei, Burma, Indonesia, Laos, Malaysia, Singapore, the Philippines, Thailand, Vietnam (Source: *The People’s Daily*, Overseas Edition, December 15, 1997, p. 6). Unless otherwise stated, ASEAN used in this dissertation only include Indonesia, Malaysia, the Philippines, and Thailand. As a result, a more accurate term, ASEAN-4, is introduced.
INTRODUCTION

For the last decade debate on the relative gains problem and its constraints on international cooperation has been a key issue between neorealism and neoliberalism, the two most influential modern approaches to the international relations theory.1 Regarding cooperation, more and more scholars have now accepted a common conception which is defined by Charles Lindblom (1965, 227) as occurring “when actors adjust their behavior to the actual or anticipated preferences of others, through a process of policy coordination” (Keohane 1984, 51-2; see also Grieco 1990, Haas 1990, Oye 1985, 1986, Young 1989). For example, Joseph Grieco (1990, 20) defines cooperation as a joint decision by two or more states to limit or regulate conflict over a contentious issue; this common endeavor will bring mutual benefit, though it may be unequal.

In this light, the definition of cooperation consists of two important elements: each actor’s behavior is directed toward some goal(s) and cooperation provides the actor with gains or rewards. What counts as cooperation thus depends on “goal-directed behavior that entails mutual policy adjustments so that all sides end up better off than they would otherwise be.” Therefore, cooperation is “usually opposed to competition or conflict, which implies goal-seeking behavior that strikes to reduce the gains available to others or to impede their want-satisfaction” (Milner 1992, 468).

When considering cooperation and distribution of cooperative outcomes in particular, each actor is typically motivated by both concerns – absolute gains and relative gains.
Absolute gains mean that each side in a cooperative arrangement focuses on maximizing its own profit, and cares little about how much the other side gains or loses in the arrangement. In other words, "Each cares about the other only to the extent that the other side's behavior affects its own prospects for achieving maximum profits." On the other hand, relative gains mean that each side not only considers its individual gain, but also how well it does compared to the other side. That is to say, "while each state wants to maximize its absolute gains, it is more important to make sure that it does better, or at least no worse, than the other side in any agreement" (Mearsheimer 1994, 12). As a result, cooperation is more difficult to achieve when states are attuned to relative-gains logic, rather than absolute-gains logic. The apparent reason is that states concerned about absolute gains need only make sure that the pie is expanding and that they are getting at least some portion of the increase, while states that worry about relative gains must care also about how the pie is divided, and that tends to complicate cooperative efforts (Mearsheimer 1994, 12-3).

In the literature of international cooperation, a consensus has now almost been reached. That is, the relative gains problem for cooperation results from the possible harmful effects of imbalanced achievements of gains in cooperative arrangements. The relative gains problem is generally illustrated as, "a state will decline to join, will leave, or will sharply limit its commitment to a cooperative arrangement if it believes that gaps in otherwise mutually positive gains favor partners as a result of their common endeavor" (Grieco 1990, 44; see also 1988b, 603). According to Grieco, the underlying logic is that states "are fundamentally concerned about their physical survival and their political independence" (1990, 10). Accordingly, relative-gains logic implies that states will not cooperate with one another if one state suspects the other is gaining more from cooperation than itself.
The classic interpretation of the relative gains inhibitory effects on international cooperation is argued by Kenneth Waltz, a leading neorealist, “[w]hen faced with the possibility of cooperating for mutual gains, states that feel insecure must ask how the gain will be divided. They are compelled to ask not ‘Will both of us gain?’ but ‘Who will gain more?’ If an expected gain is to be divided, say, in the ratio of two to one, one state may use its disproportionate gain to implement a policy intended to damage or destroy the other” (1979, 105).

This argument largely echoes Waltz’s statement twenty years earlier, when he contended that in the anarchy of international politics, “relative gains is more important than absolute gains” (1959, 198). Based on this logic, it is easy to conclude that the general insecurity of international anarchy leads states to worry not simply about how well they fare themselves (absolute gains) but about how well they fare compared to other states (relative gains). In other words, imperatives of anarchic systems compel states to be primarily concerned with relative gains because states that gain disproportionately in relations with other states may achieve a superiority that threatens the goals or even the very security of their cooperating partners.

The relative gains assumption has long been found to be inherent, especially in issues where strategic relations are often viewed as zero-sum games (see Carr 1939, Gilpin 1981, Morgenthau 1967, Jervis 1988, Waltz 1959). As realist theorists of international relations have frequently pointed out, power is the foundation of action in the international system, and power can only be understood in relative terms. However, the relative gains logic is seldom applied to international political economy (IPE) – the realm where neoliberals find their case most relevant and compelling (e.g., Gilpin 1987, Gowa 1986, 1989, Gowa and Mansfield
1993, Keohane 1986b, Rosecrance 1986). Hence, the relative gains calculations and the complexities they create for international cooperation had been largely ignored at least in the realm of international political economy before 1988.

Charles Lipson expects that states will be sensitive to relative gains only in security relationships (1984, 14-6). Neoliberals typically stress that their approach assumes that states focus on absolute gains rather than relative gains (Axelrod 1984, Axelrod and Keohane 1985, Keohane 1984, Lipson 1984, Oye 1985, 1986, Snidal 1985, Stein 1982). For example, Arthur Stein emphasized that even highly self-interested actors like states could have “things in common,” and thus could cooperate; that “suggests that actors focus on their own returns and compare different outcomes with an eye to maximizing their own gains” (1982, 314). As scholars in the field were mainly concerned with how mutual benefits would lead to international cooperation, they predicted that cheating was the main inhibitor for international cooperation and that institutions provided the key to overcoming that problem. That tendency can be clearly seen in some of the most influential works on international cooperation, as will be discussed in the following. Based on economic reasoning, those works generally posit that states act rationally to increase the net benefits they receive.

In *Evolution of Cooperation* (1984), Robert Axelrod’s analysis of the possibility of conditional cooperation is based on a definition of egoism in which actors care only about their own gains. When he used the repeated prisoners’ dilemma (PD) to model international politics, Axelrod assumed that states seek to maximize their utility (Gowa 1986, 172-9). In *After Hegemony*, where Robert Keohane challenges neorealism more directly and develops an institutional approach more fully, he argues that the states’ preferences “are based on their assessments of their own welfare, not that of others” (1984, 66). Keohane’s
analysis of the problem of cooperation in terms of repeated PD implicitly assumes that states try to maximize their absolute gains, and tries to show that anarchy does not imply a lack of cooperation. He finds that relative gains concerns may impede cooperation only in cases where states pursue “positional goods” such as “status” (1984, 54). In Cooperation Among Nations (1986), the contributors and particularly its editor, Kenneth Oye, bluntly state that the overwhelming barrier to cooperation among states with fundamental interests is the threat of cheating, and cheating is basically a “breach of promise” (1986, 1). These arguments are compatible with the ideas of mainstream economists: Policy in areas such as trade and investment ought to be asked on achieving the highest possible absolute payoffs regardless of the benefits that others realize (e.g., Feldstein 1988, Krugman 1991, 1994, but not Reich 1990).

Ignorance of the relative gains problem is well revealed by the assumed order of preference in the prisoners’ dilemma (PD) game – the analytical centerpiece of most of the literature – where each actor cares about how its opponent’s strategy will affect its own absolute gains, but not about how much one side gains relative to the others (Mearsheimer 1994, 19; see also Lipson 1984, 2; Milner 1992, 475; Snidal 1985). Put differently, each simply wants to get the best deal for itself, and does not pay attention to how well the other side fares in the process. As the most attractive strategy of the PD for each actor is to cheat and hopes the other to pursue a cooperative strategy, the principal obstacles to reaching interstate cooperative outcome “will be fear of getting suckered, should the other side cheat” (Mearsheimer 1994, 17; see also Axelrod 1984, Rapoport and Chammah, 1965, Smale 1980).

In short, relative gains concerns are rarely thought of as an important impediment to international cooperation and particularly economic cooperation before 1988. Nevertheless,
states' relative gains preoccupations should not differ significantly between security and economic realms (Mastanduno et al. 1989). As concerned about military capabilities relative to their enemies', states judge their economic performance by comparison to rivals rather than by their own performance.

NEOREALIST CHALLENGE: STARTING THE DEBATE

Using the prisoners' dilemma (PD) as a key tool of analysis for interstate cooperation has largely caused neoliberalism to fail to understand how and why states worry about gaps in otherwise mutually positive gains favoring partners. Relatedly, neoliberals also fail to appreciate the incidence or severity of the relative gains problem for cooperation. Confronted with an increasing amount of literature ignoring the relative gains problem, and in order to criticize Robert Keohane's assumption that states attempt to maximize their absolute gains (1984), Joseph Grieco has strongly challenged neoliberals since 1988. Specifically, Grieco argues that neoliberalism exclusively focuses on absolute gains of international cooperation, and fails to identify relative gains as a major source of inhibition on cooperation. In the realist's point of view, as neoliberalism fails to understand the fact that states always seek to compare their absolute gains with those of others, its causal logic is questionable. In a now classic article, entitled "Anarchy and the Limits of Cooperation: A Realist Critique of the Newest Liberal Institutionalism," Grieco contends that

States are *position*al, not atomistic, in character, and therefore realists argue that, in addition to concerns about cheating, states in cooperative arrangements also worry that their partners might gain more from cooperation than they do. For realists, a state will focus both on its absolute and relative gains from cooperation, and a state that is satisfied with a partner's
compliance in a joint arrangement might nevertheless exit from it because the partner is achieving relatively greater gains. Realism, then, finds that there are at least two major barriers to international cooperation: state concerns about cheating and state concerns about relative achievements of gains. Neoliberal institutionalism pays attention exclusively to the former and is unable to identify, analyze, or account for the latter (1988a, 487; emphasis original).

According to Grieco, realism's identification of the relative gains problem for international cooperation is based on "its insight that states in anarchy fear for their survival as independent actors." Because of the nature of anarchy, "states worry that today's friend may be tomorrow's enemy in war, and fear that achievements of joint gains that advantage a friend in the present might produce a more dangerous potential foe in the future" (1988a, 487; emphasis original). For realists in general and Joseph Grieco in particular, international anarchy is "the principal force shaping the motives and actions of states" (Grieco 1988a, 488). Anarchy causes states to prefer greater rather than smaller absolute gains and smaller rather than larger gaps in gains favoring partners. Grieco boldly claims that the nature of international anarchy means that "the major goal of states in any relationship is not to attain the highest possible individual gain or payoff. Instead, the fundamental goal of states in any relationship is to prevent others from achieving advances in their relative capabilities" (1988a, 498; emphasis original). By stating that "gaps in payoffs favoring partners will always detract from a state's utility to some degree," Joseph Grieco obviously contends that relative gains problem for cooperation is unconditional (1990, 47).

In another 1988 article, Grieco (1988b) similarly argues that a fundamental goal of states is to prevent advances in the relative power of others. Based on classic argument of realism, "the first concern of states is not to maximize power but to maintain their positions
in the system” (Waltz 1979, 126; see also 1986, 334; Gilpin 1975, 35; 1981, 175), Grieco asserts that states might even forego opportunities to increase their absolute capabilities if doing so contributes to a more stable distribution of power (1988b, 602). In the article, Grieco has put forward an amended PD model, which highlights realism's identification of state concerns about relative gains and depicts realist analysis of the inhibitory effects of such concerns on international cooperation. This reduced form asserts that a state's utility function must incorporate a term reflecting its concern for absolute gains and one reflecting its concerns for relative gains; that is highly appreciable (Powell 1994, 336). Based on the assertion that states are not egoistic, but positional in nature, Grieco contends that states “have two preferences in mixed-interest situations – maximum individual gains and minimal gaps in gains favoring partners, and [realism] finds that states thereby experience two constraints on their willingness to cooperate – cheating and the fear that gaps in jointly produced gains favor partners” (1988b, 607; emphasis original).

Furthermore, Grieco has argued that state sensitivity to gaps in payoffs derived from cooperative arrangements, which he calls “$k$” can be viewed as a variable; it will be a function of, and will vary in response to, at least six factors. These relative gains coefficients include convertibility of payoff-gaps into influence, fungibility of bargaining power, time horizon, previous experience of a state, distinction between military and economic affairs, and differences in traditional adversaries and allies. These widely cited different sources of variance in state sensitivity to gaps in gains are further discussed in his highly influential book, *Cooperation among Nations* (Grieco 1990, 43-6; see also, for example, Jervis 1982, 1988, Lipson 1984). Depending on these variables, a state may be more or less likely to choose cooperation. Yet, Grieco stresses that, “the coefficient for a state's sensitivity to gaps in
payoffs \(- k\) can be expected to vary but always to be greater than zero" (1990, 45; also 1993 et al., 323). In other words, although states' concerns about relative gains can vary, these concerns always exist to some extent and thus inhibit cooperation.

In general, Grieco assumed that mutual cooperation would generate larger gaps in gains than did mutual noncooperation. However, "if the reverse were true, states would be more like to cooperate, for the net expected utility from mutual cooperation would be more likely to be greater than that from mutual noncooperation" (Grieco 1988b, 614). Regarding how to reduce relative gains concerns, Grieco states that, "[t]he most direct way to ameliorate relative gains concern is to reduce possible gaps in gains that may result from cooperation so that, given national sensitivities to such gaps, partners are no worse off from a relative gains viewpoint as a result of cooperation as compared to noncooperation" (1988b, 615). On the role of international institutions – a central instrument for institutionalism, Grieco argues that even if states share common interests, international institutions can not play an independent role in alleviating the inhibitory effects of relative gains on the willingness of states to work together (1988b, 621). Grieco concludes that, "[b]ecause they originate at the very core of an anarchic international system, the relative gains element of state preferences and the relative gains problem for cooperation are both likely to be enduring, characteristic features of world politics" (1988b, 621).

For the purpose of reinforcing his conceptual arguments, Grieco launched an empirical attempt to further challenge the absolute gains assumption of neoliberalism. In his 1990 book, *Cooperation among Nations*, Grieco examines data on the U.S.-EC interactions in relation to six codes designed to reduce nontariff barriers to trade negotiated in the Tokyo Round of the General Agreement on Trade and Tariff (GATT) deliberations to testify hypotheses drawn
from the two theories. The use of these data on the actions of allied, industrial countries regarding economic arrangements, rather than on strategic issues of national security which realism has the obvious advantage, is asserted by Grieco to bias the case in favor of the neoliberal approach. "If neoliberalism has difficulties in accounting for U.S.-E.C. code interactions . . . its shortcomings as an analytical approach will have been highlighted . . . . Hence the [nontariff barrier] code experience may approach the status of a crucial experiment" (1990, 14).5

The conclusion of Grieco's empirical test is that, while both approaches are equally able to explain positions taken on the four more effective codes, realism offers a more adequate explanation of actions on the two less effective codes — technical standards and government procurement polices and subsidies in relation to countervailing measures. According to Grieco's account, during the 1980s the E.C. recognized that it would achieve positive gains but feared that the United States would achieve even larger gains from an aggressive implementation of the Tokyo Round on the technical barriers and government procure codes. Moreover, the EC viewed these two issue areas as a major impact on their capacity to retain an independent industrial technological base able to compete with the United States and Japan. This concern for relative gains in the strategically important areas led the E.C. to limit its commitment to the two codes, and even resisted the U.S. vigorously (Grieco 1990, 182-209). In short, based on the careful examination of the case of negotiations over non-tariff barriers (NTB), a case that Grieco believes poses a hard test for neoliberalism, Grieco concludes that he has provided convincing evidence that "realism is logically superior to neoliberal institutionalism" (1990, 11).

As a major obstacle to international cooperation, relative gains concerns were almost
totally ignored before Grieco raised it in his well-known article (1988a). Surprisingly, only two other scholars, Joanne Gowa (1986: 172-9) and Oran R. Young (1986: 118-9) had briefly discussed it. The telling effect of Grieco’s criticism of neoliberal’s neglect for this very important issue is profoundly felt. The latest round of the neorealist-neoliberal debate can be largely seen as a reaction to Grieco’s original work and a response to those reactions.

As a major inhabitant on international cooperation, the relative gains problem has now been widely accepted even among neoliberals. For example, Robert Keohane, the most prominent neoliberal, admitted that “Joseph Grieco has made a significant contribution by focusing attention on the issue of relative gains, a subject that has been underemphasized, especially by liberal or neoliberal commentators on the world economy” (1993, 283). Keohane further acknowledged that “I did make a major mistake by underemphasizing distributive issues and the complexities that create for international cooperation . . . . I explicitly recognized that cooperation involves discord, but I did not sufficiently explore the implications of that insight” (1993, 292). In a reply to the sharp criticism from John Mearsheimer (1994), a self-claimed “offensive” realist, Robert Keohane and Lisa Martin similarly acknowledged that, “[s]ituations of coordination, in which cheating is not a problem but distributional issues are serious, are equally important, although they were underemphasized (but not absent) in the early institutionalist literature” (1995, 227).

RESPONSE TO THE NEOREALIST CRITIQUE:
EXTENSION OF THE DEBATE

Grieco’s contribution by focusing on the relative gains problem for cooperation has stimulated a large amount of academic literature, and the comparative impact of relative gains
versus absolute gains on a state’s preferences for cooperation has become a crucial point of contention between neoliberalism and neorealism. That is clearly reflected in David Baldwin’s edited book (1993a), which is essentially organized around the relative gains problem, and in a number of review articles. In response to the relative gains problem for cooperation generally and Joseph Grieco’s original work particularly, Robert Keohane, Duncan Snidal, Robert Powell have provided convincing analyses of the debate. Snidal and Powell’s model-based style of studies, purporting to model conditions under which relative gains concerns vary, are highly instructive in how to think about the impact of relative gains concerns on cooperation.

Duncan Snidal’s central argument is that as the number of actors increases, the impact of relative gains motivations on cooperation declines: “A small increase in the number of actors dramatically decreases the impact of relative gains in impeding cooperation” (Snidal 1991a, 701; emphasis original). In more specific terms, Snidal states that

Only in the very special case of the two-state interaction, with high concern for relative gains and near disregard for absolute gains, is the realist case compelling. For broad range of more realistic problems where there are more than two states or where states are about a mixture of absolute and relative gains, the institutionalist case for the possibility of decentralized cooperation remains strong . . . . When two states care only about relative gains, their relations can be modeled as a zero-sum game with no room for cooperation. When states are largely, though not exclusively, motivated by relative gains, their relations are shown to be equivalent to the prisoner’s dilemma (PD) regardless of the structure of the underlying absolute gain game (1991a, 701-2).

In another 1991 article, Duncan Snidal similarly argues that as the number of states increases, relative gains become increasingly irrelevant to the prospects of cooperation.
“Relative gains considerations are shown to matter only for issues involving small numbers of states. The impact of relative gains drops off quickly with more than two states and is virtually irrelevant for issues involving a large number of actors” (1991b, 388; emphasis original). According to Snidal, the underlying reason is that the concept of zero-sum does not extend comfortably beyond the two-actor situation; that the pursuit for relative gains may emerge as a short-term strategy for states seeking absolute gains over the longer term (1991b, 389).

Obviously, if Snidal’s argument and its underlying logic are correct, realist arguments would suffer a heavy blow because the realist case is thereby shown to “be quite weak outside the pure relative gains, tight bipolar world” (Snidal 1991a, 701). Yet, that situation is almost nonexistent in the real world. Consequently, the relative gains problem does not have the general inhibiting effect on cooperation widely ascribed to it, and “the relative gains argument cannot provide a decisive response to the institutionalist claim that decentralized cooperation is possible under anarchy” (Snidal 1991a, 719). Not surprisingly, Snidal’s arguments have aroused intense criticisms from neorealists.

A comprehensive criticism of Snidal’s article was put forth by Joseph Grieco (1993, 317-21; Grieco et al. 1993, 729-36). According to Grieco, there are three serious defects with Snidal’s analysis. First, Snidal bases his model on assumptions that allow him to avoid rather than confront realist arguments on relative gains and cooperation. Second, many of his key ideas simply echo realist contentions. Finally, when he discusses cooperation in the real world, Snidal largely abandons his own model and relies on realist arguments.

In particular, Grieco criticizes Snidal for simply defining the problem of relative gains out of existence by assuming that states receive equal gains (i.e., “constant returns”) from
cooperation. This constant returns premise “has excluded by definition the exact situation that realists posit as triggering the relative gains problem for cooperation, namely, that one partner does better than another and enjoys an advance in relative position over the latter” (Grieco et al. 1993, 730; emphasis original). Regarding Snidal’s main point -- the existence of third parties reduces relative gains problem between any two partners -- Grieco contends that this idea is not new at all because realists have already suggested it earlier (e.g., Grieco 1990, 228). “We [Snidal and Grieco] are looking at different third parties: I at third parties in an arrangement, he at third parties outside it); but we are both saying the increases in such third parties can reduce the relative-gains concern of a state in regard to a partner” (Grieco 1993 et al., 731). Based upon his analysis, Grieco concludes that Snidal’s arguments fail to engage, let alone refute, the realist position. Facing those charges, Snidal defends his analysis and presents an additional proof to support the independence of his central research outcome — the diminishing impact of relative gains with increasing number of states (Grieco et al. 1993, 738-42).

In addition to fully endorsing Grieco’s criticism of the model that Snidal develops, John Mearsheimer (1994, 23-4) also questions the possible common conditions in the real world, under which states largely ignore relative gains concerns. Furthermore, Mearsheimer argues that Snidal does not offer historical examples of multipolar systems in which great powers largely ignored relative gains concern. Finally, Emerson Niou and Peter Ordeshook argues that Snidal purports to show that the realists’ predictions about the impossibility of cooperation do not follow from their assumptions about goals, but his argument is flawed in that “he fails to allow the resulting strategic imperatives to influence the determinants of goals” (1994, 216).
However, some empirical studies appear to support Snidal's central argument: the impact of relative gains attenuates in large-n interactions, while relative gains still impede cooperation in two-state PD case. For instance, by examining international monetary policy coordination, Motoshi Suzuki (1994) shows that in two-state interaction, the negative impact of relative gains on cooperation diminishes progressively under growing interdependence; that cooperation is possible even if states’ preferences contain relative gains concerns. That is, prospects of cooperation may improve further in cases of large-n interactions with high interdependence. Suzuki's analysis stresses that rising interdependence progressively reduces the inhibitory impact of relative gains on cooperation because as “interdependence grows, improvement occurs in a state’s balancing ability to deter the other from obtaining a disproportionate gains” (1994, 493).

In contrast, Robert Powell's article (1991) is more acceptable to both neorealists and neoliberals. Using a simple game-theoretic model, Powell explicitly links the states’ concern for relative versus absolute gains not to different assumptions about the states’ preferences, but to changes in the constraints facing the states. Powell assumes that states are trying to maximize their absolute gains, but the strategic setting in which they are facing induce a concern for relative gains (see also Niou and Ordeshook 1994, 233). In so doing, Powell's model shifts the focus of analysis away from state preferences for relative versus absolute gains to the constraints that states face. In Powell’s point of view, a key condition for the occurrence of relative gains is the use of force.

When the cost of using force is sufficiently low that the use of force actually is at issue, cooperative outcomes that offer unequal absolute gains cannot be supported as part of an equilibrium even through the states' preferences are
defined only over their absolute level of economic welfare. This inability to cooperate is in accord with the expectations of structural realism, though the assumption that states are maximizing their absolute gains is not in keeping with its usual formulation. If the use of force is not at issue because fighting is too costly, then the results are more in accord with neoliberal institutionalism (Powell 1991, 1304).

Based on the model, Powell concludes that two factors combine to induce a concern for relative gains and make cooperation difficult. The first factor is that the constraints defining the system create opportunities for one state to turn relative gains to its advantage and to the disadvantage of other states. The second factor is anarchy. “If opportunities to exploit relative gains exist, then the absence of a common government to ensure that the states do not exploit the opportunities may impede cooperation” (1991, 1315). More recently, Powell uses the guns-versus-butter model (1993) to isolate the effects of anarchy, and similarly supports the above arguments. In brief, Powell strongly argues that conclusions claimed to follow from the assumption of anarchy depend at least as much as on other unarticulated assumptions about the states' strategic environment.

Robert Powell's approach of reconciling the arguments about absolute and relative gains is highly constructive. In Snidal's words, Powell has developed a way that is nicely integrative of realism and liberalism rather than mutually destructive (Grieco et al. 1993, 740).8 Perhaps even more significantly, Powell's analysis has made a general valid point – where conditions mitigate a state's sense of vulnerability, relative gains should matter less even in the presence of international anarchy (Milner 1992, 484; see also Keohane 1993, 275-6). However, the Achilles' heel of Powell's model is that it does not explain those cases, where the use of force is not a relevant concern, and that no doubt limits its widespread

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application in the real world.

Joseph Grieco (1993, 312-7; Grieco et al. 1993, 729-35) argues that Powell's model, while insightful, ignores important additional sources of sensitivity to relative gains, thereby leading Powell and realists to have different expectations about the incidence of the relative gains problem for cooperation. While accepting Powell's view that state concerns about gaps in gains are rooted in their interest in survival and security (i.e., states fear that a partner might use force against them), Grieco argues that "there are at least two additional sources of state concerns about relative gains: uncertainties about one's partners and the efficacy of force, and fears about the nonmilitary consequences of gaps in gains" (1993, 313; Grieco et al. 1993, 733).9

Grieco's uncertainty category refers to uncertainty about other states' future actions which essentially reflects the persistence of uncertainty in international relations. Here, Grieco's reasoning is based on some classic arguments. For example, Robert Jervis observed that "[m]inds can be changed, new leaders can come to power, values can shift, new opportunities and dangers can arise" (1976, 168). In arguing that states worry that an advantaged partner may become a threat, Kenneth Waltz emphasizes that "the impediments to collaboration may not lie in the character and the immediate intention of either party. Instead, the condition of insecurity – at the least, the uncertainty of each about the other's future intentions and actions – works against their cooperation" (1979, 105).

Grieco's fear category refers to concern that one will become dependent on the partner, as the partner grows relatively stronger. "An advantaged partner, states may worry, could use its increased nonmilitary influence to force them to accept progressively less favorable terms in the arrangement in which the gap originated and in arrangements in other
domains as well" (Grieco 1993, 315; Grieco et al. 1993, 734). In the same vein, Waltz argues that states tend to be wary about cooperation out of a fear of becoming dependence on their partners (1979, 106-7). Robert Jervis also argues that “human action is often driven by the twin impulses of fear and temptation” (1988, 349). In short, realists would expect states, as a result of the uncertainties inherent in world politics, to be concerned about gaps in gains from cooperation not just because they seek security and survival but also “because they value their autonomy and independence” (Grieco et al. 1993, 734). As a result, Grieco concludes that a wider range of sources of state concerns about gaps in gains causes the relative-gains problem to come into operation more frequently than might be expected by Powell's model.

While accepting Grieco's view that his model excludes some important sources of state concerns about relative gains and the nonmilitary consequences of relative gains in particular, Robert Powell argues that the basic point of his model seems likely to apply in many substantive contexts where the use of military force is not at issue. In addition, he contends that none of the existing formal work in international relations theory does a good job of modeling all those sources, and such formalization remains a challenge for future work (Grieco et al. 1993, 737).

Emerson Niou and Peter Ordeshook (1994) provide another generally positive review of Powell’s model. They appreciate Powell for having shown how the goal of absolute gains is rationally transformed into a concern for relative gains (see also Berejekian 1997). But, they contend that “Powell’s analysis cannot supply any definitive resolutions of the realist-neoliberal debate” because system constraints such as technology and the actions of third parties are clearly endogenous (1994, 217). However, a negative response to Powell’s model comes from John Mearsheimer, who maintains that Powell’s model is essentially a realist
argument and the explanation is built around familiar realist concepts such as offense-defense balance and the distribution of power in the international system (1994, 22-4). Moreover, Powell has not provided historical examples to illustrate his central argument. Finally, Powell would have to look for a world where defensive military technologies dominate so that relative gains concerns matter little, but offensive and defensive weapons are difficult to distinguish.

In response to Grieco's criticism and for the purpose of defending institutionalism, Robert Keohane (1993) accuses Grieco for advocating an unconditional argument of relative gains considerations. In Keohane's point of view, "when the conditionality of Grieco's claims is recognized, his critique of institutionalist theory is greatly weakened. The contention that international anarchy dictates concern for relative rather than absolute gains is not sustainable" (1993, 275). Moreover, Keohane argues that the conditions under which relative gains may occur are rather limited and their constraints on cooperation are not so severe as Grieco claims. As Keohane writes,

Relative gains may be important motivating forces for states and firms, but only when gains in one period alter power relations in another, and when there is some likelihood that subsequent advantages in power may be used against oneself. Since the theoretical validity of the claim that relative gains matter more than absolute gains is conditional, empirical analysis should accompany a priori argument . . . Since the systemic nature of world politics guarantees that states are in many different relationships simultaneously, Grieco's statement . . . that "the fundamental goal of states in any relationship is to prevent others from achieving advances in their relative capabilities" is difficult to interpret . . . Any claims made about the impact of relative gains are highly conditional: they do not follow logically from the absence of common government, or international anarchy (1993, 275-7).
Helen Milner similarly notices Grieco's unconditional argument for relative gains calculations when she writes, "concern for relative gains should be a variable, but Grieco tends to employ it as a constant" (Milner 1992, 485). Furthermore, Keohane disputes Grieco's contention that uncertainty about a partner's future should be an important source of relative gains concerns. Drawing from a standard rational expected-utility formulation on which realists heavily develop their arguments, Keohane contends that "states will not let mere possibilities determine their behavior. If so, they would behave like paranoids, to their great cost" (1993, 282; emphasis original). From Keohane's perspective, in considering whether to worry about relative gains, states estimate "not only the consequences of adverse action by their partners but the probability of such behavior. Risk-averse states will be cautious in the face of uncertainty, but mere uncertainty, which is characteristic of international affairs in general, will not by itself mandate significant concern for relative gains" (1993, 283; emphasis original).

Finally, for Keohane, the relative gains problem is conditional on the opportunity and incentives to use the gains against others; tough negotiations, or even their breakdown, by no means provide evidence for relative-gain motivations. "To make a plausible case for such motivations, the analyst must show that the state or states resisting cooperation could have reasonably expected to be disadvantaged, in a future period, by the gains made in this current period by its potential partners" (1993, 283). Based upon this logic, Keohane concludes that Grieco's empirical evidence for relative gains motivations to account for E.C.-U.S. negotiations about technical standards and non-tariff barriers (NTB) to trade in the GATT Tokyo Round is not convincing, let alone constitute a "crucial experiment" of the two theories (1993, 280).
Facing Keohane's critique that his empirical cases are not relevant for the relative gains hypothesis, Grieco argues that "my findings about the E.C. and the government procurement and technical barriers codes actually run parallel to Mastanduno's findings [1991] about the United States and satellites and fighter aircraft: in both cases, national concerns about the strategic economic importance of issue areas led to relative gains concerns in collaborative arrangements in those issue areas" (1993, 326). In the view of Mearsheimer (1994, 22-6), Keohane's response to Grieco's original work on relative gains is lengthy and has nothing new to say.

With growing attention shifted to under what conditions relative gains will vary and concern for relative gains will make cooperation more difficult, John Matthews III (1996) has proposed a new hypothesis for variance in the sensitivity to relative gains. His hypothesis is based upon the likelihood that gains in one round will cumulate in future rounds, producing additional relative and absolute gains. In other words, the differences in cooperative outcomes are attributable to varying relative gains concerns underlying the issue areas. Specifically,

Concerns over relative gains both in security and political economy vary according to the cumulation effects inherent in the issue under consideration for cooperation. If a relative gains in a current round of interaction creates advantages that allow additional gains in future rounds, relative gains will be more important. If, however, a relative gains on a current round produces only absolute gains in that round and does not have implications for future interactions, relative gains concerns will be more muted (Matthews 1996, 114).

It is no doubt that Matthews has offered a highly instructive reformulation of how and when concern over relative gains acts as a barrier to cooperation, thus focusing our attention
on their impact on the future (Glaser and Matthews 1997, 186). This hypothesis is extremely helpful in explaining why states may pursue relative gains strategies in economic areas and unable to cooperate even if security spillover is small. It also helps explain why relative gains can be managed effectively in some cases where security is the only consideration. To a large extent, this way of analysis has nicely integrated the variance in relative gains calculations in both security and economic issues.

In general, security is inherently less cooperative and states tend to show greater sensitivity to relative gains for security than for economic affairs (e.g., Lipson 1984, 12-8; Jervis 1982, 1985). In situations where economic agreements have large security implications, relative gains consideration will also be predominant (e.g., Grieco 1988a, 487; Glaser 1994, 53). However, based on Matthews's hypothesis, security cooperation may not always be impeded by relative gains concerns even if security has been considered a vary hard case for cooperation. On the other hand, even when the security implications are low and absolute gains are the ultimate objective, interactions of economic affairs can be characterized by high levels of relative gains concerns that thwart cooperation. The key issue is, "whether and to what extent cumulation is a characteristics of an issue . . . even with an emphasis on absolute gains as the ultimate issue in IPE [international political economy], cumulation effects can still produce high relative gains concerns" (Matthews 1996, 146).

John Matthews has chosen four brief cases to serve as a test of plausibility for the hypothesis. Two cases are from IPE (negotiations between the U.S. and Japan on supercomputers and steel) and two from security (conventional and nuclear arms controls between the U.S. and the former Soviet Union). The four cases appear to have provided solid empirical evidence for his relative gains cumulation argument: As cumulation effects increase,
concern over relative gains increases and probability of cooperation decreases. However, Matthew's hypothesis makes no explicit claims about the relationship between cumulation effects and the degree or magnitude of cooperation. In addition, his argument draws upon and to some extent parallels the strategic trade literature, particularly when he states that "states will fight for relative gains in each interaction in an attempt to gain advantage that will promote greater gains, ultimately for absolute gains, in the future" (1996, 127). Therefore, the application of Matthews' hypothesis in the real world inevitably relies on the popularity and availability of the strategic trade theory. Finally, according to Glaser, the concept of "cumulation effects" appears to work well on economic but not on security issues (Glaser and Matthews 1997, 186-93).

Most recently, a partly theoretical and a partly empirical work done by Peter Liberman (1996) intends to support neoliberal's argument that multipolarity reduces the security ramifications of relative gains. Liberman's central argument is that relative economic gains are unlikely to interfere with cooperation in multipolar international system because the gains are likely to be fairly even in the multipolar system. This argument supplements the findings of Joanne Gowa and Edward Mansfield (1993, see also Gowa 1989, 1994): Allies trade more with each other than do non-allies under bipolarity, but this relationship virtually disappears under multipolarity. Liberman provides two case studies to test the hypothesis: British trade with Germany prior to the World War I and U.S. trade with Japan in the decade leading up to the World War II. According to him, both Britain and the U.S. perceived dramatically increased threats from their rivals (Germany and Japan) gaining relatively more, but neither significantly restricted trade until war virtually upon them. "Continued cooperation in both cases suggests that sensitivity to relative gains is generally low under multipolarity, at least
when compared to other incentives for trade” (Liberman 1996, 173). Based on his findings, Liberman concludes that the security implications of relative economic gains is attenuated in multipolar systems even among the adversaries, and this is particularly true among nuclear-armed states which enjoy a dominant defense advantage.

However, Liberman does not appear to draw the right generalization, and the application of his studies in practice seems to be limited. As Liberman himself admits that, “I have only provided a ‘very likely’ rather than ‘most likely’ tests of the relative gains hypothesis under multipolarity” (1996, 174). Moreover, because of geography and antagonism of the involved trading partners, the two cases were not the most dangerous or protracted that can be found in multipolar systems. Furthermore, compared with other forms of cooperative arrangements such as co-development, FDI and strategic alliances, trade tends to generate the smallest gaps in gains. As most prominent scholars (e.g., Cohen 1990, Hirschman 1945, Chapter 2; Feldstein 1988, Gilpin 1987) have taught us, among all the types of international cooperation, trade is most likely to be characterized by the nature of being temporary, easier to switch partners, and less painful to exit, thereby having generally less multiplier effects on the economy growth in the involved countries. Precisely for those reasons, trade is most visible among all nations including adversaries. Based upon this logical reasoning, Liberman’s generalization is questionable.

EMPIRICALLY TESTING THE DEBATE

After Joseph Grieco called into question institutionalistic theory’s causal logic for its focusing exclusively on absolute gains, there have emerged several empirical works. The empirical studies have focused on economic relations among the allied, industrial nations. In
addition to Grieco's empirical attempts to refute institutional theory (1990), research done by Stephen Krasner (1991) and Michael Mastanduno (1991) are widely discussed. Their results have generally supported Grieco's arguments that relative gains matter even in economic affairs among long-term allies – the cases where neoliberalism is supposed to have great explanatory power. In addition, since the tested parties are allies and examined issues are in the economic realm, this would suggest that the constraining effects of relative gains on cooperation be very strong.

Stephen Krasner examined efforts of cooperation in different sectors of the international communications industry. He finds that distributional conflicts (i.e., relative gains) can occur not just when states have opposite interests, but share strong common interests. Krasner argues that states are remarkably unconcerned about cheating but deeply worried about relative gains even with strong mutual interests. As he accounts, "there are many points along the Pareto frontier," and these multiple ways of achieving the joint gains from cooperation can create conflicts over how those gains will be distributed (1991, 337). The distributive problem arises because there are many ways to divide the cooperative gain derived from the Pareto-optimal agreement and the level of success is influenced primarily by concern about the distribution of gains. In other words, each state fights to gain as large a portion as possible, thus effectively making relative gains important.

Krasner has used these distributional issues to challenge the neoliberal approach and concluded that cheating "is not relevant for global communications" (1991, 337; see also Morrow 1995). The thrust of his criticism is that "the nature of institutional arrangements is better explained by the distribution of national power capabilities than by efforts to solve problems of market failure." According to Krasner's analysis, neoliberals give too much
weight to the resolution of "market failure" and too little to the bargaining among states that determines which Parieto-efficient outcome prevails. However, "[i]nteractions among states are not exclusively concerned with ensuring Parieto efficiency; they can also be a competition for advantage in which power determines final outcomes" (Krasner 1991, 342).

Michael Mastanduno's discussion of America's response to Japanese industrial policy makes an important contribution to empirical research by exploring the international and domestic conditions that fostered or inhibited US concern for relative gains. Through investigation of three areas – aircraft, satellites, and HDTV – which involve U.S.-Japanese competition in the development and commercialization of advanced technology, Mastanduno has found that the sensitivity to relative gains concerns was strongly evident in the U.S. policy process, and reflected primarily anxiety over its economic welfare. However, the extent to which relative gains considerations were ultimately translated into policy, were shaped by domestic factors such as the outcomes of interagency struggles and the ideological rivalry. So far, Mastanduno's article has received the most favorable comments among all the works in the debate between neoliberalism and neorealism (e.g., Grieco 1993, 306, 316; Huntington 1993; Keohane 1993, 281; Mearsheimer 1994). This is essentially because his overall finding that "relative gains concerns do matter significantly, but not unconditionally" (1991, 74) can be utilized to support either approach. Indeed, his empirical studies have been widely cited for either side's argument.

According to Keohane (1993, 281), the success of Mastanduno's empirical analysis is mainly contributed to the fact that his discussion meets Powell's criterion, i.e., opportunities for one state to turn relative gains to its advantage and to the disadvantages of other states; should such opportunities exist, relative gains may indeed be important and cooperation
inhibited (Powell 1991, 1315). That is particularly true with U.S. use of Section 301 to retaliate against Japanese barriers to the purchase of foreign communications satellite (Mastanduno’s clearest case that relative gains make a difference). In essence, “U.S. firms were not only shut out of a market they could easily have dominated, but their competitors could use their protected home base as a ‘sanctuary,’ and from it launch an export drive” (Mastanduno 1991, 98-9). Furthermore, if Japanese firms had succeeded in gaining market dominance, they would have had incentives to exploit those advantages to further weaken their American rivals.

Another empirical investigation to support the relative gains problem for cooperation can be found in Mastanduno’s book, Economic Containment: CoCom and the Politics of East-West Trade (1992). Although it aims to explain the cooperation and conflicts that have characterized the Western effort to use East-West trade as a strategic weapon, this book provides a clear demonstration of security-motivated relative gains policy through the empirical analysis of CoCom during the Cold War. Mastanduno’s studies on U.S. economic warfare and embargoes against the Soviet bloc have shown that relative gains can obstruct economic cooperation under bipolarity. As Mastanduno has observed, believing that trade would provide greater benefits to the smaller and more backward Soviet economy, American government halted trade with Soviet bloc in the 1950s and 1960s, and continued to embargo high-tech and “strategic” goods exports afterwards. Since sophisticated technology was an economic bottleneck for the Soviet Union, the Western allies led by the U.S. banned high-tech exports to the Soviet bloc longer and more rigorously than other kinds of goods (see also Baldwin 1985, 214-24).
REFLECTION OF THE DEBATE: STRENGTHS AND WEAKNESSES

MAJOR OUTCOMES OF THE DEBATE

A major outcome of the neorealist-neoliberal debate is that relative gains problem is a serious impediment to international cooperation. That is, when contemplating an cooperative venture, states must not only consider that it will gain in absolute terms, but ask how the profits or gains will be distributed. As a result, much empirical research should be conducted so that increased scholarly consensus on the deductive logic and parsimonious power of the relative gains approach might emerge. Another major achievement from the debate is that both sides have agreed that the degree of a state's concern for relative gains is conditional and subject to the influences of context, and varies from situation to situation. For example, Joseph Grieco believes that a state's sensitivity to relative gains "will be a function of, and will vary in response to, at least six factors" (1988b, 610-1). Keohane emphasizes that both approaches assume the concern for relative concerns is conditional (1993). John Matthews's hypothesis essentially contends that the sensitivity to relative gains is based on the likelihood that gains in one round will cumulate in future rounds (1996). Most recently, Jeffrey Berejekian argues that a state's pursuit for relative gains is determined by "the state's assessment of changes in the status quo . . . . When the status quo is viewed to be detrimental, states pursue relative gains" (1997, 789-90). In brief, the extent to which a state's behavior exhibits concern about relative gains will vary, depending upon whether the interaction involves allies or adversaries, economic affairs or military ones, and temporary or cumulative effects, etc. (for details, see Chapter 1).
DIFFERENCES AND THE UNDERLYING REASONS

Where neorealists and neoliberals disagree is the extent to which relative gains concern is likely to be dominant in issues of cooperation. While neorealists tend to argue that states will always be concerned to some degree with relative gains, even between long-standing allies, neoliberals see the possibility of a more benign world. Although it would be misleading to characterize one side as concerned only about absolute gains and the other as concerned only about relative gains, "[n]eoliberalism holds that states focus primarily on their absolute gains and are indifferent to the gains of others, while neorealism asserts that states are largely concerned with relative gains from international cooperation" (Powell 1993, 126; see also Baldwin 1993b, 5-6).

In addition, they can not agree upon the prevalence of state concerns for relative gains. In general, neorealists believe in a broader scope and more sources of state concerns for relative gains. For realists, such concerns can be either security-based or prosperity-based, ranging from fear of both military and nonmilitary consequences of gaps in gains to uncertainties about one's partners in future. On the other hand, neoliberals insist that a prerequisite for relative gains concerns to occur is that states must have ample reasons to believe that the advantaged partners might use gaps in payoffs against them. Because they care more about such asymmetries in gains, neorealists view international cooperation as "harder to achieve, more difficult to maintain, and more dependent on state power than is appreciated by the institutionalist tradition" (Grieco 1993, 302). As a result, "[r]ealism presents a fundamental pessimistic analysis of the prospects of international cooperation" (Grieco 1990, 27; see also Mearsheimer 1990, Rosecrane 1986; on the opposite view, see Glaser 1994).
The disagreement over the relative gains problem for cooperation between them can be largely traced to their difference in understanding of international anarchy and its implication. Anarchy is often taken to be “the fundamental fact of international relations” (Art and Jervis 1986, 7; see also Jervis 1988, Mearsheimer 1990, Milner 1991). It is “the characteristic that distinguishes international politics from ordinary politics” (Wright 1952, 122; Weber 1990: 8-9). For realists like Robert Gilpin, international politics is “a recurring struggle for wealth and power among independent actors in a state of anarchy” (1981, 7). Not surprisingly, theorists from both sides share a central assumption that states exist in an anarchic international system; either cooperation or relative gains concerns arises from anarchy. This is strongly implied in the title of a widely noted book on international cooperation, Cooperation under Anarchy (Oye 1986), where the contributors are mostly neoliberals. From this common assumption, each side draws distinct conclusions.

In general, there exist two notions of anarchy (Powell 1994, 330-1; 1993, 126-7; see also Milner 1991, Art and Jervis 1986). The first notion, widely used in international political economy (IPE), is that anarchy means lack of a central authority to enforce agreements among states in the system. In other words, international politics takes place in an arena that has no central governing body. “This – the absence of a supreme power – is what is meant by the anarchic environment or international politics” (Art and Jervis 1986, 1). According to Robert Powell, however, this formulation does not say anything about the means the units (i.e., states) have at their disposal as they try to further their ends; it only says that no higher authority exists that can prevent them from using the means they have (1994, 330).

The second notion of anarchy refers to “the means available to the units” (Powell 1994, 331). This notion, which seems to be more in line with neorealist emphasis on the
importance of force and power in international politics, adds a second concept of anarchy. Here, anarchy is the lack of central authority in a strategic setting in which the threat of force is omnipresent (Powell 1993, 126). This conceptual addition strongly implies that states are “ultimately able to depend only on themselves, and prepared to use force” (Stein 1982, 300). Therefore, “states seek to survive under anarchy by maximizing their power relative to other states, in order to maintain the means for self-defense . . . seek opportunities to weaken potential adversaries and improve their relative position” (Mearsheimer 1990, 12).

Neoliberals emphasize the first notion of international anarchy (i.e., the absence of a central authority) while fail to appreciate the second one. For them, anarchy at most implies that the system is one of “self-help,” in which any agreements must be self-enforcing (e.g., Waltz 1979, 88-93). Moreover, lack of a central government impedes cooperation because it creates cheating problem (Axelrod 1984; Axelrod and Keohane 1985, 226-7; Oye 1985, 1-2). In this light, neoliberals see less reasons for arguing that states are concerned necessarily with relative gains, consequently greater opportunities for cooperation and an expanded role for institutions as facilitator of that cooperation (Niou and Ordeshook 1994, 210).

However, neorealists expect that anarchy means that states fear not just being cheated but that others might try to dominate or destroy them. In other words, the anarchic nature of the international system forces states to be concerned with relative, rather than absolute gains (e.g., Waltz 1959, 59; 1979, 105; Grieco 1988a, 1990). As Grieco stresses, “[s]tates are fundamentally concerned about their physical survival and their political independence. Both result from and depend upon a state’s own efforts and thus its relative capabilities . . . states in anarchy are generally defensive positionalists. Defensive positionalism, in turn, generates a relative-gains for cooperation” (1990, 10).
Following this logic, anarchy means that states can depend only upon their own capabilities to survive; changes in one’s capabilities relative to other states are a state’s central concern; and states will not accept cooperative arrangements that are relatively unfavorable since this reduces their security. Similarly, for Christopher Layne (1993, 11), “the international political system is a self-help system in which states’ foremost concern must be with survival. In an anarchic system, states must provide for their own security and they face many real or apparent threats.” Therefore, “an absolute necessary effect of anarchy [is] the danger states perceive that others might seek to destroy or enslave them” (Grieco 1990, 49-50). In sum, according to neorealists, confronting with inevitable threats to their survival, which result from the fearsome nature of anarchy, states must concern themselves with relative position as measured by military capability, economic productivity, and the like.

WEAKNESSES OF THE DEBATE

Although some theoretical breakthroughs have been made in the debate on the relative gains problem for cooperation, there exist some shortcomings. First of all, as Robert Powell and others argue, that the emphasis on anarchy and its implication for state preference for relative and absolute gains are misplaced. “What have often been taken to be the implications of anarchy do not really follow from the assumption of anarchy. Rather, these implications result from other implicit and unarticulated assumptions about the states’ strategic environment” (1994, 329; 1993, 115-6, 126-7). For Powell, the extent to which a state is concerned about relative gains is a function of its strategic environment. That is, the strategic setting facing the state induces a concern for relative gains because it promotes an opportunity to exploit relative gains to its own advantage and to the detriment of others. In
addition, the degree of relative gains concerns is likely to vary with the environment such as the cost of fighting and the intensity of security dilemma.\textsuperscript{12}

In the same vein, Emerson Niou and Peter Ordeshook argue that states share the basic goal of absolute welfare maximization and that they become concerned about their position relative to others only when circumstances establish such a concern as instrumental to realizing basic objectives (1994, 209-12). Jeffrey Berejekian also contends that “states are prudent maximizers. They pursue absolute gains whenever possible, but they also are concerned with external threats to sovereignty and therefore act to shield themselves against the possibility of leverage” (1997, 795). Furthermore, Duncan Snidal contends that the assumption of anarchy does not necessarily eliminate cooperation, but probably enhances the emergence of cooperation because states “that do not cooperate fall behind other relative gains maximizers that cooperate among themselves.” And that is particularly true given with the numbers of players increasing in the system. He labels such a phenomenon as “defensive cooperation” (Snidal 1991a, 722; 1991b; see also Milner 1992, 484).

As a result, Robert Powell strongly argue that “we should focus less attention on anarchy and much more attention on characterizing the strategic settings in which the units interact . . . . We need to develop a more careful specification of the strategic settings in which units interact if we are to be able to explain the pattern of their interactions” (1994, 331, 334). In sum, too much emphasis on anarchy and the subsequent consequence of a state’s unwillingness to cooperate is a severe weakness of the debate on the relative gains problem. This weakness strongly implies that in order to accurately analyze and account for the true impact of relative gains on cooperation, we should refocus our attention on the conditions under which state sensitivity to relative gains is significant.
In her review of Joseph Grieco’s *Cooperation among Nations* (1990) together with Peter Hass’s *Saving the Mediterranean* (1990), Helen Milner (1992, also 1991) similarly argues that a serious limitation for understanding cooperation is flown from the way in which the assumption of anarchy is developed. After all, the theoretical approach “based on anarchy predict this: states will cooperate to counterbalance others whose relative power is growing” (Milner 1992, 484). Milner goes further to argue that the neglect of domestic politics is the second and perhaps even more serious weakness of the literature on cooperation.\(^\text{13}\)

According to Milner’s account, cooperation may be unattainable because of domestic intransigence, and not because of the international system: “International agreements can always be reached, but they can only be implemented if key domestic actors concur” (1992, 493; see also Evans et al. 1993, Milner and Yoffie 1989, Ikenberry et al. 1988, Putnam 1988). Farreed Zakaria (1992, 198) similarly concludes that: “Domestic political explanations can be most useful in explaining events, trends, and policies that are too specific to be addressed by a grand theory of international politics. That comprises most of international life.” Furthermore, as Joan Spero points out, international economic cooperation especially in industrial countries is “very much the substance of domestic politics;” it reflects a country’s industrial and commercial history, the productive power and competitiveness of films, the shape of domestic and international demand, and the policies of government (1990, 67; see also Milner and Yoffie 1989). As a result, Helen Milner has every reason to argue that, “anarchy does not determine whether relative or absolute gains dominate the motivations of states. Rather, that depends on the domestic character of states and other features of the issue-area.” Therefore, “...the biggest gains in understanding international cooperation in the future are likely to come from domestic-level theories” (1992, 496).
The third weakness of the debate on the relative gains problem is a relative lack of empirical investigation to test the explanatory power of relative gains approach in general and the conditions under which a state's concern for relative gains may be significant in particular (see Chapter 1). Furthermore, although the relative gains approach has been credited with a strong explanatory power in identifying, analyzing and accounting for impediments to international cooperation, no one has ever applied it to empirical exploration of economic or security issues in the context of East Asia. However, the neglect of the economic or security arrangements in the vital region of the world might greatly reduce the significance of this theoretical tool.

Precisely for those reasons, this dissertation research is structured as a "theoretically informed" empirical analysis. The selected cases will be examined in the following three chapters in detail, in an attempt to take full advantage of the theoretical breakthroughs from the recent debate on the relative gains problem, while paying attention to the weaknesses of the debate. By focusing on the conditions that are most likely to foster a state's concern for relative gains and thus substantially affect the prospects for cooperation, we purport to find solid empirical evidence to clarify some still conflictual issues and consolidate some conceptually accepted views in the field, thus making a original and significant contribution to the literature of international cooperation generally and economic cooperation in East Asia particularly.
1. The debate between these two approaches has dominated much of international relations
theory for the past decade or so (Keohane 1986a, 1986b, Baldwin 1993a, Kegley 1995). The
earlier rounds of the debate can be seen as a reaction to Waltz's *Theory of International
Politics* (1979) and a response to those reactions. The book, *Neorealism and Its Critics*
(Keohane 1986a) makes a significant contribution to this debate, by offering a wide-ranging
critique of neorealism.

The latest round of the debate started when Joseph Grieco developed a powerful
response to the institutionalist challenge by focusing on relative gains considerations (1988a,
1988b, 1990). The debate became fully engaged when the edited book, *Neorealism and
Neoliberalism* (Baldwin 1993a), was published in 1993. The book brings a number of
previously published contributions to this debate, in which Baldwin provides an overview of
the debate, and Grieco and Keohane offer their reflections and appraisals of the debate in new
essays.

According to Baldwin (1993b, 4-11; see also Kegley 1995), six central points
characterize the current debate between the two sides: 1) The nature and consequences of
anarchy; 2) International cooperation; 3) Relative versus absolute gains; 4) Priority of state
goals; 5) Intentions versus capabilities; and 6) Institutions and regimes. According to Powell
(1994, 329-44), three issues are at the center of neorealist-neoliberal debate: the meaning and
implications of anarchy, the problem of absolute and relative gains, and the tension between
cooperation and distribution.

2. Robert Gilpin similarly argues, “Nation-states are engaged in a never-ending struggle to
improve or preserve their relative positions” (1975, 35). Indeed, relative gains concerns can
be found in Thucydides's classic realist work, *The Peloponnesian Wars*, when he concludes
that what made the Peloponnesian War inevitable was the “growth of Athenian power and the
fear that it caused in Sparta” (1954, 25, 49).

3. Zero-sum competition usually refers to the situation, where increases in one state's relative
power necessarily result in decreases in the other's relative power. According to the game
theory, if such situation dominates, there is virtually no hope for cooperation.

4. A good collection of essays on the nature of power in international relations is Baldwin
(1985). More recently, Samuel Huntington has forcefully argued that power can only be
understood in relative gains because it “concerns the ability of people to influence each other”

5. On the concept and methodology of "crucial experiment" as well as the criterion for
selecting cases to establish such a methodology, see Eckstein (1975, 118-20; also Stinchcomb
1968, 20-8). In essence, a crucial experiment seeks real world observations confirming one
theory's empirical expectations in circumstances which is most unlikely to have done so
unless the theory is very powerful, while simultaneously disconfirming a competitive theory's
empirical expectations in circumstances which is most likely to have provided those
confirming observations (e.g., Grieco 1988a, 504; 1993, 306).

6. Joanne Gowa's observation of concern for relative gains can be found in her review of Axelrod's book, *Evolution of Cooperation*. In the review, she states that Axelrod's analysis of the possibility of conditional cooperation is based on a definition of egoism in which actors care only about their own gains (Gowa 1986, 175-9).

7. Regarding the argument that interdependence is becoming typical characteristics of contemporary international political economy (IPE), see Ruggie (1992, 593). The idea that asymmetrical interdependence is a source of power is nowadays quite common in the literature of international political economy. It is implicit in the title of the book, *Power and Interdependence* (Keohane and Nye, 1977). The most elaborate development of the idea is probably Albert Hirschman (1945). On the topic of economic interdependence and political influence, see Harrison (1988).

8. Similarly, in a study of patterns of cooperation on economic sanctions, Lisa Martin (1992a; 1992b), an institutionalist, has also provided a good example of how neoliberal and neorealist theories can be well combined. She shows that both approaches should pay more attention to asymmetrical games in which issue-linkage is a rational strategy.

9. The category of the efficacy of force is almost identical to Powell's technology of warfare that determines the cost of fighting (1991), although Powell does not list it as an independent factor to lead to relative gains concern.

10. The classic work on the offense-defense balance and the effects on cooperation between states is done by Robert Jervis (1978). Sean Lynn-Jones (1995) has provided an excellent overview of the literature on the offensive-defense balance, its critics, and defense of the concept. Lynn-Jones argues that while any particular weapons have both offensive and defensive potential, some weapons and constellations of weapons make offensive maneuvers less costly and make defense more costly (1995, 674-7).

11. A Pareto-optimal arrangement is one in which it is impossible for this to happen because the total gains to be realized are bounded. In such a situation, any alteration in the existing arrangements would increase the share of one party only at the expense of others' share. When states or firms are at the Pareto frontier, i.e., when they have reached this boundary of total gains, the only way to increase their own absolute gains is by taking some from a partner or rival.

12. Security dilemma (SD) is referred to the fact that most of the ways in which a country seeks to increase its security have the unintended effect of decreasing the security of others (see Hertz 1950, Jervis 1978, 1988). Currently, considerable academic literature has emerged to direct attention to the “dilemma” between economic prosperity and security instability in East Asia. Strong economic growth in the region has provided the relevant countries with ever increasing resources to be engaged in region wide military buildup (Klare, 1993; see also The Economist, “Asia’s Arms Race,” February 3, 1996, pp. 26-31), but that only tends to put them in an unintended less security position. According to some analysts, China's rapid economic growth and its assertion of sovereignty over the South China Sea and Taiwan are
an important factor leading to the regional security dilemma (e.g., Buzan and Segal 1994, Segal 1996, Lee 1993).

13. Grieco seems to notice the drawbacks of his systemic approach, by which he does not pay sufficient attention to domestic factors. Indeed, he wrote that, “there is no doubt that domestic institutions and dynamics also shape a nation's foreign economic goals and strategies and especially its foreign trade policies” (Grieco 1990, 24).
CHAPTER III

TAIWAN'S RESTRICTION OF ECONOMIC RELATIONS WITH CHINA

AN OVERVIEW OF ECONOMIC RELATIONS ACROSS TAIWAN STRAITS

For the first thirty years since 1949 when the Kuomintung (KMT) fled to Taiwan, the Republic of China (ROC) (i.e., the nationalist government on Taiwan) and the People's Republic of China (PRC) (i.e., Communist government on the mainland) exhibited high levels of political hostility. Before 1979, Zero-sum politics dominated the conflict across Taiwan Straits; each vowed to conquer the other. Even the Preamble to the 1978 Chinese Constitution asserts that “Taiwan is China’s sacred territory. We are determined to liberate Taiwan and accomplish the great cause of unifying our motherland.” On the other hand, Taiwan’s traditional unification policy rested on a militant and unambiguous formula of militarily reconquering the mainland China, Guangfu dalu, ousting Communist regime and restoring the Nationalist government. As a result, there existed virtually no commercial relations between Taipei and Beijing. By 1979, indirect trade via Hong Kong was worth a mere $78 million, and the word of “smuggling” best described cross-strait trade (Ash and Kueh 1993, 712-4).

However, significant changes have taken place in the economic relations between Taiwan and Mainland China since 1979, when Beijing changed its Taiwan policy from “liberation” to “peaceful unification,” advocating “three links” (mail, air and shipping services, and trade) and “four exchanges” (relatives and tourists, academic groups, cultural groups, and sports representatives) with Taiwan as a first step toward the ultimate goal of reunification. Development of bilateral economic relationship gained further momentum in October 1987,
when Taiwan authorities made a dramatic move, lifting the ban on the Republic of China citizens visiting their relatives in the mainland China, and thus reversing Taipei’s stubborn, long-standing “three nos” (no contact, no negotiation, and no compromise) policy. Three months later, the mainland travel policy was further relaxed by allowing low-level government officials to visit their mainland relatives.

The tourist nature of the original visits soon translated into business trips. In 1988, right after Taipei’s removal of the ban on its citizens’ visit to the mainland, more than 380,000 people from Taiwan visited the mainland, among whom more than 40 percent were not “mainlanders” but “Taiwanese” who did not necessarily have mainland relatives (Zhao 1991, 45-6). Taking advantage of the historical opportunity, Taiwanese businessmen flocked to the mainland to set up various types of joint ventures. In addition, from 1987-89 while allowing a "semi-legal" trade and lifting the ban on many imports, Taipei adopted a policy of "no contact, no encouragement and no interference" towards the mainland. In early May 1989, a 12-member official delegation headed by Taipei Financial Minister, Shirley Kuo visited Beijing, to attend the Asian Development Bank meeting. Even more importantly, on April 27-28, 1993, the Association for Relations Across the Taiwan Straits (ARATS) from Mainland China and the Straits Exchange Foundation (SEF) from Taiwan held a historic conference in Singapore, producing four agreements on functional matters such as registered mail delivery. Similar talks were held subsequently in November 1993 and March 1994. Although characterized as unofficial, both delegations were headed by former high-level officials closely tied to the top leadership (Chiu 1993, 8-10; Cabestan 1996, 1267-8). Naturally trade does not exist in a political vacuum. The lessening of cross-strait political tensions, while not officially acknowledged, encouraged a trade and investment trickle to reach a torrent.
DRAMATIC INCREASES IN CROSS-STRAIT ECONOMIC EXCHANGES

Total value of indirect trade, mostly through Hong Kong, reached $1 billion in 1986 and increased to $4 billion in 1990. By 1991 trade volume had risen to $5.8 billion, accounting for 4 percent of Taiwan's total trade (Kao Chang 1992, 55). In 1992, bilateral trade grew to $7.4 billion; with its exports of $6.2 billion, Taiwan enjoyed a tremendous trade surplus. By 1994, trade across Taiwan Straits totaled $16.5 billion or 9.3 percent of Taiwan's total, with exports to China reaching $12.6 billion. Vincent Siew (1995, 3), Chairman of the Mainland Affairs Council and now Taipei's Prime Minister, stated that the volume of indirect trade via Hong Kong amounted to $18 billion in 1994.

Table 3.1 Percentage of Taiwan's Export Markets, Selected Years

<table>
<thead>
<tr>
<th>Year</th>
<th>All Asia</th>
<th>Japan</th>
<th>PRC(via HK)</th>
<th>Europe</th>
<th>North America</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>29%</td>
<td>11%</td>
<td>8%</td>
<td>16%</td>
<td>36%</td>
<td>19%</td>
</tr>
<tr>
<td>1990</td>
<td>38%</td>
<td>12%</td>
<td>13%</td>
<td>18%</td>
<td>35%</td>
<td>9</td>
</tr>
<tr>
<td>1995</td>
<td>53%</td>
<td>12%</td>
<td>23%</td>
<td>14%</td>
<td>25%</td>
<td>8</td>
</tr>
</tbody>
</table>


As shown in Table 3.1, by 1995 the PRC had become Taiwan's single most important export country and the trend has been growing very fast. Even Lee Tenghui's U.S. visit in 1995, which set off Beijing's political and military campaign against Taiwan does not seem to slow down trade expansion; trade volume has posted year-on-year gains. The proportion of cross straits trade increases so dramatically that some fear that the growing trade
relationship could make Taiwan “hostage” economically to China.\(^5\)

However, expanding investment in China has become more prominent than the growing trade. But, because of the indirect nature, the total stock of Taiwanese capital flowing into Mainland China remains difficult to estimate, and the estimated figures vary depending on different time and sources. Yet, direct and indirect investment has increased tremendously. The PRC’s Ministry of Foreign Trade and Economic Cooperation (MOFTEC) estimated that the cumulated Taiwan’s investment stood at $22.6 billion through 1994 (Siew 1995, 3). In addition, large amount of capital inflow into China does not seem to be interrupted by the political turmoil of 1989 Tiananmen Incident and the military threat from China’s missile launches and live war games during summer 1995 and spring 1996.

By 1988, Taiwanese investment on the mainland China reached $294 million while before the mid-1980's it did not exist at all. By 1989, the figure increased to $600 million and soared to $2 billion by 1990 (Zhan 1993, 112-6). As Fujing province has particularly close historical and ethnic ties with Taiwan, by the end of 1990, $1.2 billion Taiwanese capital reached there, occupying about one third of its foreign investment inflows.\(^6\) By the end of 1992, total investment from Taiwan amounted to $9 billion involved in 10,245 ventures, making it the second largest investor in Mainland China just behind Hong Kong (Chen 1993, 180). Cumulative investment amounted to $14.5 billion through June 1993 with a total of 15,812 ventures. Direct and indirect investment continues to grow through the 1990s. According to Taiwan’s leading business association, Taiwan Majestic Trading Company, as of March 1995, some 15,000 companies had poured around $20 billion to the mainland.\(^7\) By the end of 1995, the figure had reached a formidable $25 billion, ranking second after Hong Kong; one in every three listed companies in Taiwan now has significant interests in China.\(^8\)
The large scale of Taiwanese capital inflows into the mainland have manifested the following resilience and momentum: First, the amount of investment has been increasing year by year. During January-August 1994, capitalization of the average approved Taiwan investment project peaked at $2.1 million; for the first nine months of 1996, the average size reached $3.4 million (Cabestan 1996, 1265). Second, the duration of investment has increased from two or three to ten or twenty years; its scope has widened from manufacturing (processing and assembly) to include architectural, agricultural and services industries (finance, tourism and real estate). On top of that, proportion of Taiwanese investment in the non southern coastal region (Guangdong, Fijian, Jiangsu, Shanghai and Zhejiang) rose from 22.4 percent in 1991 to 25.4 percent in 1994. Third, increasing numbers of Taiwanese investors have exported to the mainland new and full sets of equipment rather than used and incomplete ones. The typical investor has also evolved from an individual businessman to large financial groups.

More importantly, investment in Mainland China has shifted from labor, low value-added, and short-term operations to more capital- and technology-intensive industries with longer investment horizons such as automobiles, computers, construction equipments, machinery, and petrochemicals. For example, Taiwan’s largest personal computer maker and the world’s 7th largest, Acer Computer, Inc. has begun to manufacture a large number of advanced color monitors in China, and half of its capital is valued as technology transfer in Suzhou, Jiangsu province.

MAJOR REASONS FOR THE DRAMATIC ECONOMIC INCREASES

Such a remarkable cross-strait commercial movement could not take place without
at the least the grudging acquiescence of the Taipei and a willingness in Beijing to be committed to more open door policy. However, arguments for Taiwanese investment in China are based primarily on comparative and complementary economic advantages (e.g., Xiangming Chen 1996, Howe 1996). In other words, the key determinants of “going China” lie in the fact that Taiwan’s abundant capital and advanced technology match well with ample resources and low cost of production in the mainland China. The comparative advantages, along with similarity in culture, tradition and language as well as favorable locations, are the key factors underlying the Taiwanese-to-mainland China capital flow.

First, China's cheap and abundant labor, vast land, huge domestic market, and strong engineering and technology capacity in selected industries are complementary to Taiwan's abundant capital, manufacturing experience, management skills, and some R&D capacity. For example, based upon his mainland trip, Wang Yung-ching, one of Taiwan’s most successful businessmen, figured that the cost of labor in the mainland was 5-10 percent of that in Taiwan, and the cost of land only 0.5 percent. Such compatibility may have increased in the 1990s and does not appear to be interrupted by major political crises. This economic integration, based largely on vertical division of labor, can encourage industries in China to concentrate on low value-added manufacturing while allowing Taiwan to accelerate industrial upgrading. Also, China's traditional orientation toward heavy industries and large state-owned enterprises can be balanced by Taiwan's small and medium-sized firms investing in China. These firms can use their well-established production and marketing networks to help Chinese companies enter the international market.

Moreover, division of labor is not exclusively vertical. Recognizing the engineering and technology capacity and skilled work force in some China's large state-owned enterprises,
Taiwanese have begun to co-produce some relatively technology- and skill-intensive products such as major computer or vehicle components and parts in China. Accordingly, more and more Taiwanese businessmen carry out increasingly sophisticated OEM (original equipment manufacturing) products as an experienced subcontractor and supplier of parts to the mainland. These kinds of economic ventures are generally viewed by both government and business in Taiwan as “win-win” or mutually beneficial situations. Furthermore, the investment environment in Taiwan was deteriorating, and that compelled entrepreneurs to look for opportunities outside. Owing to cultural, historical and ethnic ties, Mainland China in general and Fujian in particular naturally become Taiwanese ideal investment sites. Not surprisingly, Taiwanese companies ranging from cheap shoes and plastic toys to computer chips and consumer electronics are pouring cash into huge China market. As a result, Taiwan and China are becoming more and more economically interdependent: China relies on Taiwan’s investment to fuel its double-digit growth while Taiwanese firms need China’s lower cost labor and growing consumer market to maintain their competitive production and exports.

Second, since 1979, Beijing has continued and even escalated its effort to attract Taiwanese investors. As former President Nixon (1994, 123) argues, “[w]hile the Chinese leadership may worship in a communist church, they believe in capitalist scripture. They are committed to free market economic politics – to capitalism with a Chinese face.” During July and August 1989, approved by State Council (China’s Cabinet), Fujian opened up a new special economic zone in Xiamen, Xinglin and Haicang with a specific goal to attract Taiwan capital. Despite its grave financial difficulties, Beijing decided in late January 1990 not to collect newly-added taxes from enterprises with foreign, including Taiwanese, investment in
the coming year with the obvious aim of enticing foreign investors. In December 1991, Beijing announced that "reduction of tensions and expansion of economic cooperation and cultural exchanges," rather than the earlier goal of reunification, would guide its relations with Taiwan for the rest of the decade (Huang 1991, 565). Even when China staged missile tests to intimidate Taiwan into abandoning what China calls "separatist activities" during summer 1995, Chinese leader Jiang Zemin sent out an order instructing governmental officials not to harm Taiwanese investors, and reaffirming that political clashes not affect business. In early September 1995, Beijing put it explicitly in the official press, "we condemn only Lee Teng-hui, which will not affect trade and economic cooperation."

Finally, Taipei, although officially still upholding "Three Nos" principle, under strong pressure from the business community, has further loosened its restrictions and demonstrated growing tolerance in its practices toward economic activities across the Taiwan Straits. In mid January 1989, Taipei's National Trade Bureau Director indicated that his government would no longer verify the final destination of exported goods so long as not directly shipped to the mainland. This policy simply recognized the growing importance of Chinese economy on Taiwan which had become the fourth largest market for the island's exports in 1988. By 1990, the commercial policy of "Three Nos" (no direct shipping, direct communications, and no direct trade) existed in name only (Lin 1993, 784). After all, the sustained rapid economic growth in China has provided Taiwan with huge economic opportunities which could not be found elsewhere. From 1991-96, China saw an annual GDP growth of 12.1 percent; in the first half year of 1997, its GDP grew 9.7 percent.
TAIPEI’S RESTRICTION OF ECONOMIC RELATIONS WITH CHINA

Economic interactions across the Taiwan Straits have become truly enormous and constituted the most important part of the widely discussed “Greater China,” an area with most dynamic economic growth in the world (e.g., Ash and Kueh 1993; Harding 1993; 1994a; Shaubbaugh 1995). However, Taipei officials have long struggled to put a brake on the rapid expansion of the commercial ties across the straits. Internal divisions in Taiwan over the pace and scope of economic opening to Mainland China have developed with increasing intensity since the PRC unilaterally ended its ban on Taiwanese investment and trade in 1979. It took Taipei six years to lift its own ban on trade and investment with China, and it did so only with strict regulations that have been very gradually relaxed in the years since.

Although in 1996, two-way trade reached $22 billion and Taiwanese investments on the mainland were estimated at over $30 billion, Taipei still maintains a ban on direct commercial ties with China, the world’s most dynamic economy. There are no direct shipping or air links, no direct post or telephone links and no direct commerce. All shipping to China must pass through a third port, and all travelers to China must go via a third airport. Even telephone calls are rerouted. Indirect trade is expensive. According to Wang Chishiung, a deputy for the ruling KMT, the current indirect arrangements cost an unnecessary $2 billion a year, although the actual figure is certainly much higher. Taipei insists that direct economic links with the mainland can not be achieved until there is “mutual trust”; this can only be achieved when Beijing recognizes Taipei as an equal government, renounces the use of force against Taiwan, and relinquishes its effort to obstruct the ROC’s international diplomacy.

Facing China’s fresh willingness to develop wide-ranging economic ties which might make the island more dependent on the mainland, in early 1994, Taipei formally launched the
"go South" investment strategy in an attempt to shift its business emphasis towards Southeast Asia and away from China. Furthermore, on August 14, 1996, President Lee Tenghui remarked to the National Assembly, calling on Taiwan's companies to scale back their mainland investments and warning that greater interdependence will make Taiwan vulnerable to political pressure from Beijing. President Lee was also reported to have paid a call on the governor of Taiwan's central bank to discuss ways of limiting China-bound capital outflows. Immediately afterwards, the island's biggest manufacturer, Formosa Plastic Group, withdrew an application to build a $3.8 billion power plant in southern China – the largest ever foreign investment project in the Chinese history. Meanwhile, the Council for Economic Planning and Development in Taiwan announced to withdraw a proposal to relax limit investment in China. Most recently, Taiwan authorities unveiled new rules on its corporate investment in China, which ban major outlays for infrastructure work and limit single-project investment to $50 million. The new regulations, backed by industrial leaders, are aimed at safeguarding economic growth and national security on Taiwan, which is always considered a renegade province by the PRC.

Taipei's restriction of economic cooperation with Beijing can be accounted for by a number of reasons such as prevention of a "hollowing out" of Taiwan's industrial structure (this will be further discussed later), fear of lack of any legal protection for Taiwan's investment, potentially unstable China's domestic policy, and poor protection for intellectual-property rights in China. Yet, these explanations give only partial rather than key insights. For example, Taiwan's investment in China does face high levels of commercial risk because of lacking a formal legal and consular structure through which to operate; it exists on a territory not formally recognized by the ROC on Taiwan. However, Taiwanese are effectively using
*guanxi* (connection or contact), the predominant mode of getting anything done in China, "to make up for the lack of the rule of law and transparency in rules and regulations." In a hazy business environment like China, speaking the same language and sharing cultural bonds is a vital lubricant for any serious transactions.

**KEY FACTORS AFFECTING TAIWAN’S RELATIVE GAINS CONCERNS**

The central hypothesis in this chapter is that Taipei’s restrictive economic policies toward China are essentially motivated by security/politics-based relative gains concerns. More specifically, Taipei is deeply worried about the political dangers of its growing economic dependence on Mainland China because the development of economic dependence would compromise its pursuit of a legitimate and autonomous international role. Moreover, there is a high possibility that Taiwan’s investment could eventually strengthen China’s comprehensive economic strength and economic power could in turn be converted into military superiority over Taiwan, thereby more easily reclaiming the island by force in the future. After all, when choosing Guangdong and Fujian as the initial focus of reforms to develop economic ties with Hong Kong and Taiwan, Chinese leader, Deng Xiaoping had the tacit goal of preparing them for reunification. Beijing felt that this segment would gain strength over time through intensified economic and other contacts and because international isolation would offer Taiwan no other way out. It is very clear to Taipei that, in the world of realpolitik, it simply does not matter what the people of Taiwan want. As China’s economy grows more powerful, and Taiwan becomes economically more dependent on the mainland, China’s shadow over the island will grow longer. Even if there is a body invasion, the West will do nothing. Just like after 1989 Tiananmen Incident, the West will make righteous noises,
then realize the significance of economic relations with the world’s most dynamic economy.

Communist China has been consistently the island’s most dangerous adversary both politically and militarily. It has never renounced the use of force to reclaim the island and has been desperately isolating Taipei on the international arena. Moreover, China has wielded its growing commercial clout to bully other countries into isolating Taiwan and directly dig up Taipei’s foreign policy foundation in order to destroy Taipei’s international living space. On the other hand, Taipei constantly seeks out new ways to enhance its international support and standing and the effectiveness of its deterrent capabilities.

As a result, high hurdles of security/politics-motivated relative gains concerns can be assumed as a good explanation for why Taipei has been constantly restricting the cross-strait economic interactions. Fundamentally opposing policy guidelines on issues of sovereignty and national unity, mutual military standoff, destructive diplomatic competition as well as Taiwan’s much smaller economy compared to that of Mainland China constitute the primary sources of Taipei’s sensitivity to relative gains over the cross-strait economic relations.

CONFLICT ON SOVEREIGNTY AND NATIONAL REUNIFICATION

On September 30, 1981, Chairman Ye Jianying, de facto head of the PRC, made a specific nine-point proposal to Taiwan on unification. The proposal offers Taiwan “a high degree of autonomy as a special administration region,” where Taiwan can retain its armed forces. Renewed 1979 call for establishing “three links” and “four exchanges” with Taiwan as a first step toward the ultimate goal of unification, Chairman Ye’s proposal set forth the basic principles of China’s policy for peaceful unification. However, Taipei had deep-rooted suspicion of Beijing’s sincerity of peace talks. In 1981, it openly stated that “in Chinese
communist strategy, peace talks are a dose of poison for us to swallow and kill ourselves slowly, while the use of force is like slabbing us with a sharp dagger" (ROC 1986, 80-1).

Article 31 of the 1982 China's constitution states that the "country will establish special administrative regions when necessary. The system adopted in this special administrative region will be stipulated according to the specific conditions in form of law by the National People's Congress." This has provided for a basic legal framework of what Deng Xiaoping later called the formula of "one country, two systems" (Qimao Chen 1987, 1170-1).

In 1983, Deng said that after unification Taiwan could continue to buy weapons abroad to sustain its own defense capability, "so long as they do not constitute a threat to the motherland."31 Taiwan could also enjoy certain power in foreign affairs such as signing commercial and cultural agreements with foreign nations and keep its own judicial system including final judgement power.32 On June 22-23, 1984, during the period of negotiation on the question of returning Hong Kong, Deng referred to China's policy as "one country, two systems," i.e., allowing Taiwan to "keep its own independent character and keep its own system different from that of the mainland" (Deng 1987, 41-2).

However, Deng rejected the concept of "complete autonomy" and placed two important limitations on the "high degree of autonomy." The two restrictions are Taiwan can no longer be called the Republic of China but called China-Taipei or China-Taiwan and the People's Republic of China would be the sole representative for foreign affairs and international relations. Despite Taipei's rejection of the terms of "one country, two systems," which is preconditioned on the ROC's giving up its sovereignty, the PRC decided to implement the policy in Hong Kong and attempted to use the 1984 Sino-British Joint Declaration on the Question of Hong Kong as a model for the basis of unification with
Taiwan. On September 27, 1984, a day after the announcement of the declaration, an editorial of the *People's Daily* stated that the Joint Declaration based on Deng's remarkable formula of "one country, two systems" would "promote Taiwan's return to the motherland," and noted that the same formula could be applicable to Taiwan.

The ROC on Taiwan and public opinion immediately rejected the statement. On October 3, 1984, Taiwan's Foreign Minister, Chu Fu-sung told the Foreign Affairs Committee of the Legislative Yuan (Congress) that the so-called great theory is nothing but a guise used to confuse foreign countries as Communists pursue their political plots. In essence, by agreeing to become a "special administrative region" of the PRC, the ROC would immediately lose its sovereignty and international status. Moreover, there exist no legal restraints and credible guarantees to prevent the PRC from repudiating its promise after unification. Taipei clearly remembers that during Hong Kong negotiation, PRC leaders first announced that no troops would be sent to Hong Kong after 1997, but later changed their minds. Furthermore, on April 28, 1988, the "Draft of Basic Law for Solicitation of Opinions" published by PRC's Basic Law Drafting Committee undercuts the promise of a "high degree of autonomy" provided in Joint Declaration. Article 17, paragraph 3, of the Draft authorizes the State Council to apply Chinese laws in Hong Kong in case of an "emergency" as decided by the Council, thus effectively ending Hong Kong's "high degree of autonomy" (see Chiu 1988, Copper 1995, Shaw 1988). Finally, the so-called constitutional guarantee of Taiwan's "high level of autonomy" after reunification is unreliable, because since 1949 five China's constitutions were promulgated.

In an apparent effort to break the stalemate in low-level cross strait talk, on the eve of Chinese New Year of 1995, President Jiang Zemin put forward eight-point proposal on
reunification with Taiwan. Jiang’s proposal is consistent with Deng’s formula in principle but offers different points of emphasis. According to Qimao Chen (1996, 1058), a senior Chinese scholar, Deng provided a framework for the relationship after reunification; Jiang, while reaffirming “one country and two systems” principle, focuses on how to handle cross strait relations before reunification and how to move toward it. Jiang’s proposal, which contained the clause “Chinese will not fight Chinese” and envisaged high-level exchange across the Straits, represented the acme of a moderate, non-belligerent China’s reunification approach. Since April 1996, it has again been cited as Beijing’s principal line toward Taiwan, the “breakaway province.” To Beijing’s disappointment, on April 18, 1995, Lee Tenghui issued a six-point response, reiterating Taipei’s insistence that accepting the reality of cross-strait political divisions is a condition to the pursuit of national unity (Tien 1996).

In sum, the terms of China’s peaceful reunification with Taiwan is preconditioned on “one China” principle, i.e., Taiwan is an inseparable part of China and the ROC’s relinquishment of its sovereignty and agreement to become a “special administrative region” of the PRC. In addition, Beijing never renounces the use of force against the island should Taiwan claims independence.

Taipei categorically rejects Beijing’s “one country, two systems” formula, regarding it as a political plot to relegate Taipei to the status of a local government and an excuse to annex Taiwan eventually. Before 1992, Taipei did conduct a “one China” policy. Both the Nationalists (Kuomintang Party) in Taiwan and the Communists in the mainland claimed to represent the whole of China and claims over China’s sovereignty and territory basically overlapped. Beijing said the PRC was the representative of China while Taipei said the ROC was, but both said only one China and Taiwan is an inseparable part of China. No dispute
existed over this principle.

They disagreed on everything else, but they shared a commitment to the goal of reunifying the mainland and Taiwan under a single government. This aim gave dictators on both sides of the Taiwan Strait patriotic legitimacy and formed the basis for an alliance of enemies that lasted more than four decades (Buruma 1996, 76).

However, Taipei’s formula for reunification is that China should be reunified under the principles of “freedom, democracy and equal prosperity,” as stated in Taiwan’s Guidelines for National Reunification (ROC 1994, 148-9; Copper 1995, 27-9). From Beijing’s view, that means that the mainland should give up its socialist system and reunify under Taiwan’s capitalist system, and that is obviously unacceptable. Recently, Taipei insists that it favors eventual reunification but only after China attains Taiwan’s level of development, a process that could take decades and further ensure Taiwan’s autonomy.

With the death of Chiang Jingguo in 1988 and peaceful transfer of political power to Lee Tenghui, a native Taiwanese, a new generation of Taiwan authorities increasingly appear to be less committed to one China principle (Chang 1990, 8-11). In the inaugural address following his presidential reelection by the National Assembly in 1990, Lee Tenghui called for “full academic, cultural, economic, trade, scientific, and technological exchanges” between the PRC and Taiwan, and that implicitly recognizes the PRC and abandons Taiwan's claim to represent all of China. Mainly after 1993, in the wake of economic development and democratization in Taiwan, Taipei seems to be more and more frustrated with the one China principle. In Mr. Lee’s words, Taiwan had grown up from a five-year-old kid to a twenty-year-old man who should not be fettered by the one China framework. Taipei maintains that
China had already been divided into two political entities and that ROC was originally an independent sovereign state and has the right to pursue international recognition. It accused Beijing’s opposition to its “pragmatic diplomacy” or “substantial diplomacy” as efforts to “obstruct and kill Taiwan’s living space” and vowed to overcome the opposition.41

Although major official documents, including the Constitution of the ROC and the National Guidelines of Reunification still maintain “one China” principle, Taipei’s current policy guideline can be summarized as “phased two Chinas,” or “two Chinas over a certain period of time with the orientation toward one China” (e.g., Cabestan 1996, Clough 1996, 1057-8; Yahuda 1996). This notion was originally put forth by Taiwan’s Foreign Ministry and first expressed by Economy Minister Chiang Pin-kung at the Seattle Conference of the Asian-Pacific Economic Cooperation (APEC) in November 1993.42 Widely criticized as a violation of the “one China” principle both inside and outside Taiwan, Taipei never formally recognized it nor denied it.

However, the “phased two Chinas” policy guideline reflects Taipei’s current position. This is clearly reflected in a series of Lee Tenghui’s talks and statements. As early as August 1994, Mr. Lee openly said that one China is a future and only after reunification will there be one China.43 In his inaugural speech, Lee did not mention the “one China” principle at all. In the interview with American CNN TV, Lee reaffirmed his position that at the current stage there is no “one China,” but “two separate sovereign states: the ROC on Taiwan and the PRC on the mainland”; that “one China” is an American policy and before national reunification, Taipei will never accept a “one China” policy.44

The guideline is also reflected in Taipei’s diplomacy. With the end of Cold War, Taiwan has launched a series of diplomatic initiatives characterized by “pragmatic diplomacy”
and has pursued the "parallel representation model of pre-1989 Germany and Korea" on the international arena. To a large extent, "pragmatic diplomacy" is aimed at survival, and according to Foreign Minister Frederick Chien, it "is part and parcel to the ROC’s democratic transformation" (Chien, 1991). A crucial point of Taipei’s "pragmatic diplomacy" is to raise Taiwan's international recognition and improve its international status through multifaceted channels including sending its leaders to visit countries which have formal relations with the PRC, using economic leverage to invite incumbent high ranking officials to visit Taiwan, and launching a campaign to reenter the United Nations (beginning 1993) (Yu and Longenecker 1994; Yahuda 1996, 1321-4).

The highlight of the “flexible diplomacy” was reached in June 1995 when Lee Tenghui was issued a visa to the U.S. for a “private” visit. Lee’s U.S. trip was acclaimed by Taipei and news media as a big diplomatic breakthrough, and indeed “the biggest diplomatic victory since October 1971.” Following Lee’s trip to the U.S., Prime Minister Lien Chan began with his own June 1995 tour through the Czech Republic, Austria and Hungary. Simply put, Taipei wants more international recognition, even though China has repeatedly said that it will not rule out the use of force as it starts down the road to independence. Lee Tenghui’s overwhelming popularity in Taiwan, which is further strengthened in March 1996 presidential election, has fostered skepticism of Beijing’s muscle-flexing (Cabestan 1996, 1273-4). As a result, Taipei will continue its defiance in the face of Beijing’s threats.

Most significantly, the two opposing policy guidelines on national unity and sovereignty are strongly supported by the people on both sides. If Taiwan became independent and separate, Mainland China would never tolerate. From the perspective of China, Taiwan highlights the national unity, sovereignty, and territorial integration of China;
sovereignty concerns the most fundamental national interests of China and Chinese national feelings. Taiwan issue is also regarded as a living example of Chinese humiliation over the past century and a half (Ping Deng 1997, 11-2). Any Chinese leader who is perceived as soft on Taiwan issue would be regarded as another Li Hongzhang, or Lishi ruiren (a person condemned by history).47

In this light, there is a strong degree of support for the Chinese leadership to do anything necessary to prevent Taiwan from declaring independence even if this means a large scale of military conflicts. Not surprisingly, Henry Kissinger well observes, “Whatever the cost, China will fight rather than give up what it considers Chinese territory.”48 This is in line with some Chinese scholars’ argument, “If China’s sovereignty is seriously harmed . . . China has no choice but to adopt all necessary means to protect its sacred sovereignty and will spare no blood and life in doing so (Qimao Chen 1993, 249). This is particularly true when we consider the fact that current Chinese leadership is preoccupied with securing their positions and not able to rein in the military and other hawkish elements; in the same time, as communism has fallen out of favor as an official creed, it is rousing the nationalist fervor as China’s unifying force (Ping Deng 1997, 4-6, 11-2).49

On the other hand, Taiwan’s long separation from the mainland China has created a special national identity particularly among native Taiwanese, who now account for approximately 85 percent of Taiwan’s population. This unique national identity which elsewhere is called nationalism largely contributes to the democratization in Taiwan. In a leading journal, a well-known scholar even argue that

[t]he most powerful force driving Taiwan's newborn democracy is not a rising
standard of living but a peculiar kind of nationalism. It pits those Chinese whose ancestors came to Taiwan over the past several centuries against those who fled to Taiwan from the mainland in 1949. It sets the vision of an independent Taiwan against the dream of one China. At the core of the nascent democracy is the clash between Taiwan’s nationalists and China’s old Nationalists (Buruma 1996, 78-9).

With political democratization, the transition of power to native Taiwanese has been completed. Accordingly, the dominant faction is rapidly transforming the ruling Kuomintung (KMT) into a Taiwan party, stripping of its all-China emphasis. By the early 1990s, two major groups could be identified in the KMT: the mainstream faction, primarily native Taiwanese who constitute the party’s majority, and the non-mainstream faction comprising mostly mainland-born members or children of mainlander born in Taiwan.

Democratization altered the political interests of the Taiwan authorities and their commitment to national reunification. Unlike previous leaders, the new generation are much less committed to national unity. Instead, they see their interests in perpetuating de facto separation if not outright independence. Mainstream members believe the recent KMT success can be attributed to their willingness to give the people what they want. In order for the party to continue to be vibrant and successful at the ballot box, KMT will have to become more democratic and more public-minded.

Therefore, political democratization will have two contradictory and unavoidable effects in Taiwan. As its democracy matures, Taiwan will become increasingly independent of the mainland, thus heightening concerns in Beijing. At the same time, democracy is its greatest defense against any hostile attempt by China to reunite the island. “The greatest difference between China and Taiwan is no longer the level of economic development as the
emergence of democracy has brought fundamental changes to Taiwan’s political culture. Similarities of language, custom, history, and philosophical tradition are no longer enough to keep Taiwan and China together, and democracy has become the strongest incentive for the people of Taiwan to seek independence” (Hood 1996, 482).

Furthermore, while majority of Taiwanese see the status quo (i.e., *de facto* independence) as their best interest and prefer to stop short of supporting formal independence for fear of a Chinese military attack and lose of business opportunities in the booming Chinese economy, the rising Democratic Progressive Party (DPP), with its platform of formal independence, effectively competes with the ruling KMT. Partly as a result, Taiwan authorities have sought a higher international profile by means of “flexible diplomacy” to satisfy proponents of *de facto* independence and to weaken the appeal of elements of seeking formal independence (You 1996, 119; Yahuda 1996, 1329-33).

As a result, the insistence on the two opposing guidelines on national unity and sovereignty is bound to a head-on collision, thereby forming a contributing factor to Taipei’s official restriction of economic exchanges with Mainland China. In essence, Taipei would never want to see that its archival political rival, Communist China, is getting more bargaining power over the issue of national unity, and that leverage can be obviously derived from enormous economic interactions with Taiwan. However, due to highly complementary economies, both sides face pressure to ease tension with an orientation of establishing a stable and peaceful cross-strait relationship. Most importantly, almost three-quarters of Taiwanese now favor *de facto* independence and can not afford to support the declaration of formal independence. As a result, in the aftermath of the election in Taiwan, with China captaining its threats and Taiwan suggesting the possibility of direct links with the mainland, the prospect
of imminent confrontation has died down.50

In his inauguration speech as the ROC's first-ever democratically elected president, Tenghui said that "independence is totally unnecessary and impossible . . . . I would like to embark on a journey of peace to mainland China."51 Ironically, although Taiwan's presidential election is widely seen as a dramatic assertion of Taiwanese identity, and a possible step on the road to an eventual declaration of formal independence from China, the DPP, the largest opposition party, which is most closely associated with the cause of Taiwanese independence, is the biggest loser in the election and is now playing down the issue of independence. Its new chairman, Chang Chunhung, is now reported to be saying that independence is a vote loser and should no longer be advocated by the party.52 Finally, Taipei is toning down its high-profile push to reenter the United Nations, an effort that has been a flashpoint in relations with China and may have contributed to a series of China's military exercises off Taiwan.53

Peaceful reunification might be the sacred mission of all Chinese people, yet the conditions are not mature. Most Taiwanese agree that the mainland is a backward country economically, politically, and culturally, and have serious reservation about the prospects of its being turned into a modern nation-state. Moreover, political and social development seem to be moving in opposite directions. Taiwan is moving in the direction of Western styles democracies with free market economy, while the PRC retains authoritative political system and allows only limited economic freedom. As majority of Taiwanese want to maintain the status quo and take a wait-and-see attitude, key political figures like Lee Tenghui will have to maintain a two-pronged diplomatic strategy. On the one hand, Taipei claims that Taiwan is a part of China in order to avoid a military invasion from the mainland and retain some vintage of KMT ideology necessary for the time being. On the other hand, Taipei is actively
seeking to enhance its political entity worthy of international recognition and the island’s
democratization in order to provide Taiwan with additional stature and support, despite the
widespread loss of formal diplomatic ties.

BEIJING’S NON-RENUNCIATION OF USING FORCING AGAINST TAIWAN

“Taiwan is becoming more closely tied to mainland China’s economy each year. But
the chances for political reunification seem no better now than at the height of their isolation”
(Grane 1995, 270). Taipei’s “pragmatic diplomacy” aiming to raise its international profile
has seriously upset Beijing. Political democratization in Taiwan steadily weakened the
influence of those supported reunification with China. As Lee Tenghui has consolidated
power, he frees himself from the need to compromise with domestic political forces for
reunification with China and pursues what Beijing has long suspected the policy of
consolidating Taiwan’s international autonomy. As a result, Beijing not only takes a tough
position on Taiwan's international status but also intimidates Taiwan’s independent
movements militarily.

While Beijing still believes that peaceful reunification is preferable to the alternatives,
it is beginning to show more inclination to use other means if necessary to achieve the goal.
While taken positive steps to increase contacts and improve mutual understanding, Beijing
has not ceased its efforts to isolate Taiwan internationally. It is no doubt that Lee's U.S. trip
is a success in terms of lifting Taipei's international status. However, it has also induced
Beijing to feel a new sense of urgency to deal with Taiwan issue; it repeatedly reaffirms the
use of force against Taiwan should the latter goes down its road to the declaration of
independence. Between October 1981 and October 1991, no fewer than 65 public
pronouncements of a threatening nature were made concerning the island by PRC leaders including Jiang Zemin, Li Peng, Yang Shangkun and very often by Deng Xiaoping (Metzler 1996, 155-6). Indeed, the PRC has never renounced the “right” of use of force against Taiwan. “The nature of the threat is usually couched in the caveat that any manifestation of ‘independence’ or ‘separatism’ would invite attack” (Metzler 1996, 156).

On May 27, 1990, Chinese President Yang Changkun, while receiving overseas visitors, reiterated Beijing’s non-renunciation of force against Taiwan with a remainder that “we [Chinese] have nuclear warheads, ballistic missiles, submarines, and many submarines.”54 Bordering on nuclear blackmail, such statements coming from a key figure of Chinese leadership who claimed never to use nuclear weapons against a non-nuclear states were unprecedented. On June 10, 1991, the State Council’s Taiwan Affairs Agency Chief Wang Zhaoguo commented to a visiting delegation that “if Beijing merely launches a blockade, Taiwan cannot endure it.”55 Public belligerent rhetoric denouncing the escalating independent movement reached a new height when President Yang made a speech in the memory of the 80th anniversary of the 1911 revolution led by Chinese nationalist founder Sun Yat-sen. Yang stated bluntly, “A small number of separatists be warned. Do not misjudge the situation. Those who play with fire will perish by fire.”56

Likewise in his 1995 address, although intended to offer a peaceful plan for reunification, President Jiang Zemin raised the tone against Taiwan separatism. While “fellow Chinese should not fight fellow Chinese,” Jiang refuses to refute the option of force. According to Jiang’s account, “our not undertaking to give up the use of force is . . . against the schemes for forces to interfere with China’s reunification and to bring about Taiwan independence.” In addition, Taipei’s campaign for international recognition and diplomatic
space was met with Beijing’s bellicose rhetoric and pugnaciously saber rattling such as missile tests and a large scale of military maneuvers in 1995-96. In February 1996, China’s premier, Li Peng warned that the PRC would not rule out the use of force in unifying Taiwan and stated that bringing Taiwan “back to the Motherland” was the leadership’s dearest objective once Hong Kong and Macau were handed over in 1997 and 1999 respectively.57

Despite formidable military threat, Taipei will continue to press for international recognition of Taiwan without claiming it so loudly that Beijing would resort to force. Taipei believes that an enhanced international profile and the island’s democratization provide Taiwan additional stature and support (Yahuda, 1996). Taiwan authorities will also take active military measures to protect its de facto independent status. Although with only 1/270th of China’s territory and 1/61th of its population, Taiwan’s GNP is around one-fifth of that of China (based on foreign exchanges rate in 1997). Huge foreign reserves, which has long ranked second in the world (it was just surpassed by Mainland China in 1996), and rapid economic growth have generated enough cash for Taiwan to purchase advanced weapon systems to protect itself from Beijing’s military invasion (Shambaugh 1996a, 1284).

STRATEGIC AND MILITARY STANDOFF

In strategic terms, apart from rare occasions of mutual support on territorial disputes with “foreign” countries such as the Spratlys in the South China Sea, both sides have manifested distrust and friction.58 A set of contentious trends manifest most strongly in strategic and slightly less so in political interactions. Accordingly, mutually distrustful perceptions have been reinforced by the increasingly unfriendly, if not hostile, strategic behavior of each party. Beijing’s non-renunciation of the use of force has further aggravated
Taipei's misgivings, and Taiwan feels compelled to accelerate its military strengthening. A set
of military contentions certainly portend Taiwan authorities' relative gains concern over the
across-strait economic interactions.

Flush with cash from fast-growing economies, both Taipei and Beijing are spending
billions of dollars on modern weapons systems, thus constituting an extreme example of a
broader trend of arms race visible across East Asia. That tit-for-tat mentality has been in full
swing since China conducted missiles tests in Taiwan Straits in an attempt to intimidate
Taiwan's independent movements during summer 1995.

Taiwan's impressive progress in defense capability emphasizes improvement in quality
over expansion in quantity (Clough 1996, 1061-4; Shambaugh 1996a). Its military equipment
is generally more up-to-date than that of the mainland. The 1989 Taiwan's defense budget
was $6.84 billion, exceeding $6.67 billion budget of the People's Liberation Army of China
(PLA). Taipei's defense expenditures grew 27 percent to $8.69 billion in 1990, and another
7 percent to $9.29 billion in 1991, surpassing the published PLA's military spending every

Such efforts have continued and probably accelerated with the end of the cold war.
Since the early 1990s, Lee Tenghui has presided over a vigorous upgrading of U.S. military
sales to Taiwan, thereby reaffirming America's security commitment to the island, which
Beijing had sought so assiduously to erode. In 1992, Taiwan was allowed to purchase as
many as 150 advanced F-16s from the United States. Taipei not only takes full advantage of
the 1979 Taiwan Relations Act (TRA), in which the U.S. pledged to provide Taiwan with
arms sufficient to protect itself and purchases a large amount of better and newer weapons,
but also is increasingly active in indigenous development of armaments (Ping Deng 1997, 7-
Chiefly with U.S. technology, Taiwan has developed its own surface-to-air missile, air-to-air missile, and a surface-to-surface missile capable of destroying warships at long range. Taipei also co-produces advanced frigates with an American shipyard. In the meantime, Taiwan is striving for diversification of weapon suppliers. In 1992, Taiwan bought 60 Mirage 2000s jets and six Lafayette-class frigates from France (IISS 1993, 1995).

More significantly, Taiwan is good at exploiting every military standoff across the Taiwan Straits to improve its military built-up (Shambaugh 1996a, 1316-7). Facing the threat of China's missile tests in summer 1995, Taiwan immediately announced a 20 percent increase in military expenditures for the year 1996-97, to $11 billion. Meanwhile, the hostile atmosphere across Taiwan Straits has led to a breakthrough in sales of a whole range of systems that the United States would not countenance before. In March 1996, U.S. Congress lifted some restrictions on arms supplies to Taiwan, which may enable it to buy American submarines and anti-submarine aircrafts (Ping Deng 1997, 8).

For the time being, China is not capable of mounting a full-scale invasion of Taiwan (Shambaugh 1996a, 1317-8). Western intelligence noted that it had only enough vessels to land one division (about 20,000 army personnel). Although Chinese military enjoys a strong numeral advantage over Taiwan, but not in quality. Much of the Chinese defense technology is decades-old and pilot training also is weak. Taiwan has a precarious superiority in all the relevant fields except submarine warfare. No wonder, some China scholars comfortably conclude that “At this point, the two sides are too evenly balanced for outsiders to say which would prevail in an invasion attempt” (Nathan 1996, 91).

However, China could try to blockade Taiwan or simply lobby missiles at it. “Even if China cannot easily invade, it can certainly intimidate” (You 1996, 119). China's 2.9 million
armed forces dwarf those of Taiwan, which has only 370,000 people under arms. In an invasion scenario, the Chinese military could overwhelm Taiwan quantitatively by ten-to-one ratios of aircraft, naval vessels and troops (Shambaugh 1996a, 1295-6).

Taipei can also no longer be oblivious to the longer term growth of Chinese military power, which is most likely to increase Taipei's vulnerabilities. China is not only trimming its once-vast military troop to more efficient levels but getting the most complicated weapons by exploiting its increasing economic power and post-Cold War international environment (Wortzel 1994). In 1994, China has displayed its two dozen Su-27 advanced Russian fighters, while continued to work with Israel on the f-10, a fighter that has already been in service beginning 1995. In 1996, China took delivery of two Russian kilo-class submarines and have ordered several more. On the other hand, Taiwan is dependent on foreign suppliers for key weapons systems. With Mainland China becoming economically stronger, Taiwan tends to be increasingly isolated on the international arena and its military supply sources thus become more limited. Buoyed by spectacular economic development, China is rapidly increasing its military spending and vigorously moving forward with the modernization of its aimed forces. In 1994, PRC's defense outlay rose by 22 percent and in 1995 it was slated to grow 21 percent (ROC 1995, 1996). Beijing's military buildup and more aggressive assertion of sovereignty over Taiwan are putting Taipei in an especially dangerous position.

ISOLATION OF TAIPEI INTERNATIONALLY

To a large extent, Taiwan's international status varies with its economic leverage relative to that of Mainland China. Since 1971 when Taipei lost its UN seat, the number of the countries that has diplomatic relations with Taiwan keeps on falling while the number that
has established official relationship with the PRC tends to increase in a continuous linear fashion (see Table 3.2).

Table 3.2 No. of Countries Recognizing the PRC and ROC
(1970-1997, selected years)

<table>
<thead>
<tr>
<th>Year</th>
<th>PRC</th>
<th>ROC</th>
<th>UN Membership</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>54</td>
<td>67</td>
<td>127</td>
</tr>
<tr>
<td>1971</td>
<td>69</td>
<td>54</td>
<td>132</td>
</tr>
<tr>
<td>1975</td>
<td>105</td>
<td>27</td>
<td>144</td>
</tr>
<tr>
<td>1980</td>
<td>121</td>
<td>22</td>
<td>154</td>
</tr>
<tr>
<td>1985</td>
<td>127</td>
<td>23</td>
<td>159</td>
</tr>
<tr>
<td>1990</td>
<td>136</td>
<td>28</td>
<td>160</td>
</tr>
<tr>
<td>1995</td>
<td>156</td>
<td>29</td>
<td>181</td>
</tr>
<tr>
<td>1997</td>
<td>168</td>
<td>27</td>
<td>195</td>
</tr>
</tbody>
</table>


Moreover, among the current 27 countries which officially recognizes Taiwan, none of them are influential and most are obviously lured by Taiwan’s cash; since South Korea recognized the PRC in 1992, not a single Asian country has formal diplomatic ties with Taipei (see Table 3.3). To make the matter worse, on November 27, 1996, South Africa, Taipei’s most important diplomatic ally, formally announced that it would sever its official ties with Taiwan and recognize the PRC beginning 1998. On May 28, 1997, Bahamas also decided to recognize Beijing rather than Taipei.

On top of that, Mainland China has a much larger economy and possesses enormous commercial opportunities for other countries. It has also been experiencing a higher economic growth rate for a dozen of years. Hence, Taipei’s international status, which is fundamentally determined by each other’s economic strength, is certainly not favorable to Taipei. Indeed,
Table 3.3 Countries That Maintain Official Relations with Taiwan
(As of May 1997)

<table>
<thead>
<tr>
<th>Region</th>
<th>Name of the Country</th>
<th>Date of Recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Pacific Islands</td>
<td>Kingdom of Tonga</td>
<td>April 10, 1992</td>
</tr>
<tr>
<td></td>
<td>Republic of Nauru</td>
<td>May 4, 1980</td>
</tr>
<tr>
<td></td>
<td>Solomon Islands</td>
<td>March 24, 1983</td>
</tr>
<tr>
<td></td>
<td>Tuvalu</td>
<td>September 19, 1979</td>
</tr>
<tr>
<td>Africa</td>
<td>Burkino Faso</td>
<td>February 1994</td>
</tr>
<tr>
<td></td>
<td>Central African Republic</td>
<td>July 8, 1991</td>
</tr>
<tr>
<td></td>
<td>Gambia</td>
<td>July 13, 1995</td>
</tr>
<tr>
<td></td>
<td>Liberia</td>
<td>October 9, 1983</td>
</tr>
<tr>
<td></td>
<td>Malawi</td>
<td>Pre-1971</td>
</tr>
<tr>
<td></td>
<td>Niger</td>
<td>June 19, 1992</td>
</tr>
<tr>
<td></td>
<td>South Africa</td>
<td>1976</td>
</tr>
<tr>
<td></td>
<td>Swaziland</td>
<td>Pre-1971</td>
</tr>
<tr>
<td>Europe</td>
<td>Vatican</td>
<td>Pre-1971</td>
</tr>
<tr>
<td>Central &amp;</td>
<td>Belize</td>
<td>October 1989</td>
</tr>
<tr>
<td>South America</td>
<td>Coasta Rica</td>
<td>Pre-1971</td>
</tr>
<tr>
<td></td>
<td>Dominican Republic</td>
<td>May 10, 1983</td>
</tr>
<tr>
<td></td>
<td>El Salvador</td>
<td>Pre-1971</td>
</tr>
<tr>
<td></td>
<td>Grenada</td>
<td>July 20, 1989</td>
</tr>
<tr>
<td></td>
<td>Guatamala</td>
<td>Pre-1971</td>
</tr>
<tr>
<td></td>
<td>Haiti</td>
<td>Pre-1971</td>
</tr>
<tr>
<td></td>
<td>Honduras</td>
<td>Pre-1971</td>
</tr>
<tr>
<td></td>
<td>Nicaragua</td>
<td>November 1990</td>
</tr>
<tr>
<td></td>
<td>Paraguay</td>
<td>Pre-1971</td>
</tr>
<tr>
<td></td>
<td>St Christopher and Nevis</td>
<td>October 1983</td>
</tr>
<tr>
<td></td>
<td>St Lucia</td>
<td>May 1984</td>
</tr>
<tr>
<td></td>
<td>St Vincent and Grenadines</td>
<td>Pre-1971</td>
</tr>
</tbody>
</table>

Sources: List supplied by the Press Division of the Taipei Representative Office in Britain and cited in Yahuda (1996, 1327).

China has wielded its growing commercial clout to bully other countries into isolating Taiwan.

Today, Taipei can not send top people even to meetings in which it participates, such as the APEC (Asian-Pacific Economic Cooperation) or the International Olympic Games. Beijing is also directly digging up Taipei's foreign policy foundation and intends to destroy any room
that Taipei might move in the international community.\textsuperscript{61}

Thus, concern over Mainland China's relative position both politically and economically compels Taiwan authorities to calculate two-way economic cooperation in relative gains terms. After all, huge cross-strait trade and investment have become a contributing factor to rapid Chinese economic growth. The State Statistical Bureau of China has identified foreign investment as one of the "main" contributors to China's sustained industrial growth, the others being collectively owned and private enterprises.\textsuperscript{62} Through their investment in productive enterprises in China, particularly those engaged in exports and imports, Taiwanese investors have become a major force behind China's economic success. However, the military power which is stimulated by China's remarkable economic growth could help it one day to retake Taiwan by force.

As a powerful China has more alternatives to kill Taipei's international living space and militarily intimidate Taiwan, striping Taiwan off its \textit{de facto} independence, Taipei has every reason to desperately block China from achieving relative gains from a large scale of two-way economic interactions. Based upon this reasoning, economic interdependence may have exacerbated rather than lessened its security concern -- the government of Taiwan is particularly wary of its economy becoming "hostage" to Mainland's political goals.\textsuperscript{63} As a result, Taipei's official "go South" investment strategy and prevention of Formosa Group from investing in China constitute a typical part of its restrictions on cross-strait economic interactions. Those behaviors clearly reflect Taipei's relative gains calculation.

\textbf{"GO-SOUTH" STRATEGY: OFFSETTING GROWING DEPENDENCE}

In the beginning of 1994, Taipei launched a "southern strategy" to encourage
investment in Southeast Asian countries and to shift Taiwan’s business emphasis towards that region and away from China. Several external policy measures have been adopted to facilitate investment in that region.

First, the Executive Yuan enacted the Operational Programs for Economic and Trade Relations with the Southeast Asian Region, whose goals were to conduct research on economic and trade development in Southeast Asia through data collection and holding symposiums; to strength bilateral trade by helping businesses set up marketing channels; to promote mutual investment by providing banking and insurance services; and to use the government financed Overseas Economic Cooperation Fund (OECF) to support private businesses indirectly (Chi 1995, 28-30).

Second, Taipei has set up special cooperative work groups to focus on promoting trade with, and investment in Singapore, Indonesia, the Philippines, and Vietnam. The work groups on Indonesia and the Philippines helped develop the industrial parks on Batam Island of Indonesia and in Subic Bay of the Philippines. Under this formal policy structure, Taiwan signed an official agreement to provide a low-interest loan of $60 million through the OECF to improve the physical infrastructure in Subic Bay. Taipei also provided $45 million to help Vietnam improve its business infrastructure.  

Finally, Taipei sent a number of its leaders to visit the region in order to stimulate investment there. President Lee Tenghui’s “diplomatic vacation” in the Philippines, Indonesia, and Thailand in early 1994 gave the highest official blessing to the “go South” investment initiatives. The “inspection” tours by Taiwan’s Minister of Economic Affairs to Batam Island of Indonesia in November 1993 and Subic Bay of the Philippines in February 1994 provided a strong boost to the investment confidence of Taiwanese firms in these specifically targeted
areas. Those conscious policies no doubt reflect the aggressive effort of Taipei to "seize the chance" to continue advancing Taiwan's position in the world economy through internationalizing state-business relations (Xiangming Chen 1996, 448-51).

Apart from economic complementarity, Taipei sees less political risk in developing close business ties with ASEAN countries (the Associations of Southeast Asian Nations) because they have more compatible ideologies and political systems. Most of these countries also have bilateral government agreements with Taiwan to guarantee its investment. Moreover, they are potentially large markets. Taiwanese capital is also attracted there because of a longer history of Taiwan's investment and more familiarity with business environment there than elsewhere. While officially initiating the "go South" policy in 1994, Taiwanese companies began investing in Southeast Asia in 1959 when they set up a cement factory in Malaysia (Xiangming Chen 1996, 453).

Between 1959 and 1980, the bulk of Taiwan's investment was concentrated in that region, especially in Malaysia and Thailand. However, Taiwan's investment there declined dramatically in the early 1990s, mainly due to a diversion of investment to Mainland China. Furthermore, a number of new incentives were introduced in the ASEAN countries. For instance, both Indonesia and the Philippines in 1994 began to allow foreign companies to have 100 percent equity ownership; to attract specific industries, the Philippine offered Taiwan some of its textile and garment quotas for exports to the U.S. (Xiangming Chen 1996, 452).

However, with high inflation and rapidly rising wages in those countries, cost of investment and manufacturing has increased. In addition, policy of Malaysia and Thailand aimed to pull back from labor-intensive industries and withdraw the incentives for foreign investment in them. Furthermore, physical infrastructure in some areas remains poor and
underdeveloped. Those factors, combined with religious and language barriers, make it more difficult to invest, thus reducing Taiwanese investment momentum there. This investment downturn is largely confirmed by a comprehensive survey of Taiwan's Ministry of Economic Affairs in 1994. According to the survey, during the next three years, less than 20 percent of the surveyed firms intended to invest in ASEAN countries (excluding Brunei), and that is much lower than those planning to invest in China (48%) and only a little higher than those planning to invest in Hong Kong and the U.S. (10% and 9% respectively). 65

Taipei officials maintain that investment in China and Southeast is somewhat complementary, with both serving the goal of developing Taiwan as the operational center of transportation, manufacturing, telecommunications and financial services for the Asian-Pacific, which in its most ambitious form envisions Taiwan as a regional hub linking Singapore and Shanghai. 66 However, in essence, this strategy is an attempt to cool down the high “investment fever” in Mainland China and to develop an alternative to increasing economic interdependence with China.

Since the late 1980s, Taiwanese investment in China has increased dramatically and has been gaining further momentum in the 1990s. Cumulative investment reached $14.5 billion through June 1993 in a total of 15,812 ventures. Even official Taiwanese approved investment in China which tends to be much lower than the actual one indicates that Taiwan’s investment jumped dramatically in 1993, with a total investment of around $3.2 billion involved in 9,329 projects, while in 1992 with only 237 million in 264 projects. 67 As investment and trade tend to go together, exports to China in 1994 reached a new record high, $12.6 billion, second only to that of the U.S. 68

Too much trade and investment may make Taiwan’s economy too dependent on
China's market. The most commonly used evidence for this market dependence is that Taiwan's trade with China as a share of its total trade has grown too fast and become too large, from 1.5 percent in 1986 to 8.4 percent in 1993; this would double to 17 percent if illegal direct shipment across the Taiwan Straits and other transit trade via places other than Hong Kong were included. Measured more meaningfully in terms of export volume, in 1993, Taiwan depended on the China market for 16.5 percent of its total exports. By 1995, China had become Taiwan single most important export destine (see Table 3.1). Taipei estimated that discontinuation of all trade with China could result in an annual loss of $12 billion, equal to its approximate total exports to China through Hong Kong in 1994, and turn Taiwan's overall surplus into a deficit.

Economic interdependence across the Taiwan Straits has increased so rapidly that Taipei fear that the growing relationship could make Taiwan "hostage" economically to China because "threats to terminate the relationship differentially influence the side gaining relatively more" (Milner 1992, 487). According to Robert Keohane and Joseph Nye (1977), power in an interdependent relationship flows from asymmetry: the one who gains more from the relationship is the more dependent (see also Baldwin 1980). Largely due to the zero-sum political competition, Taipei is trying to channel capital flows in ways that are consonant with its security interests. From the Taipei's perspective, the "go South" policy serves as alternative to gradually detract from the advantages that accrue from its proximity to the mainland China and offset the growing economic dependence; it also acts as a means of responding to domestic political and economic pressure (Xiangming Chen 1996; Liu 1994, 30-4).

Furthermore, the "go South" strategy is a deliberate effort to strengthen economic
diplomacy toward Southeast Asia, and the development of political and economic relations with ASEAN countries in turn helps enhance Taiwan’s international profile. The strategy also clearly demonstrates Taipei’s typical diplomatic measure: Use of its economic power trying to resume formal ties or build better ties with others and revive its political standing in the international community. This was especially true after the loss of its only remaining diplomatic partner in Asia, South Korea in August 1992. As a scholar well observes,

[w]hile the geoeconomic factors created by the emergence of the subregional growth zones have become very significant, geopolitical conditions remain important in channeling Taiwanese investment to Southeast Asia. After all, the go-South program is a conscious government policy, and some major respondents have been KMT-controlled firms. The recently popular investment sites in Southeast Asia-Batam Island, Medan, and Subic — are also in highly favorable and strategic physical locations (Chi 1995, 466).

Sending its officials to visit those highly visible investment sites whose countries have official relations with China can certainly help increase Taiwan’s international recognition. The “go South” strategy largely contributed to Lee Tenghui’s highly publicized Southeast Asian “vacation tour” in early 1994. During the tour, Lee visited Indonesia, the Philippines and Thailand, and that drew Beijing’s strong protest against those host countries. In the zero-sum diplomatic competition, that is definitely beneficial to Taiwan’s international profile.

Finally, in order to take full advantage of the financial crisis in East Asia, Taipei has recently reemphasized its old “go South” policy, encouraging businessmen to invest in South-East Asia rather than China. Although businessmen in Taiwan see more volatility than opportunity there, government officials in Taiwan have obviously tried to steer business away from the mainland, thereby increasing its diplomatic and economic leverage in the region and
offsetting its growing economic dependence upon China. Taipei's strategy remains the same: Using its wealth to build better ties to its neighbors.

FORCING FORMOSA GROUP TO WITHDRAW MAINLAND INVESTMENT

Immediately after President Lee Tenghui called on Taiwan's companies to scale back their Chinese investments in August 1996, the island's biggest manufacturer, Formosa Plastics Group, was forced by Taipei to withdraw an application to build a $3.8 billion power plant in southern China. That prohibitive measure constitutes a critical part of Taipei's long struggle to limit mainland investment. This was a development of some significance, given that Formosa Plastics is Taiwan's largest non-state company and its proposed power station would have been the biggest-ever foreign investment in the mainland's history. With its plan, the petrochemical giant could tip the economic balance across the Strait and make Taiwan's economy more dependent upon Mainland China.71

After several years of deliberations and planning, in May 1996, Formosa Plastics Group announced to invest $3.8 billion in Chinese power plants as the centerpiece of a vast petrochemical complex. The project, which would top any investment made by multinationals in China and would be 22 times the size of the next-largest investment by a Taiwan company in China.72 Formosa Plastics is the world's largest producer of polyvinyl chloride, a widely used plastic, and one of the most vertically integrated petrochemical producers even by international standards. The group almost singlehandedly created Taiwan's world-class plastics industry.73 According to the company's 1995 annual reports, its 1995 revenue was at $10.8 billion, with pretax profits of $1.3 billion; it has 18 chemical-processing companies in the United States as well. As the island's biggest private employer, it accounts for 5 percent
of Taiwan's economic output.

The initial phase of its investment involves the installation of two 600,000-kilowatt generators with an investment of about $1.2 billion. If Formosa follows through with plans to build six thermal power plants in the coastal province of Fijian, it is most likely to set the stage for later investments of its core petrochemical business, thus starting a large-scale shift to the mainland, where it already has a handful of plastic factories. This is well indicated by the fact that Nan Ya Plastic Corporation, the group's biggest subsidiary and the world's largest maker of synthetic leather, has planned to move about a third its factories to the mainland in the next three years. Formosa's huge investment in the mainland could also herald a massive exodus of other manufacturing companies to China. In addition, by picking the power plant industry as his starting investment point in China, Formosa Plastics is putting its money in the type of basic infrastructure that Chinese government most favors. Because of the significance of the investment program both economically and politically, China, Taiwan's archival, has been aggressively bidding for Formosa Plastics Group's confidence.

When the group was picking a construction site, Chinese government high officials announced a large scale infrastructure project to ease the way. China's economic czar, Vice Premier Zhu Rongji dined with Wang Yu-ching, founder and chairman of Formosa Plastics, on his April 1996 mainland visit. In addition, Wang "was warmly received" by Shi Dazhen, China's minister of electric power, who "promised to offer necessary help at Mr. Wang's request," according to a ministry spokesman. The political significance of the Formosa's potential investment is further reflected in the fact that other big similar China's favored power projects have not gone forward quickly. For example, Hong Kong tycoon Li Ka-shing had waited three years for approval of a similar-size power plant in Zhuhai, a special
economic zone on the southern coast.76

As a result, Taipei got very nervous with the investment initiatives and had to force Formosa Plastics out of the move. In essence, “if [Formosa Plastics] goes to China to invest, it will create a crisis of confidence among Taiwan companies . . . . What Taiwan fears most is that China's economic influence will surpass Taiwan's.” To a large extent, Formosa Plastics’ withdrawal of its intended investment underlay Lee Tenghui’s warning to look at ways of limiting Taiwan’s investment in China in August 1996.77 Most business see the island’s economic future as inseparable from China’s. However, if Taipei does not deliver on its call to limit investment in China, it will have less clout in strengthening its hand for the future tough talks over political issues exempted by national reunification.

RELAXATION OF ECONOMIC RELATIONS AND “DEFENSIVE COOPERATION”

At the government level, Taipei is apparently less responsive to Beijing’s appeal for full-scale economic exchange and reacts more slowly to the fast-evoking reality shaped largely by the economic initiatives of Taiwanese citizens. However, Taipei has gradually and cautiously relaxed restrictions on bilateral economic relations. By 1990, Taiwan’s commercial policy of the “Three Nos” existed in name only. In mid-January 1990, then Economic Minister, Chen Li-an, indicated that his government should not regulate trade and investment by means of restrictions, and that his ministry would reconsider its current policy of banning direct investment on the mainland.78

While continuing to ban official direct trade, Taipei has incrementally expanded the list of agricultural and manufactured commodities that can be indirectly imported. That list
grew, year by year, from 30 items in 1987 to approximately 4,500 at the end of 1994. In 1990 Taipei allowed indirect investment in the mainland, and in 1991 Taipei’s Ministry of Economic Affairs began to promote a division of labor in which core factories are based in Taiwan (“keeping the roots planted”) and peripheral (supporting) factories are set up in China (“letting the branches and leaves grow out”) (Lin 1993). Between August and October 1994, Taipei approved hundreds of new products whose manufacturers could invest in China, and it also decided to allow trade officials and managers to visit Taiwan for business purposes. Finally, despite the political standoff which can be traced to the summer of 1995 when President Lee Tenghui made a US visit and China fired missiles in the waters off Taiwan, Taipei’s approved investment in China jumped 22 percent in the first 11 months of 1997. This is particularly significant given that the overall foreign direct investment in China grew only 3 percent in 1997.

<table>
<thead>
<tr>
<th>Year</th>
<th>Volume</th>
<th>% Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>$0.95</td>
<td>N/A</td>
</tr>
<tr>
<td>1995</td>
<td>1.14</td>
<td>20.12%</td>
</tr>
<tr>
<td>1996</td>
<td>1.47</td>
<td>28.95</td>
</tr>
<tr>
<td>1997*</td>
<td>1.79</td>
<td>21.77</td>
</tr>
</tbody>
</table>


*Through November. Actual Taiwanese investment is much larger.

No doubt, Taipei’s relaxation of the cross-strait economic interactions is mainly
reactive to enormous domestic pressure. Moreover, Taipei clearly recognizes that economic interaction has manifested unexpected momentum and that trends towards cooperation and integration seem more numerous and significant than those arguing conflict and disintegration. Given the existing and growing degree of economic integration, the political costs of halting or even slowing trade, investment and labor flows will likely be too high for Taiwanese leadership to bear. Taiwanese officials are obviously in the position of reacting to domestic pressures to further liberalize trade and investment in Mainland, while being constrained from doing so by security concerns.  

Investment in China has generally been labor rather than capital intensive, due to the massive relocation to the mainland of Taiwan’s small and medium sized firms in highly labor-intensive industries. This economic integrity, based largely on vertical division of labor, can encourage industries in China to concentrate on low value-added manufacturing while allowing Taiwan to accelerate industrial upgrading. That is certainly in the Taipei’s best interests. After all, Taiwan has been undergoing a fundamental transition from a labor-intensive economy to a semi-technological and capital-intensive one; Taiwan’s government has been encouraging the upgrading of its economy. It also encouraged the business community to reduce its dependence on U.S. market and diversify its exports to others.  

As Taiwan's traditional markets either became saturated or increasingly difficult to crack because of protectionism, enormous economic opportunities in Mainland China could not have come at a better time. Moreover, as Southeast Asian countries such as Malaysia and Thailand increasingly pulled back from labor-intensive industries and withdrew the incentives for foreign investment in them, investment in vast new China market seemed to be a natural choice especially for those small and medium-sized private firms most of which were textile.
and shoe manufacturers. Furthermore, rapidly increasing labor and land costs, the labor shortage and local environment movement compelled businessmen to actively look for opportunities to move their operations in coastal China, where environment regulations is quite relax. By taking advantage of the mainland’s low-cost labor and land, they turn out final products at competitive prices for exports. Finally, in Taipei’s point of view, the growing dependence of China’s coastal regions on trade and investment with Taiwan will inhibit Beijing from accelerating direct military pressure on the island, since a large scale invasion of Taiwan would put China's broader developmental goal at risk.

Therefore, it is in the Taipei’s best interests to let its companies to invest in China and take full advantage of enormous market opportunities there. If Taiwan had not invested there, huge economic opportunities would have been taken by other countries, and that would put Taipei in a more disadvantageous position. In this sense, Taipei cooperates with China for fear that other states will get ahead by cooperating among themselves, and that might strengthen China’s relative capabilities over Taiwan. Based upon relative gains consideration, if Taiwan refuses to invest or trade there, China may work together with other countries and gain even greater relative advantages over Taiwan than it might otherwise. As the economic and political costs of halting cross-strait economic flows are too high, a wise option for Taipei is to try to manage and channel growing interdependence to its own possible political advantage. As a result, relative gains consideration might also well account for why Taipei has gradually relaxed its economic interactions with China. This empirical evidence has to a large extent confirmed what Duncan Snidal calls “defensive cooperation,” which essentially “makes cooperation the best defense (as well as the best offense) when your rivals are cooperating in a multilateral relative gains world” (Snidal 1991a, 722; 1991b; see also Milner
In addition, expansion of economic relations with Mainland China means market diversity. Diversity of its once predominant trade links with the U.S. has fundamentally reduced the growing pressure to reduce once-lopsided trade conflict with the U.S. In this sense, building commercial bridges across the Taiwan Straits might have been a delicate but deliberate Taipei official endeavor, carefully taking advantages of opportunities to create trade conflicts between Mainland China and the U.S. while at the same time reducing Taiwan’s trade deficit with the U.S. That certainly can act as an implicit political activity to worsening Sino-U.S. relations and improve Taipei’s friendly image in the U.S., thus strengthening Taiwan’s diplomatic leverage relative to China.

In 1996, the United States imported $51 billion-worth of Chinese goods, $40 billion more than China bought from it. Moreover, the deficit tends to keep growing. The U.S. trade deficit with China was $31 billion for the first eight months of 1997, 28 percent wider than the year before. America’s Trade deficit with China, which was nil in 1985, is now second only to that with Japan. Political significance of trade deficit is considerable in that it highlights China’s economic conflict with the U.S. However, much of China’s trade deficit with the U.S. just reflects a shift of production by Asian manufacturers into China from Taiwan and Hong Kong. Cheap Chinese labor has persuaded firms to move Taiwanese labor-intensive production into China. Goods that America once imported from Taiwan now count as Chinese, increasing its recorded imports from China and cutting the corresponding figures for Taiwan. Not surprisingly, U.S. deficit with China and Taiwan combined rose by less than 10 percent between 1987 and 1992, but its deficit with China alone grew by a whopping 550 percent.
Huge Sino-U.S. trade deficit is bound to increase pressure on China to import more U.S. goods and stiffen the U.S. resolve to force Beijing to agree to tough terms before approving its entry into the World Trade Organization (WTO). It has also provided ammunition for friends of Taiwan in the United States against Communist China, thereby strengthening Taipei’s relative capabilities to deal with the US, while at the same time decreasing those of China. However, it is Taiwan’s investment that is indirectly or directly heightening trade frictions between Beijing and the US by driving up China’s trade surplus.\(^6\)

The huge trade surplus number did not emerge until the Taiwanese invested in China. After all, “[a]t least 70% of the growth in China’s trade surplus with the U.S. is in one way or another linked to Taiwan companies.”\(^7\)

**ALTERNATIVE WAY TO EXPLAIN TAIPEI'S RESTRICTIVE POLICY: “HOLLOWING OUT”**

The “hollowing-out” theory has been commonly used to account for governmental restrictions of domestic capital outflows in general and restriction of Taiwan’s mainland investment in particular. It is essentially concerned with the massive export of a nation’s manufacturing and innovating capacity (Fumio and Kiba 1994, 22). According to the theory, heavy manufacturing investment may lead to deindustrialization in Taiwan. In other words, migration of capital and jobs to coastal China will lead to both a capital shortage in Taiwan and a hollowing out of the island’s industrial base. Some data seem to support this view. For instance, a Taiwan source attributed the loss of nearly 20,000 manufacturing jobs and $10 billion in manufacturing output due to the shift of production to China through 1993.\(^8\)

Taiwan's key industries might “hollow out” if company invest too much in China.
However, more evidences do not support the "hollowing-out" theory and thus it can not provide a good account for Taipei’s restriction on mainland investment. First, most of the manufacturing activities that have been relocated in the mainland are no longer competitive in Taiwan. Besides, Taipei still bans investment in China industries it regards as strategic, such as high-tech and infrastructure projects (Kao et al. 1995, 18).

Second, the overwhelming majority of the firms with investment in the mainland keep more important functions such as R&D, product design and engineering, finance and accounting, sales and marketing, planning and inventory control, and after-sales services in Taiwan. That to a large extent meet Taipei’s expectations: to safeguard core industries, large companies should invest locally before they cross the Taiwan Straits (Hsu 1993, 70, 97).

Third, Taiwan's industries have already upgraded to more capital- and technology-intensive products and exports. Government data show that the share of high labor-intensive products in Taiwan's total labor-intensive exports decreased from 47.6 percent in 1987 to 39.2 percent in 1992, while the high capital products's share in its total capital-intensive exports rose from 22.4 percent to 29.3 percent.  

Fourth, had Taipei really been concerned with capital outflows, it would have not initiated the "go South" strategy in early 1994. That strategy aims to increase investment in Southeast Asia. Moreover, in the wake of recent Asian financial crisis, Taipei has reemphasized the investment strategy. After all, Taipei has one of the highest foreign currency reserves in the world, and has been flexing its economic muscle to extract political gains on the international arena.
Table 3.5  Taiwan’s Gross Domestic Investment  
(In billions of U.S. dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment Value</th>
<th>As % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>$38.3</td>
<td>23.1%</td>
</tr>
<tr>
<td>1991</td>
<td>42.2</td>
<td>23.3</td>
</tr>
<tr>
<td>1992</td>
<td>54.5</td>
<td>24.9</td>
</tr>
<tr>
<td>1993</td>
<td>55.7</td>
<td>25.2</td>
</tr>
<tr>
<td>1994</td>
<td>57.1</td>
<td>23.9</td>
</tr>
<tr>
<td>1995</td>
<td>64.2</td>
<td>24.5</td>
</tr>
</tbody>
</table>


Finally, while Taiwan’s investment in China has been increasing, so has its investment at home. In addition, the domestic investment as a proportion of GDP is actually rising, albeit slightly (see Table 3.5).

Many Taiwanese companies believe that investment in China, far from damaging their island, represents its best hope for the future. As costs rise in Taiwan itself, China offers a new source of cheap labor, while Taiwanese companies can supply the capital and technology. It is this sort of reasoning that leading companies press for a relaxation of the ban on direct links — whatever the security implications. However, Taipei says it will not restore direct links until China renounces the threat of force against the island and treats the government in Taipei as its equal. Until these are met, Taiwan's trade with China has to go through somewhere else, usually Hong Kong. Obviously, what Taipei worries most is not the "hollowing out," but that as more Taiwan’s companies become dependent on the mainland, Beijing will gain political leverage over Taipei.
SUMMARY

Through the above careful analyses, we have found that Taipei’s economic restrictive behaviors are ultimately rooted in its deep security concerns that are largely derived from the fear of a growing economic dependence on Mainland China. Treating Taiwan as a runaway province, Beijing constantly isolates Taipei diplomatically and threatens Taiwan’s physical survival. In the meantime, Taipei is trying every effort to maintain its de facto independent status and seek international recognition. Mainly due to the dominating logic of security competition and the possibility of war always in the background, Taiwan must be motivated primarily by relative gains concerns when engaged in economic interactions with China. In other words, while to maximize its absolute gains is important, it is more important for Taiwan to make sure that in any economic agreement it does better, or at least not worse, than China. The major findings of the empirical case study will be further elaborated in the concluding chapter.
NOTES


7. *The Economist*, “China and Taiwan Takes Cares of Business,” August 19, 1995, p. 34. Yet, the official Taiwanese figure demonstrated a total $4.8 billion invested in 10,800 companies in the mainland, and that is certainly too low. One of the key reasons is that many small and medium-sized companies do not report their investment plans to Taiwan's Ministry of Economic Affairs.


17. Greater China is most commonly used to refer to an economically integrated geographical area comprising the 120 million inhabitants of Hong Kong, Taiwan, and the provinces of Guangdong and Fijian in southern China (Ash and Kueh 1993, 712-3). It can be regarded as an "iron triangle" constituting a complementary and interdependent commercial and economic partnership (Chang 1995, 964).


26. Concerns for Beijing include the fear that greater presence of Taiwanese economic power on the mainland might weaken people confidence in the Communist regime, compared to Taipei's success in development, and that a network of Taiwan investors might defy Beijing's control. See, _Shijie ribao_ (in Chinese), "Communist China Actively Invited Taiwan Investors but Prevented Them from Networking," December 15, 1989, p. 31.

27. As a matter of fact, the Taiwan issue supersedes all others in China's foreign policy. To that end, Beijing's Taiwan strategy has four elements, as observed by Michael Swaine at
RAND Corporation, an American think: Creating conditions under which Taiwan would benefit from good relations with the mainland; maintaining pressure on other states to isolate Taiwan; barring the island from international forums that would connotate political sovereignty; and avoiding provoking Taiwan militarily. See Matt Forney, “Under Fire,” Far East Economic Review, August 31, 1995, p. 38.


29. Under the 1978 Chinese Constitution, according to Article 26, paragraph 1, the chairman of the Standing Committee of the National People’s Congress (NPC) in fact exercises the function of Chinese president because the position was not renewed until 1983 after the 1982 new constitution was enacted.


37. Currently, Taipei has established a three-tier structure of government and private institutions to deal with the PRC. In September 1990, National Unification Council (NUC) was created as an advisory board to Taiwan’s President. It is made up of thirty members and chaired by Lee Tenghui. In January 1991, the Executive Yuan (Cabinet) established the Mainland Affairs Council (MAC), a formal administration agency under the premier to manage Mainland/Taiwan political relations. One month later, MAC approved the semi-official Straits Exchange Foundation (SEF) to handle commercial/technical relations with the mainland.

38. Native Taiwanese include those Chinese families who lived on the island before and during Japanese colonization between 1895 and 1945, while mainlanders mainly include those who fled to Taiwan after the KMT lost a civil war with Mao’s Communists in 1949 and...
identify closely with the China they left behind.


42. United Daily, November 22, 1993, pp. 1-2; China Times, November 23, 1993, pp. 1-2. Actually, the notion of “phase two Chinas” can be dated back to the idea of “one China, two areas” proposed by Shi Qiyang, deputy head of Taiwan’s Executive Yuan in June 1990. It advocated a “peaceful coexistence of two separate-but-equal regimes.” See Yang Liyu, “From ‘One Country Two Systems’ to ‘One Country Two Areas,” Zheng Ming, August 1990, pp. 76-8.


47. Li Hongzhang was a top-ranking official in late Qing Dynasty who signed the April 1895 “Shimonoseki Treaty” after China was defeated during the Sino-Japanese War in 1895. According to the treaty, Taiwan and Peihua Islands are ceded to Japan. Since then he has been regarded as a traitor in Chinese history.


49. Chinese nationalism has become a focus of attention largely due to the fact that rapid economic growth combined with political uncertainty may lead Chinese leaders to assume a more assertive nationalistic stance towards the sovereignty issues including Taiwan and the South China Sea and its dealings with the U.S. See Oksenberg (1987), Townsend (1992), Unger (1996), Whiting (1995); Nicholas Kristof, “The Real Chinese Threat,” New York Times Magazine, August 27, 1995, pp. 50-1.


58. For example, both have expressed an intention to cooperation militarily with each other in the defense of the Spratlys. See, "Rear Admiral on Cooperation with Taiwan navy," *Voice of Pujiang*, Shanghai, January 30, 1989, translated in *FBIS-CHI*, February 2, 1989, p. 73; "Taipei Decreed naval Guidelines for Patrolling the Spratlys," *Huaqiao ribao*, April 12, 1988, p. 2.


81. How domestic factors and absolute gains concern shape and constrain the extent to which relative gains concerns are translated into policy outcomes will discussed in detail in the last chapter from the comparative perspective.


CHAPTER IV

JAPAN'S REDUCTION OF ITS ODA COMMITMENT TO CHINA

AN OVERVIEW OF JAPAN'S ODA TO CHINA

In 1979, China received the first package of Japan's official development assistance (ODA). Despite a late-comer in joining the list of Japan's aid recipients, China has become a top recipient of Japan's ODA from the very beginning and Japan has constantly ranked as China's largest ODA donor for nearly twenty years. Moreover, China enjoys as the receiver of especially favorable conditions: It is the only country that receives from Japan multi-year aid rather than support for specific projects.

Table 4.1 Top Six Recipients of Japan's ODA, 1993
(In millions of U.S. dollars)

<table>
<thead>
<tr>
<th>Countries</th>
<th>Values</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>$1,350</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1,148</td>
</tr>
<tr>
<td>The Philippines</td>
<td>758</td>
</tr>
<tr>
<td>Thailand</td>
<td>350</td>
</tr>
<tr>
<td>India</td>
<td>295</td>
</tr>
<tr>
<td>Egypt</td>
<td>275</td>
</tr>
</tbody>
</table>


From 1979 to 1984, Japan's ODA accounted for about 45 percent of the total amount of foreign aid that China received. During the same period of time, International Monetary Fund (IMF) contributed China's second largest source of external aid (14%), followed by UN agencies (12%) and West Germany (9%) (Okubo 1986, 5). During the period of 1982-86,
China was the largest recipient of Japan’s ODA; from 1987 to 1992 (except 1991), China ranked second, just behind Indonesia, Japan’s traditional top recipient (Zhao 1996, 148). In 1993, China again became Japan’s top aid recipient country (see Table 4.1).

Japan’s ODA to China mainly consists of government loans, grants and technical aid, of which government loans, commonly known as “soft loans,” are the most important part (see Table 4.2).

Table 4.2 Japan’s ODA to China, 1979-94
(units = 100 million yen)

<table>
<thead>
<tr>
<th>Year</th>
<th>Loans</th>
<th>Grants</th>
<th>Technical Aid</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>¥971.79</td>
<td>¥56.88</td>
<td>¥40.51</td>
</tr>
<tr>
<td>1990</td>
<td>1,225.24</td>
<td>66.05</td>
<td>70.49</td>
</tr>
<tr>
<td>1991</td>
<td>1,296.07</td>
<td>66.52</td>
<td>68.55</td>
</tr>
<tr>
<td>1992</td>
<td>1,373.28</td>
<td>82.37</td>
<td>75.27</td>
</tr>
<tr>
<td>1993</td>
<td>1,387.42</td>
<td>98.23</td>
<td>75.27</td>
</tr>
<tr>
<td>1994</td>
<td>1,403.42</td>
<td>78.47</td>
<td>N/A</td>
</tr>
<tr>
<td>Total (1979-94)</td>
<td>¥15,394.44</td>
<td>¥956.68</td>
<td>¥635.14</td>
</tr>
</tbody>
</table>

Sources: Japan’s Official Development Assistance, various volumes

From 1979 to 1998, there are four major packages of Japanese government loans to China (see Table 4.3). The first government loan was 350 billion yen ($1.5 billion) covering the period from 1979 to 1984. It was pledged by Prime Minister Masayoshi Ohira when he visited China in December 1979. This was followed by a 470 billion yen ($2.1 billion) package for the five-year period of 1985-90, which was offered by Prime Minister Yasuhiro Nakasone in March 1984. The third loan package agreement was signed by Prime Minister Noboru Takeshita on his visit to China in August 1988. It covered the five-year period of 1990-95,
valuing at 810 billion yen ($5.4 billion). After unprecedented tough negotiations and delay, the fourth loan package was signed in December 1994. Unlike the first three ODA packages which covered five-year period, the fourth loan package is reduced to a three-year pledge (1996-98), with the total value of 580 billion yen ($5.8 billion).³

<table>
<thead>
<tr>
<th>ODA Package</th>
<th>Fiscal Years</th>
<th>Billions of Yen</th>
<th>Billions of Dollars*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1979-83</td>
<td>¥350</td>
<td>$1.5</td>
</tr>
<tr>
<td>2</td>
<td>1984-89</td>
<td>470</td>
<td>2.1</td>
</tr>
<tr>
<td>3</td>
<td>1990-95</td>
<td>810</td>
<td>5.4</td>
</tr>
<tr>
<td>4</td>
<td>1996-98</td>
<td>580</td>
<td>5.8</td>
</tr>
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Source: OECD, Geographical Distribution of Financial Flows to Developing Countries, various years. *Dollar values are calculated using the exchange rate prevailing at the time each of the packages was announced.

MUTUAL BENEFITS IN THE ODA RELATIONSHIP

The substantial bilateral economic exchanges enhanced by the large scale ODA program has created an extensive economic cooperation between the two countries. It becomes more and more clear that Japan's ODA has not only become a crucial element of Sino-Japanese economic cooperation, but also significantly influenced the overall bilateral relations. According to Chinese Minister of Foreign Trade and Economic Cooperation, Wu Yi, from 1979 to 1997, China has borrowed from Japan nearly 2 trillion yen in the form of low-interest loans involved in almost one hundred construction projects, and Japan's governmental loans account for more than 40 percent of the total foreign loans that China has received.⁴ In essence, the fact that both China and Japan perceived them mutually beneficial
in terms of economic, political and strategical interests provides a key explanation for the success of the large-scale government-to-government loans.

From the perspective of China, Japanese government loans contributed significantly to its economic development as well as international bargain power. Those soft loans have longer payback periods and lower interest payments than China could obtain elsewhere. They are usually repayable in thirty years at approximately 3 percent interest rate with ten-year grace period. Yet, loans obtained from other sources including the Export-Import Bank of Japan are much tougher, with higher interests up to 9.75 percent and shorter payment periods ranging from ten to fifteen years. Large amounts of less expensive capital from Japan’s economic aid could satisfy China’s seemingly unstable demand for funds for large-scale infrastructure construction projects in the area of transportation, energy, and agriculture. As fiscal crises repeatedly threatened China’s key projects, Japanese government loans which came to account for about 45 percent of China’s total foreign aid have their particular significance.

In addition, Japan’s five-year loan packages to China were in line with China’s five-year plan for economic development and could provide advanced technology for its modernization and particularly for its large-scale infrastructure projects. This is extremely beneficial to China, where local capital remains by and large ‘technology-less’ and where foreign capital thus serves as the most important source of technological know-how. For years, scholars have argued that foreign investment and capital serve as an especially effective mode of technology transfer (e.g., Chen 1983, Naya and Ramstetter 1988). As the lion’s share of Japan’s ODA is directly used to purchase advanced foreign equipments and technologies and government loans involve a sustained relationship between the transferor
and transferee, it is very likely to bring about a more effective technology transfer than other channels.

Furthermore, Japan’s ODA to China could enhance China’s position in world economic system and international markets. It enabled Beijing to act more assertively when facing possible economic sanctions from the West over political issues, thereby enhancing China’s bargaining powers in the international arena. In the summer of 1988 after the third ODA agreement was signed, Deng Xiaoping was reported to have stated at a meeting with Japanese Prime Minister Noboru Takeshita, “Economic cooperation brought by Japan at this time was by no means small and we express our hearty welcome and appreciation.” Such a straightforward remark by Chinese paramount leader, Deng, was quite unusual and the significance of Japan’s ODA to China was well reflected.

On the other hand, benefits for Japan are also obvious both economically and politically. According to one evaluation conducted by Japanese Ministry of Foreign Affairs, Japan’s aid program to China was a “total success” (Zhao 1995, 191-2). The most important reason is that the economic aid has improved both Japanese international standing and its competitive position relative to other developed countries in China.

First of all, large-scale aid programs have enhanced Japan’s international reputation as a leading aid donor and also improved its relations with other countries, noticeably with the United States. As the first non-communist country to offer government loans to China, Japan took the lead in improving the West’s relations with China, and that was just the U.S. State Department and aid officials had strongly encouraged Japan to do so. In the U.S. point of view, if foreign aid could help restore a moderate and open China, it would undoubtedly serve the U.S. interests (Orr 1990, 73).
On top of that, to keep its international standing, Japan was under high pressure to increase its aid spending. Prior to 1978, Japan's ranking was quite poor among the then 18 DAC members. Its spending on ODA as the percentage of its GNP was only 0.25 percent, which was far below a 1970 UN guideline of 0.7 percent for industrialized countries (Rix 1980, 31-2). In July 1978, Prime Minister Takeo Fukuda pledged to double Japan's ODA budget within three years. Accepting China as a new recipient of this increased ODA funds was obviously in line with Japanese policy. By 1989, Japan had already replaced the United States as the largest aid donor in the world. The status as the world's largest donor has certainly helped increase Japan's international profile. However, in terms of percentage of ODA to GNP, Japan's contribution remains a problem. In 1993, it ranked only 18th among the 21 member countries of the OECD's DAC (Hiroshi 1995, 7). Moreover, the share of ODA in Japan's GNP has actually been declining since 1991; the ratio vacillated between 0.3 percent and 0.32 percent since 1987 but reduced to only 0.29 percent in 1994. Therefore, continuation of large scale governmental loans to China is in the interest of Japan's international standing.

Second, Japanese loans are mainly used in China's important infrastructure construction projects. As large-scale projects normally have "high-feasibility" status, Japan can receive better publicity in the international community. In the meantime, large amounts of foreign aid has also enabled Japan to gain more leverage in its dealings with China. It is very clear to Japanese government that those project loans would be a convenient and useful way to enhance Japan's long-range economic position, thus allowing Japan "to establish a firm foothold in China's economic infrastructure, and induce a spillover effect to other areas of Sino-Japanese economic cooperation" (Chae-Jin Lee 1984, 116-9).
Third, with rich natural resources and especially energy, China was an ideal country through which Japan could diversify its energy supplies. After oil shocks in the 1970s, because of further political instabilities in the Middle East, Japan became increasingly worried about its energy supply sources. With rich natural sources such as coal and oil as well as closer sea routes, China has not only ensured Japan of long term raw materials and energy supplies but also enhanced its competitive position in the China market. After all, Japan's economic competition with other countries was a major factor in the formulation of its aid policy toward China. "The degree of Japan's involvement in China's economic affairs as a result of its ODA policy cannot be matched by any other country."\textsuperscript{10}

Finally, Japanese aid can effectively serve as surrogate reparations for Japanese wartime behaviors towards China and fruitfully appeal to the hearts of the Chinese people. During the 1980s when large scale anti-Japanese demonstrations inspired by controversial issues such as "textbook controversy," Yasukuni Shrine problem and Kodaryo case, Japanese leaders pledged enormous "soft loans" to China.\textsuperscript{11} Obviously, those governmental loans were served as goodwill gestures for Japan to cultivate political ties.\textsuperscript{12} Moreover, a large amount of Japanese aid to China helped act as an unmatchable channel for Tokyo to gain greater access to top Chinese leaders including paramount leader Deng Xiaoping and Communist Party Chief Hu Yaobang than any other Western leaders and diplomats. As a result, "no other country can compete with Japan for access in China."\textsuperscript{13}

However, facing a changing post-Cold War international environment and more diverse domestic demands, Japan has made noticeable changes in its ODA policy toward China. Specifically, beginning in the 1990s, it has begun to bargain more and more toughly on both the terms and the duration that China could use the government loans, thus entering
what some scholars called the “crisis-and-bargaining stage” of Japan’s ODA to China (Zhao 1993, 1995).

JAPAN’S REDUCTION OF ITS ODA COMMITMENT TO CHINA

After 1989 Tiananmen Incident, facing both strong international pressure and domestic reactions, Japan became the only Asian country to join the West to impose economic sanctions against Beijing’s military suppression of the prodemocracy movement.14 Tiananmen event represented a watershed in the relations between China and the West including Japan. As a crucial part of bilateral economic relations, Japan’s ODA to China had to be changed accordingly. One of Japan’s major economic sanctions was to freeze its government loan of 810 billion yen ($5.4 billion) to China which had been scheduled for disbursement in April 1990. It was only in July 1990 did Japan decide to gradually resume the loan package. The controversy forced Tokyo to search for a balance among various options that would confirm Japan’s continued support for the West and, at the same time, avoid pushing China into further isolation.

In April 1991, Kaifu government stated four ODA guidelines which became in June 1992 part of the “Official Development Assistance Charter of Japan.” It announced that decision on ODA would be made after reviewing the recipients’ performance in four areas: military spending, promotion of democracy, moves toward market economies and human rights. Specifically, the guidelines call to consider: 1) the relationship between environment and development; 2) the avoidance being used for military purposes or the aggravation of internal disputes; 3) the defense expenditures, the development and production of weapons of mass destruction and missiles, and attitude towards export and imports of weapons; and
4) the promotion of democracy and a market-oriented economy, fundamental human rights, protection of freedom (MOFA, 1993).\(^\text{15}\)

The new ODA principles introduced clear political, economic and military standards for the recipients to follow. This new emphasis on environment, human rights, and nonmilitary issues might be more immediately prompted by concern that the parliamentary opposition (the Upper House was controlled by the opposition) and some non-government organizations might demand stricter control of ODA and force the hands of government by setting guidelines into law. It was also to counter the accusations of Japan having no clear policy and its ODA being commercially biased. However, I will argue that this new pledge is essentially influenced by post-Cold War international environment and to a large extent targets post-Tiananmen China. After Tiananmen, China appeared to be a growing and assertive regional military power abroad and a decaying, weakened state at home.

For the West, especially for Japan seduced by the paradigm of a “changed China” in the post-Mao era, the government was shocked and the people sickened by Beijing’s military repression of prodemocracy movements. It appeared the ghost of the dead dictator Mao had returned, and systematic use of coercion and terror in China had survived. After Tiananmen, a hard-line Party held power and was leading the punishment of “counter-revolutionary elements.” In this light, the guideline would have far reaching significance for Japan's ODA to China in the 1990s. China's nuclear weapon test on May 15, 1995 tested Japan's commitment to peaceful regional development and its willingness to use the stick as well as the carrot in its dealings with Beijing. Japan’s surprisingly firm response to the nuclear test was the first meaningful application of its 1992 ODA principles, which link aid disbursements to recipients' military behavior (Blaker 1996, 51).
Beginning in 1993, Japan and China started a series of negotiations for the fourth aid package. During the negotiations, Japan pressed China on human rights, defense spending, nuclear testing and pollution. During his trip to China as Foreign Minister in January 1994, Tsutomu Hata informed his Chinese counterpart of Japanese concern about Beijing’s military build-up, urging increases in transparency of defense planning. One month later, Hata told Chinese vice premier and economic czar, Zhu Rongji in Tokyo that the size and terms of Japan’s new package of official yen loan would be conditional on Beijing’s efforts to produce environmental projects and clearer information on military spending.16

The extensive and unprecedented tough bargaining made it difficult to reach an agreement. While emphasizing that on human rights issues Japan would not push China as hard as the U.S., Tokyo would like to see China's military spending policy more transparent. Japan also emphasized that China should achieve higher environmental protection standards. However, the real controversy during the negotiations for the fourth ODA package to China did not center directly on such sensitive issues as military spending or human rights. Instead, it concentrated on a seemingly technical issue – the length of the aid package. The Japanese focused on whether and how to change the previous preferential formula for Beijing under which Tokyo made an advance pledge of yen loans to cover a five-year period.17 In order to increase its control, Japan proposed that the previous pattern of multiyear agreements be replaced by annual aid packages. This proposal was strongly opposed by the Chinese side. In the end, Japan provided a new loan package to China without insisting on any Chinese compromise in the security area but held the aid plan to a three-year schedule – a cut from the previous five-year plan.
ALTERNATIVES TO EXPLAIN JAPAN'S REDUCTION OF THE ODA

From the Japanese point of view, there were three reasons to change the pattern of Japan's ODA. First, China was the only recipient country that enjoys multiyear favorable treatment from Japan, while all others were given annual aid pledges. Second, increasing public concerns about the growth of the ODA funds in Japan. Until 1993, the privileged situation of ODA in the general budget went unquestioned, but with the economic recession hitting Japan the proposed increase of 4.8 percent of ODA for the budget of 1994 fiscal year was for the first time criticized by the media (Nuscheler 1994, 165; Koppel and Orr 1993). Third, it was the normal practice for the Ministry of Finance to determine budget-related matters on an annual basis. China's exceptional multiyear aid treatment had constituted a conflict between political leaders and government bureaucrats. The politicians of the ruling Liberal Democratic Party (LDP) had been firm supporters of the long-term arrangement for yen loans to China, while the government bureaucracy was in favor of annual reviews. However, with the domestic chaos in Japanese politics in the early 1990s, particularly with LDP's loss of power in summer 1993, the influence of politicians significantly declined; advocates of the short-term arrangement became stronger (Ladd and Bowman 1996, 7-9; see also Inoguchi 1988).

Apart from above official accounts, there are some other popular explanations for why Japan wants a reduction of the government loan coverage. They include the stage of development already achieved by China, the negative impact of the yen's appreciation on China's repayment ability, Japanese economic recession and fiscal pressures in the earlier 1990s, and the Japanese doubts about the degree of true appreciation of the aid by the Chinese and its effect on the improvement of bilateral relations (JFOIR 1995, 23-5; Koppel
and Orr 1993). Those reasons might give a good account for certain circumstances and particularly Japan’s domestic pressure to replace a multiyear aid package favorable to China with annual aid pledges, they fail to explain the real motivations that underpin Japan’s changing ODA policy toward China.

It is true that Japan had some anxiety over China’s repayment ability because 70 percent of China’s foreign debt ($49 billion in 1989) was to Japan. Due to a sharp rise of Japanese yen since the mid 1980s, formerly low interest loans suddenly became a major debt burden, and Beijing asked for a debt relief. However, China has been witnessing a particularly dynamic economic growth beginning in 1992 and its foreign exchange reserves have already jumped to No. 2 place in the world, totaling more than $100 billion in 1996. On top of that, during the 1990s, China’s external debt rate is constantly under 16 percent of its GNP (gross national products), well below the standard international rate; it does not have any record of late payment of its foreign debt. Therefore, for China, there does not exist any serious repayment crisis in the 1990s, as some people advocated.

In addition, although China’s total GNP has doubled during the period of 1990-95, its GDP per capita still ranks the lowest among Japan’s major ODA recipients (e.g., IMF 1995, World Bank 1994, 1995). As a result, to use the development stage already achieved by China to account for Japan’s reduction of its ODA commitment to China can hardly hold water. Based on the development index established by the UN, China remains a less developed country. Its eligibility for obtaining official development aid from industrial countries and multilateral institutions including the World Bank and IMF is almost undisputable. Indeed, according to the latest report on development assistance published by the OECD, since the earlier 1990s, China has constantly been the biggest recipient of official
aid in the world. Although China's official-aid receipts in 1996 ($2.6 billion) are not as large as those in 1993 ($3.3 billion), China is still the biggest recipient of official aid. Moreover, as the OECD report has clearly pointed out, this decline is largely because between 1992 and 1996 net official aid to developing countries from developed countries and multilateral institutions fell by 16 percent in real terms.²² That China still belongs to a third world country is also well indicated by the percentage of the UN budget that it pays because that is mainly determined by the member countries's development level. Although China is one of five permanent members of the UN Security Council, it pays only 0.74 percent of the UN budget during the fiscal years of 1995-97. That figure is much lower than those of many non-permanent members, let alone those of the other four permanent UN members. During the same period of time, for example, the United States contributes 25 percent of the UN budget; Japan and Germany pay 15.65 percent and 9.06 percent respectively.²³

In brief, had those factors been real reasons, they should have been reflected in the Japanese policy process and Japan would have focused on reducing the amount of the Japanese ODA to China. As a matter of fact, those concerns were never raised as an issue during the negotiations for Japan's fourth ODA package to China. Nor did Tokyo think about reducing the amount of ODA to China. As Table 4.3 clearly indicates, no matter in what method of measurement, the value of the fourth ODA package to China has sharply increased. This is particularly true in terms of US dollars. The dollar value of three-year coverage in the new loan package is even larger than that of five-year coverage in the third package.

As has been mentioned above, the real controversy during the negotiations for the fourth ODA package to China centered directly on the length of the aid package and the Japanese focused on whether and how to change the previous preferential formula. Tokyo
also wanted to see China's military spending policy more transparent and emphasized that China should achieve higher environmental protection standards. In the end, the new loan package was a comprise which did not meet either China's demand for a five-year package or Japan's request for one-year program; instead, it was a three year (1996-98) coverage. In addition, although Japan did not get any Chinese compromise in the security area, the aid package did emphasize that China should strengthen its efforts for higher environmental protection standards.

KEY FACTORS AFFECTING JAPAN’S RELATIVE GAINS CONCERNS

The major hypothesis in this chapter is that Japan's pursuit of shorter ODA arrangement and tough bargaining on the terms that China could use Japanese yen loans are essentially because of the emergence of a powerful non-status quo China in the post-Cold War era. Central to Japanese worries about China's role in the post Cold War is the growing perception that China is neither a normal state nor satisfied with the status quo. It is instead highly nationalistic state, seeking primacy as the regional hegemon in the creation of a greater Sinocentric East Asian order. Moreover, the post-Cold War era provides a different environment for Japan where the need of a strong China to counterbalance the former Soviet Union has rapidly declined. The hope of getting strong Chinese support to keep North Korea on a more rational path on nuclear problem has also evaporated. China proved either not to have much influence in Pyongyang or it was not willing to use the remainder of this influence in order not to risk its national security interests; it is not entirely congruent with Japan when it comes to nuclear non-proliferation (Drifte 1996, 57). Furthermore, the importance of China as a source of energy has diminished considerably because of Japan's diversification of energy
sources and China's own rising needs for them. Finally, the end of the cold war, America's continuing budgetary problems and the bitter nature of trade disputes have made the Japanese wonder about the future of US military presence in Japan. Privately, Japanese policy-makers worry most about three possible adversaries: Russia, Korea, and above all, China.24

In dealing with such a China that in the coming years "is likely to territorially amorphous, economically dynamic, culturally proud, socially unstable and politically unsettled" (Funabashi et al. 1994, 3), Japan has to calculate its economic cooperation with China generally and its ODA to China particularly in relative gains terms. As Joseph Krasner (1993, 263) has suggested, ODA can create "asymmetrical opportunity costs of change," allowing the donor nation to exercise economic power over the recipient. "By using its economic power, Japan seeks to become a political power" (Chu 1990, 17). As Japanese ODA is not only economically significant to China but also has constituted a crucial part of Japan's diplomacy toward China, Japan has tried to link it to other issues and ensure Chinese behaviors would not be detrimental to Japan's national interests. In this light, the relative gains hypothesis can be utilized to explore some insights into Japan's changing ODA to China in the 1990s.

In essence, by reducing a long-term ODA arrangement with China, Japan is more likely to obtain relative achievements of gains in that Japan might be in a better position to address its concern about China's military buildup, link yen loans with its environmental destruction, thereby increasing its bargaining power relative to a possible expansionist China. In other words, by changing the previous multiyear aid package to the annual pledge, Japan's ODA to China would become an avenue for the annual review of China's behaviors sensitive to Japanese interests including environmental issues and military spending, thereby
strengthening the effort of this aid on improving Japan's political and economic influence over China. In the Japanese point of view, linkage of ODA to other issues could be more effective in addressing the harmful behaviors that a powerful China might bring about. Should China's behaviors be detrimental to Japan's national interests and regional balance of power, Japan could more easily and flexibly show its economic muscles against China in the next year's loan renegotiation. That is almost equal to American practice to use annual China's most-favored-nation (MFN) treatment status to review such sensitive issues as human rights and weapons proliferation. Furthermore, with the end of Cold War, facing a more politically uncertain and economically dynamic China, Japan's overall policy to China has already seen some noticeable changes. As economic power has become both the means and an end of foreign policy and national security, Japan's ODA policy to China expects to change accordingly so as to show its particularly political significance. This seems to be enhanced by the fact that close bilateral economic relations have so far failed to give Japan the promised leverage over Chinese political decisions and some prominent Japanese figures have advocated the use of ODA and other policy tools to influence errant Chinese behaviors (JFOIR 1995, 45).

In this light, seeking more leverages through ODA to deal with a possibly expansionist China can be understood in terms of the significance of relative gains as contrasted with absolute gains. After all, in the post-Cold War, the defining feature of East Asia's international relations is characterized with a "remarkable degree of political fragmentation and hostility" (Buzan 1995, 26). This anarchic nature requires Japan to be deeply concerned not only with how its ODA policies and outcomes directly affect it, but with whether they can help enhance Japan's bargaining power in dealing with China and thus better serve Japanese national interests. In other words, Japan must be concerned about how it will fare in regional
primacy and maximize its relative advantage over rivals like China or at least ensure that it is not disadvantaged.

In short, Japan sought to set more limited terms and reduce the duration of its ODA package to China with the purpose of being more able to insure its security, promote its interests, and shape the regional environment in ways that will reflect its interests and values. Many well-known scholars have strongly argued that for decades, Japan has acted in a way totally consistent with the "realist" theory of international relations, which holds that international politics is basically anarchic and that to insure their security states act to maximize their power; Japan has accepted all the assumptions of realism and applied them in the economic/diplomatic realm in the pursuit of economic/political power (e.g., Huntington 1993, 72; 1991, 8; 1992; Luttwak 1990, Olsen 1992).25 Regarding Japanese manufacturing investment, the typical Japanese strategy in Asia and particularly in China is: the Japanese utilize low-wage labor, tap the domestic market, raise quality to a level for export to third countries, and keep key technologies and skills to assure that they would retain the upper hand over potential Asian rivals in global production (Harwit 1996, 987-88).

EMERGENCE OF A POWERFUL, NON-STATUS QUO CHINA

Since Deng Xiaoping carried out economic reform and open door policy in late 1978, China has experienced an astounding economic growth, with an annual growth rate nearly 10 percent for the last two decades. Sustained economic boom has greatly increased China's comprehensive economic strength. Using the measure of purchasing power parity (PPP), in 1993 China already became the world's third-largest economy just behind the US and Japan, with a total GDP of $1.66 trillion.26 In 1995, based on the figure of the World Bank, China,
with GDP of $2,746 billion already surpassed Japan (with GDP of $2,596) as the world second largest economy. Current economic trends in China suggests that it could become the world largest economy by 2010 and a formidable economic competitor to Japan. On a per-capita basis, China will remain little more than a medium-income country, but with 1.2 billion people and an economy growing more rapidly than any other country, it is becoming Asia’s economic engine; its new economic capability could easily be translated into not only regional but perhaps global military might.

In contrast to a fast growing Chinese economy, the Japanese economy has gone into recession since 1993. The long-term trends suggest that although they used to operate primarily in different spheres (Japan in the economic and China in military), China has now chosen to enter the economic sphere as well, making it a more all-round power (Segal 1993). Its more modern economy and its greater economic influence have already given it the power to resist international dissatisfaction with its policies and practices, and expand its power and prestige abroad in ways hostile to Japan’s interests. Concurrently, the collapse of former Soviet Union removed its main regional security threat and increased, virtually overnight, China’s comparative power in Asia. Moreover, proximity and size make Japan and China natural rivals for leadership in Asia. Japan is already an economic superpower; China, according to the World Bank and others, is on its course to become the largest economy by 2010. As a result, “China’s economic maturation may make it a potential competitor with Japan in both economic and diplomatic arenas; and, most seriously, China might exploit its economic strength to become a military superpower” (Kenkyujo 1992, 151-2).

“Unlike the Soviet Union, China is not becoming a powerful military power founded on a pitifully weak economy, but a powerful economy creating a credible military force”
(Bernstein and Munro 1997, 29). Cashed by fast growing economy, China has stepped up efforts to modernize its armed forces at an alarming speed. Its official defense budget doubled in the five-year period of 1990-94, with real growth, adjusted for inflation, estimated at about 40 percent. It can be expected to continue to rise sharply, as economy grows apace. This is partially supported by 1997 defense budget, announced in earlier March 1997; it shows a sharp rise of about 13 percent, more than twice the expected rate of inflation. Although official figures showed that China’s military budget was less than $9 billion in 1994, US Government Information Office and Institute of International Studies and Strategy (IISS) have concluded that actual spending is at least several times that figure. According to IISS, in 1995 China’s total military spending was more than $30 billion, roughly comparable with Britain’s, although far behind US $250 billion. Richard Bernstein and Ross Munro go further to argue,

A conservative estimate of China's actual military expenditures would be at least ten times the officially announced level. In other words, China's real defense budget amounts to a minimum of $87 billion per year, roughly one-third that of the United States and 75 percent more than Japan's. Moreover, the figure was 11.3 percent higher in 1996 than in 1995, and 14.5 percent higher in 1995 than in 1994. Even adjusting for inflation, that is still an exceptionally high rate of growth. No other part of the Chinese government budget has increased at a rate anywhere near that, whether adjusting for inflation or not (1997, 25). 

More worrisome, a study by Rand Corporation, a prestigious American think tank, used PPP to arrive at the stunning $140 billion for 1994 Chinese defense spending. In short, enhanced by astounding economic growth, China is now engaged in one of the most extensive and rapid military buildups. It is constantly upgrading its military potential by buying new
fighters, missiles, and submarines. Increasingly, it is acquiring a blue-water naval capability and rapidly gaining its power projection capability.

China is Russia's largest weapons customer, buying $4.5-6 billion-worth of its weapons and military equipments in 1991-94. As IISS reported, "the Russians claimed to have sold China $2-3 billion worth of arms in 1994 alone" (1995, 167). In 1993, China took delivery of 72 supersonic Su-27 Flanker all-weather fighters. It also signed an agreement to buy 24 Mig-31 Foxhound high altitude interceptors and would manufacture up to 200 more in Shenyang (Jenkins 1993, 17). The Stockholm International Peace Research Institute (SIPRI) noted that "Israel is involved in Chinese combat aircraft, air-to-air missile and tank programs" in their assistance to China's military modernization (Arnett 1995, 367). Their cooperation in defense industries will enable China to fill in the gaps in its defense technology, providing it with both a greater offensive capability and the ability to export dangerous arms. China has recently taken delivery of some 48 SU-27 fighter aircraft. It has acquired the second (of four) Kilo class submarines. It is also reported to have bought two Soviet guided missile destroyers, which have far greater range than the most modern of China's surface ships. For China, to launch a wider program to modernize naval forces and to extend its power-projection capability are obviously motivated to contest for promising offshore sources in the South China Sea and to strengthen its strategic position for negotiations with Taiwan (Valencia 1995).

China's large scale armament program raises deep concern for Japan because of China's leadership succession, numerous unresolved territorial disputes in East Asia, the zero-sum-game approach of China's leaders to foreign and security policy, the Chinese perception of having to regain their country's dignity and place in the world and the region, the huge
perception gap between Chinese elite's self-perception of a peaceful China and that of its neighbors, and China's past record of using military power to attain political objectives (e.g., Shambaugh 1994, Drifte 1996). In this context, Japan has expressed varying degrees of reservation about the increase of China's defense capabilities and its longer-term consequences. For example, the director of the First Research Department at Japan's National Institute for Defense Studies wrote,

Despite the fact that China and Japan have a close relationship, it remains essentially fragile. . . . Japan is becoming apprehensive about China's military build-up, particularly the naval modernization, its continued supply of missiles to areas of potential conflict, and its testing of nuclear weapons . . . . The evolution of the Chinese navy from defensive coastal force into an offensive blue-water fleet would be destabilizing because it would change the balance of power in the Asia-Pacific region. This will happen if the Chinese economy continues to expand rapidly. 37

Paradoxically, the rise of China's economy comes at a time when the coherence of the Chinese state is rapidly deteriorating. "Deng's policies of the 1980s and 1990s have only dismantled Maoism; they have not set in place a new policy, public philosophy, or socioeconomic order" (Terrill 1994, 138). In other words, China's economic strength rests on a fragile political base and perhaps fragmenting political reality characterized by power struggle and political succession crisis (Friedman 1996). Third-generation leadership headed by President Jiang Zemin could not be capable of mobilizing the kind of political clout as Deng Xiaoping did. Moreover, any Deng's successor faces profound constraints on his freedom of action: he must maintain high rates of growth in the short term, even at the expense of long-term economic stability. He must also appease the military and impose a
heavy hand toward political opposition. Lacking the most crucial power resources, authority, and legitimacy, the new leadership will not be in a position to cope effectively with the rising tension between nationalism and the necessary compromises on sovereignty issues relating to the Senkakus in the East China Sea and the Spratlys in the South China Sea.

Domestic weaknesses enhanced China’s external assertiveness, thus threatening the regional peace and stability (Ping Deng 1997, 4-6). In addition, Chinese leaders feel they should live up to the great Chinese leaders of the past who unified the country and made it wealthy and powerful. The current policy of Fuqiang, meaning “wealth and strengthening,” contains the same characters as Meiji Japan's Fukoku Kyohei (“rich country, strong army”), and Fuqiang will undoubtedly be China’s most nationally inspiring and socially cohesive slogan in the coming decades. Driven by nationalist sentiment and a yearning to redeem centuries of humiliating weakness, along with the historic “middle kingdom” mind set, China tends to see itself as the dominant force in Asia and thus seeks to be a regional hegemon. A weak, reactive, insecure, and fragmenting China is more unpredictable and dangerous than a strong, confident, and cohesive China. But a powerful China is most likely to be an unsatisfied power and, given its historical legacy and serious internal problems, China tends to feel it is not treated with the importance it deserves on the world stage, thereby spawning conflicts with neighbors, especially with Japan. As a result, how China exercises its newfound power and influences is of great concern to Japan.

Although China repeatedly states that they need to maintain a peaceful environment to promote its top priority of economic development and concentrate its limited resources and energy on domestic construction, Japan remains nervous about the secrecy surrounding PLA’s budget and strategic plans, especially with respect to its air and naval modernization.
While mainstream China scholars argued that China's use of force was primarily reactive, defensive, and for deterrence purposes only and that use of force was also cautious and deliberate (e.g., Whiting 1975), neighbors may read the increase in military capability quite differently especially at a time when there is no apparent military threat to China. They tend to see that a powerful China will adopt a militarily expansionist policy, setting off a spiral of regional hostility and arms race. For various reasons, China has in this century been in military conflict with no fewer than seven countries: Russia, India, Japan, Vietnam, South Korea, Taiwan and America. Therefore, the danger remains that China will be an unsatisfied power.

Largely as a consequence of its growing economic/military strength and domestic politics, China did adopt a series of more assertive external behaviors in the last five years. In February 1992 Chinese National People's Congress (NPC) promulgated the "Law on Territorial Waters and Adjacent Areas," which puts Senkaku Islands and virtually the entirely South China Sea under Chinese sovereignty and reserves the right to use force if necessary to defend areas deemed to be its territory (Leifer 1995). Moreover, China tend to adopt self-interest approaches to territorial disputes. For example, China has applied the continental shelf principle in defining its maritime claims in the Yellow and East China Seas, but claims of the South China Sea on the basis of "historic use and administration" (Jun 1994). In early 1995 it occupied controversial Mischief Reef close to the Philippines.

Recently, China has proceeded with its oceanographic survey in the controversial Senkaku waters in East China Sea. Beijing has also intensified with its exploration for oil and other minerals in the adjacent waters. To some, such actions reflect the emergence of China as a more assertive power with a thirst for oil. In 1992, China pledged to use its naval forces to back up an oil exploration project contracted to a US company; if necessary China would...
use its “whole naval force” to protect the company’s oil exploration activities in the South China Sea. More recently, a Chinese navy deputy commander was quoted as saying that it was high time for China to readjust its maritime strategy and to make more efforts to recover the oil and gas resources in the South China Sea.

The energy and military issues are intertwined with the territorial disputes in the South and East China Seas, making Japan especially sensitive to provocative Chinese actions. China’s economic ascent is likely to produce a vast new oil demand. It is already a net oil importer, by 2015, according to Shell Corporation predictions, it will import 7 million barrels of oil per day (Salameh 1996, see also Calder 1996b). That is about the current level of imports into the US. The impending energy shortage may further heighten territorial disputes over potentially oil-rich areas in both East and South China Seas. To Japan, a more powerful and militarily assertive China has started to press territorial claims against its neighbors, from Japan in the north to the Philippines and Indonesia in the south. Even Singapore, an outspoken pro-China expresses concerns. “In Asia, China’s rising power and arms buildup has stirred anxiety,” Prime Minister Goh Chok Tong said, “it is important to bring into the open this underling sense of discomfort, even insecurity, about the political and military ambitions of China.” As a great power, China will behave boldly, more inclined to force its will upon others than to consult with them. In the competition among conflicting national interests, strong countries are inevitably tempted to force their will upon the weaker ones; it is to be taken for granted that China will use its new economic and military strength to dominate the region insofar as possible.

Japan is closely watching Chinese assertiveness in East Asia, because it has territorial disputes over the Senkaku in East China Sea and has key security interests in maintaining the
openness of vital sea lands of communications (SLOCs). As 75 percent of Japan’s oil imports pass through the South China Sea, as does much of its intra-Asian trade, Japan would lose its economic lifeblood if it were denied access to the South China Sea (Calder 1996b, 57). Moreover, if there is oil in the disputed territory, the East China Sea is an obvious focus for rivalry. There is little doubt that any further Chinese assertive behaviors in the Spratlys and Senkaku waters and shifting their sources to military buildup would seem to prove Japanese suspicion that China is a rising hegemon. As a result, Japan has more reasons to consider its ODA to China in terms of relative gains. After all, it would be increasingly difficult for Tokyo to justify to domestic taxpayers why Beijing should remain the largest beneficiary of Japan's foreign aid while it devotes resources to a nuclear arsenal and asserts its claims in the South China Sea.

China’s economy continues to grow at an astronomical rate. Japan is made uneasy by the doubling of China’s military budget between 1990 and 1995. China’s 3 million strong army, undergoing modernization, and the growth of its sea and air power-projection capabilities produce apprehension in its neighbors and add to the sense of instability in a region where issues of sovereignty and territorial disputes are abound. As a strong China cast a long shadow over its neighbors, Japan begins to feel that it needs the range of capabilities possessed by other countries in its region and in the world, in order to cope defensively and preventively with present and possible future problems and threats. As a result, “[a]ny country in Japan's positions is bound to become increasingly worried about its security, the more so because China is rapidly becoming a great power in every dimension: internal economy, external trade, and military capability . . . . Unless Japan responds to the growing power of China, China will dominate its region and become increasingly influential beyond it” (Waltz
To Japan, the heart of the problem is to decide whether it is better to appease China or to stand up in order to protect its own national interests.

Japan's natural inclination so far has been appeasement because of a cultural tendency to avoid direct confrontation, because of its negative past legacy notably in China and a resulting guilt complex, because a stronger stance would open many cans of worms in domestic and international politics, and finally because of its growing confidence in its huge economic power as replacement of military power (Drifte 1996, 57).

However, given the fact that China now embodies extraordinary contradictions—economic dynamism, political stagnation and social alienation, some noticeable changes in Japan’s China policy have gradually come into being. The future of China is probably the most difficult challenge for Japan’s foreign and security policy, as it is for the whole of Asia and those outside powers involved in Asian security. China is a rapidly developing country, a nuclear weapon state and a leading regional military power, as well as a global powers thanks to its permanent seat on the UN Security Council. All its Asian neighbors and particularly Japan have a vital stake in China being a stable and peaceful country (Overholt 1996). Thus, the changing Japanese policy to China must begin with the ultimate goal: trying to help China become a stable and peaceful political entity.

CHANGES IN JAPAN’S OVERALL POLICY TOWARD CHINA

Since the early 1970s, the major Japanese political parities, media and business communities forged a national consensus on Japan's China policy, known as the 1970s system.
The system essentially has four elements: A pro-China and anti-Soviet security stance; yen loans to China to help it economically and integrate with the world; victory by pro-China factions in the domestic political arena; and a shared feeling of guilt among the older generation for Japanese actions during the War (Funabashi 1996, 109-10). This consensus started to change after the 1989 Tiananmen event and with the end of Cold War. Facing a powerful and unsatisfied China, Japan’s post-cold war policy and politics are gradually towards a more aggressive and less cooperative China policy. On the whole there has been, as Green and Self (1996) have written, a shift from "commercial liberalism to reluctant realism. The more active, if not a more forceful, policy toward China basically reflects the need to develop a policy that will at the same time push China toward economic interdependence and make explicit which Chinese provocations will justify a forceful Japanese response in an attempt to deter Chinese nationalism and militarism (Green and Self 1996, 39).

The geopolitical and strategic interests led Japanese government to treat China as too important to isolate (Mason 1994, 207). “Japan’s official attitude now is balancing between engagement of China through trade and political/military contacts on the one hand and demanding transparency and restraint in the military area on the other” (Drifte 1996, 57). The former is, for example, illustrated by Japan’s lack of enthusiasm in joining generally tougher sanctions against China because of the brutal repression of prodemocratic demonstrations in 1989. Japan broke with its G-7 patterns and resumed official loans to China in July 1990. In August 1991, the then Prime Minister Toshiki Kaifu was the first leader among the major developed countries to visit China (Takagi 1995, Tanino 1990).

Hoping to achieve Japan's true long-term goal: establishing an interdependence relationship with China, Japan employed ODA, low-interest loans and export guarantees to
support both Chinese modernization and its economic activity in China. In the view of Japanese policy-makers, if integration of China into the international community could be achieved, Japan would get more leverage over China. The reason is that China's growth is based on greater reliance on the global market, and close ties of interdependence will keep it from contemplating aggressive action. As a Japanese scholar bluntly states, "as economic mutual dependence increases and China becomes part of the international economy, it will need to conform to international standards. Therefore, Japan will have a greater chance to exercise influence to increase the transparency of Chinese political institutions, especially its military" (JETRO 1992, 151; IIGP 1990).

At the root of Japanese thinking was the conviction that integration of China into the world economy would make it more moderate and cautious in foreign policy and more open and democratic at home, thus becoming friendly to Japan. Japanese leaders, scholars and diplomats were confident to triumph as trade and investment transformed China into a cooperative partner in developing a new Asia. After all, no one, especially Japan, really wants China to fall apart. The resulting chaos might well lead to war and mass migration, interfering with regional growth. Therefore, Japan are deeply concerned about China’s economic collapse or political turmoil which would result in a flood of refugees attracted to Japan. Other than direct military attack, Japan's worse nightmare is to deal with large numbers of alien people especially from China.

However, confronted with China's growing military potential and assertiveness in the post-cold war era, in order to protect its strategic interests, the Japanese government has become now more assertive and is applying some pressure on China to moderate its military posture. The major instruments for this pressure are putting China’s defense policies on the
bilateral agenda, engaging in an open debate about security issue and using Japan’s considerable aid power (Drifte 1996). Meanwhile, Japan is experiencing its own political realignment and growing debate about its proper world role. The debate was initiated by the end of the Cold War, accelerated by the embarrassing ineffectiveness of Japanese diplomacy during the 1991 Gulf War, and now made acute by questions about China's future. There is still strong consensus in Japan that maintaining friendly ties with China is essential and that a primarily economic strategy towards China still has potential. However, Japanese leaders in politics, business, academia and even in the Foreign Ministry are increasingly arguing that Japan must be prepared for other scenarios (Greene and Self 1996, 36).

Japan has now started to discuss security more openly at home as well as with the Chinese and its security policy seems to have focused on “China threat.” To a large extent, Japan’s military and certain politicians were using the “China threat” to justify defense increase. Japan’s real defense budget grew an average 3 percent a year during the 1991-95 plan. Despite a constitution that circumscribes the role of its armed forces, Japan already has the third-largest defense budget; in 1993, its military spending reached $34 billion, not far behind that of Russia ($52 billion) (Jenkins 1993, 16).

The Japan Defense Agency (JDA) and military force, the Japan Self-Defense Forces (JSDF), have grown particularly concerned about Chinese military capabilities in recent years. “The fear is not of sudden or imminent danger, but of the longer-term potential for instability caused by seemingly irreversible trends in Chinese strategic requirements” (Drifte 1996, 44). In a meeting with US national security advisor, Anthony Lake, in May 1995, Japan’s Defense Agency Director General Tokuichiro Tamazawa expressed concern over China’s military build-up, saying that Beijing’s intentions were unclear. The Yomiuri Shimbun, Japan largest-
circulation daily newspaper, has also published feature articles on the likelihood of continued
Chinese expansionism in the direction of the potential oil-rich Senkaku in East China Sea.
Beijing's threat to develop MIRV-equipped missiles in response to possible Japanese
participation in a purely defensive TMD (theater missile defense) system has prompted the
JSDF to take a closer look at Chinese ballistic missile capabilities and threats to Japan as well
(Yamamoto 1995a, 1995b).

Concerns over Chinese security policy are by no means limited to the defense
establishment. Leading China experts in Japanese academia and Ministry of Foreign Affairs
are also concerned about the potential for instability in and around China. Mainstream
Japanese observers of China have advocated repeatedly a strengthened security ties with the
US in order to balance possible Chinese instability or expansion. Moreover, Japan has been
the leading East Asian voice in support of greater restraint in the marketing of arms.
However, China's purchases, including SU-27 aircraft and a new air-defense system, helped
boost Asian arms race and suggested that China was prepared to enter into long-term military
procurement. In August 1992, in response to rumors about China acquiring an Ukrainian-built
aircraft carrier from Ukraine, Vice Foreign Minister Kakizawa Koji issued an official
statement that such a deal would harm East Asian security. Why should China be the only
power to increase its military capabilities while others reduces their defense? Under such
circumstances, why should large scale of Japanese ODA to China not be exploited to increase
its bargaining power in curbing Chinese possible expansionist behaviors? Japan is gradually
waking up to the security challenge of China and there is a growing concern about the long-
term impact of China.

The Japanese concerns about a more assertive China are clearly spelled out by people
close to the government. As indicated by the comment from Nishihara Masashi,

Where is China heading? Will it become a hegemonic power, establishing a new regional order under its control by taking advantage of the upper hand it has over its neighbors in size and power? . . . . Despite the fact that China and Japan have close ties in virtually all fields, their relationship remains essentially fragile.43

In another interview, Masashi further warned that "the way [the Chinese] have behaved in South China Sea may one day be applied to the Senkaku islands. It’s a creeping expansionism."44 In the same vein, the former chairman of the Nomura Research Institute, Kiichi Sacki, warned that, "[f]or the United States, only in another 20 years or more might China pose a serious military threat . . . . Japan, however, given its limited defense capabilities, will feel the military threat much sooner" (1995, 203-10).

Japanese officials were expressing increasing concern, mainly privately, about Chinese intentions and the resolve of the US to guarantee East Asian security. Yet, with signs that China seemed increasingly willing to throw its weight around, Japan became willing to express its concerns more explicitly and officials in Tokyo were speaking more openly of the need for a robust attitude towards China.45 In May 1993 Japan proposed to Chinese Foreign Minister Qian Qishen to resume bilateral security negotiations, frozen after Tiananmen, and tried to draw China into regional security discussions.46 At the same time, a leading member of the then ruling LDP, Mitsuzaka Hiroshi, expressed concern about the modernization of China’s military and the defense spending increase. When Foreign Minister Hata of the Hosokawa cabinet visited China in January 1994, he directly asked China about the intentions behind the 15 percent increase in the 1994 defense budget and urged China to abide by the
guidelines of the Missile Technology Control Regime (MTCR). He also registered a protest against China for resuming nuclear tests, but Tokyo did not take any action to cut off or even reduce Japan's aid. Moreover, Both the LDP and NFP (New Frontier Party) accepted a policy statement on China prepared by the Japan Forum on International Relations and signed by 72 Japanese leaders in January 1995. The statement urged the government to "admonish China for its chauvinism" in the Spratly and Senkaku Islands.

In February 1995, Admiral Nishi became the first uniformed senior JSDF official to visit China and was reported to have asked for transparency in China's defense budget and armament program. When the Japanese Prime Minister, Tsutomu Hata visited China in May 1995, he was robust in raising difficult security issues where Japan felt China was not acting in the best interests of regional and global security (Segal 1996, 125-6). In October 1995, Foreign Minister Kono Yohei made front-page news in Japan by mentioning in the Japanese Diet that Chinese military modernization and territorial polices could be a source of instability in Asia. In March 1996, Prime Minister Ryutaro Hashimoto summed up Tokyo's new attitude towards China where he expressed his concern that Chinese policies in the region "might be heading in the wrong direction."50

Most significantly, Japan has finally started to take a series of military measures in response to a more assertive China. It has now embarked on the linkage of Japan's ODA directly with China's military transparency and nuclear tests. The basis of Japanese security policy is still close cooperation with the United States. Japanese leadership has consistently maintained that a robust forward US defense commitment in Asia is the most important factor in regional stability and Japan's own security. In 1994, Prime Ministers Morihiro Osokawa and Tsutomu Hata both took a harder line on China's military transparency and nuclear tests
than their predecessors ever had. When China tested a nuclear device in May 1995 just after the renewal of the Nuclear Non-proliferation (NPT), Japan took the opportunity to send a more general warning to China that if it took action opposed by its neighbors and the international community, it should expect punishment. It reduced its grant aid by a symbolic amount, but the action was, especially for the usually cautious Japanese, a loud signal of serious worries about Chinese behavior. In August 1995, Japan suspended a larger grant assistance ($75 million) as a protest against China's continued nuclear weapons testing.

For decades, Japanese defense strategies were premised on the Soviet threat, but earlier drafts of the new revision of Japan's 1976 National Defense Program Outlines (NDPO) equally focused on the threat posed by China's growing military modernization, nuclear tests and expansionist policies in the South China Sea and the Senkaku Islands. Only after opposition from members of the Social Democratic Party was the China-threat language removed from the final version. Even with the changes in the NDPO, the original language was used by Prime Minister Murayama himself in a speech to the Japan Self-Defense Forces in October 1995. In addition, Japan's Defense White Paper published in June 1995 expressed explicit concern with China's more aggressive policy in the South China Sea and called for an improvement in the quality of Japanese forces as a result.

Furthermore, in the April 1996, President Bill Clinton and Prime Minister Ryutaro Hashimoto announced US-Japan communique, declaring increased Japanese logistic support for US missions in the region and consideration of future cooperation on theater missile defense systems. The upgrading would encourage the development of Japan's force projection capabilities. Implicitly, increased Japan's defense reliance on the US would show increasing concern about Chinese intentions and that China was seen as the main challenge.
to the regional balance of power. In early 1996, Japan responded to Chinese activities in the East China Sea (and in effect to Beijing’s 1992 law reaffirming Beijing’s claim to the Senkaku Islands) by deciding to formally extend its Exclusive Economic Zone in the area.

As China develops economically and militarily, and becomes the central actor in post-Cold War Asia, its interests and actions are more likely to diverge from those of Japan. Meanwhile, desire of Japan’s leaders to play a militarily and politically more assertive role has become apparent, a natural response to its enhanced economic standing. “The pressure on Japan to assume a more active role in world affairs appear to outweigh the countervailing forces. Japan has the will, the need and the capacity to assume more global responsibilities. It is driven by a tenaciously held aspiration to occupy an honorable place in the world, increasingly dictated by the self-interested need to sustain international stability and economic prosperity” (Inoguchi 1992a, 78). This aspiration is particularly strong among young people who think Japan has already dwelled too long on its past war crimes, especially since most others have similar histories (Buzan 1988). They believe that Japan should become a more normal great power and that it should obtain a permanent seat on UN Security Council, have more military spending, deploy forces abroad, revise constitutions, and be more assertive on the Senkakus disputes.54

On the other hand, China is not simply a status-quo, but it is pursuing nationalistic aims. It also loudly protested against Japan to send mine-sweepers to Gulf in 1991, to pass legislation that would allow the JSDF to be sent abroad, and to send troops as part of UN peacekeeping operations in Cambodia. Although some view the efforts by Japan to assume increased security responsibility as largely a response to pressure from US, China claimed that they were a sign of increasing Japanese militarism and the emergence of potentially more
assertive Japanese state (e.g., Howe and Hook 1995, Pollack 1990). As a result, Japan believes that Beijing was trying to force it to remain in abnormal state so that it would not challenge China and would be denied a UN permanent seat.

In addition, China often exploits historical issues in bilateral negotiations. The Chinese frequently mention "hurt feelings" in their complaints against Japan, transferring the injury done during the World War II to the present (Whiting 1989, 41-65; Dirlik 1993). When Japan cut grants to China in August 1995 against its continued nuclear weapons tests, Premier Li Peng made an explicit link between Japanese aid to China now and the Japanese invasion of China in the 1930s and 1940s. The alleged Japanese failure to understand history is said by the Chinese to inflict harm on the Chinese people. China thus assumes the moral high ground, giving it leverage it would otherwise lack. In response to this, the Japanese tend to make minimal concession, quieting the furies but never "liquidating history" (Johnson 1986, Ijiri, 1990a, 1990b).

During the October 1992 visit, Japanese Emperor Akihito "deplored" the "unfortunate period" in which Japan "inflicted great sufferings upon the Chinese people." That does not seem to have relieved Chinese bitter criticism of Japan by raising the question of "Japanese revival of militarism." Japan has also been criticized repeatedly for growing military budget, and remarks made by right-wing politicians who played down aggression. That Chinese officials repeatedly play the anti-Japan card and encourage popular resentment of the Japanese has to some extent confirmed Japan's suspicion that China which is regarded as ideological bankrupt is becoming an unsatisfied power and seeks to be the hegemon in Asia. Furthermore, the end of Japan's one-party (i.e., LDP) rule in the summer of 1993 has a decided impact on Japan's China policy. New generation has removed some of Beijing's strongest allies from the
ranks of the conservatives in Tokyo and Japan tended to be more aggressive in its deals with China.

Based on the above discussion, it is not difficult for us to conclude that beneath the surface of overt policy changes a more fundamental shift has taken place in the dynamics of Japan's China policy; a shift resulting not from short-term tensions but from changes in the structures that underpinned Japanese policy towards China for four decades. The underlying reason is obviously the emergence of a more powerful unsatisfied China and almost inevitable confrontation with Japan's aspiration to be a political power in the world community. With easily the most advanced economy in East Asia and close ties to the West, Japan has a strong claim to regional leadership. Confidence in economic ability and technical skill leads Japan to aspire to a larger political role.

However, East Asian traditions suggest that China will be unwilling to accept a subordinate role to Japan. Chinese leaders still hold a sense of being Asia's naturally dominant power in East Asia, even when it is ostensibly pursuing a relationship of equality. It expects Japan to accept a subordinate role – not to mention to pay for the evils done to China during the World War II. Its regular reference to Japan's failure to purge its war guilt is evidence that Beijing feels morally justified in putting Japan in an inferior position (Newby 1991, 28; Whiting 1989). This trend seems to be particularly true given the fact that there are ten times as many Chinese as Japanese and its economy is growing fast. With relative economic and military power increasing, China feels that it has legitimate claims to territory and to increased status in East Asia and the wider world. However, as some leading China scholars have argued,
In the coming years it [China] is likely to territorially amorphous, economically dynamic, culturally proud, socially unstable and politically unsettled. The above strains may pull its current communist structure apart, causing a shift towards Chinese nationalism in an attempt to maintain unity. This would make China more aggressive internationally, and increasingly strain its relations with the US and Japan (Funabashi et al. 1994, 3).

“During the past two decades, Japan's economic policy objectives toward China have gradually been tinged with political interests that help to stabilize the bilateral relationship” (Wang 1993, 640). In a changing world order, as a crucial part of Japanese diplomacy toward China, Japan’s ODA policy has to be changed to better serve its national interests. This seems particularly true given that Japan now uses ODA, not simply to develop new sources of supply and to open new markets, but more broadly to pursue its strategic and political goals. With disappearance of the Soviet Union and China becoming its top security worry, Japan’s concern for relative gains favoring China in the ODA program should take precedence over its concern over absolute gains. In this light, Japan’s use of economic means including ODA to increase its security and other national interests seems to be quite rational.

PURSUIT OF ECONOMIC INTERESTS THROUGH ODA

Japan’s ODA is generally linked to the interests of private enterprises. Accordingly, the aid to China has to be considered in conjunction with Japan’s increase of private investment flows into China which are increasing rapidly. Thanks to Japan’s close unofficial and official links between bureaucracy and industry, corporate sector interests are reflected in the way that ODA is distributed. The new ODA Charter of June 1992 contains a paragraph
says, "A close relationship will be maintained between ODA, direct investment and trade, so that those three can organically promote the development of developing countries."57

As the recipient of enormous sums of foreign aid from Japan, China is predisposed to give favors and concessions to members of Japanese-dominated production network. In exchange for large amounts of Japanese ODA or aid, host countries grant Japan and business officials an opportunity to influence and, in some cases, even write the industrial policies of the recipient. This is no exception with China. Moreover, with the help of the governmental loans, Japanese MNCs are building production networks based on a regional division of labor and technical ability. In this way, Japanese manufacturers achieve economies of scale and scope, as well as what Hatch and Yamamura (1996, 108) called "economies of networking," thus giving them a powerful edge against international competitors.

To some extent, Japan's ODA also helps Japanese MNCs integrate Chinese industry and labor into their own strategic networks, and they become enmeshed in a Japanese production alliance (Emmott 1992). That well reflects Japan's grand strategy of "flying geese" regional development, a pattern of promoting its own technology growth and competitive position by tightly embracing Asia (see Chapter 5). After all, Japan's close government-business network has constituted a key element of Japan's economic development. Government has penetrated business and business has penetrated government through a process that Richard Samuels calls "reciprocal consent." "In exchange for the use of public sources, private industry grants the state some jurisdiction over industrial structure in the 'national interest'" (1987, 9). In other words, Japan's government-business network is a mutually reinforcing alliance or partnership, which has long been identified as critical to Japan's national security (Emmott 1992, Johnson 1982).
As government and industry are bound tightly through ODA, Japanese aid program contends distinctive features that highlight public-private partnership. Most of ODA is allocated to economic infrastructures, especially to transportation and communications that help spur exports and attract otherwise reluctant overseas investment. In 1992, 40.7 percent of Japan's ODA was used for economic infrastructural projects (Love 1994). The official explanation for the aid distribution is that adequate infrastructure is the foundation of development (Hanabusa 1991). Yet, this kind of priority clearly benefits Japanese private industry in terms of involvement in the creation of such infrastructure and using it for Japanese trade and investment, and thus reflects some degree of self-interest. After all, government-business officials have complained for years that foreign direct investment from Japan is stymied by infrastructure bottlenecks in many parts of Asia and particularly in China (JETRO 1992). Japanese ODA has been used largely to build "the type of infrastructures that will benefit Japanese multinationals and their partners" (Katzenstein and Rouse 1993, 232).

Moreover, Japanese engineering firms, contractors and other private investors continue to receive the lion’s share of projects financed by Japan’s ODA loans (Orr 1990, 68). It is almost difficult to find non-Japanese firms engaged in public works administrated by Asian governments but funded by Japanese ODA. That, according to critics of Japan’s ODA policies, is because Japanese architects and engineers, acting as consultants on such projects, write detailed specifications that only Japanese contractors and suppliers can meet. "You are beaten before you start," says a representative for Schlage Door Hardware International.58 Indeed, MNCs, especially the big trading companies, occupy center stage in Japan’s aid program by recommending projects to recipient governments and helping them draft proposals to the aid bureaucracy in Japan (Orr 1991, 39-41).59
On top of that, the actual selection of projects funded by Japanese ODA to China tends to reflect “the needs of the donor rather than the recipient, that is, it followed Japanese rather than Chinese economic priorities” (Story 1987, 35). That is well reflected in Japan’s selection and approval of China’s first yen loan request in 1979.

China’s first loan package request was for eight infrastructure construction projects which included three hydroelectric power plants, three railroad lines, and two ports. In the first aid package, Japan agreed to provide government loans for six out of the eight proposed construction projects: all of the railroad and port projects were selected, but two hydroelectric power plant projects were dropped. This selection clearly reflected Japan’s economic interests. The two ports, Shijiusuo and Qinhuandao, which got full yen loan, were important for exporting coal to Japan. Two of the three railroad lines, the Yanzhou-Shijiusuo Railway and the Beijing-Qinhuandao Railway, directly connected the two ports. Japan provided 62 percent and 100 percent of requested loan amounts respectively. But the third railroad, Hengyang-Guangzhou Railway, was irrelevant to Japan’s energy supply route and thus received only 16 percent of what China had requested. The two rejected hydroelectric power plant projects (Longtan and Shuikou) conflicted with Japan’s economic interests. For example, the Longtan Hydroelectric Power Plant would have had the capacity to supply electricity to a large aluminum refinery with an annual production capability of 600,000 tons and make it a potential competitor with Japanese joint ventures in aluminum production in Indonesia and Brazil.60

Furthermore, the status as the biggest aid donor has also given Japan the opportunity to influence environmental conditions and policies of China. Japan is deeply concerned about China’s rapid industrialization and the subsequent environmental degradation. Being
downwind from China, Japan may soon suffer serious damage from acid rain. Japan is prepared to ameliorating it with time, technology, and money. Accordingly, Japan has now embarked on linking ODA to the environment problems. In this sense, linkage of Japan’s ODA with China’s environmental issues clearly serves the interests of Japan’s national policy; it also parallel with Japan’s priorities to invest in China.\textsuperscript{61}

Beginning in 1990, Japanese government has launched a series of programs and institutional measures related to domestic and global environmental issues. These actions were to a large extent a reaction to foreign criticism of the ecological consequences of Japanese economic activities, but also the realization of an alarming increase of transnational pollution from China (acid rain). China’s pollution as a result of reckless industrialization is a serious concern for the future of Japan and East Asia. For the first time Japan's loan program is linked to environmental concerns. The first round of Japan’s fourth yen loans to China, scheduled for 1996, focus on environmental protection and agricultural development of the interior provinces (Nelsen 1995, 85). In the view of Japan, it could achieve greater stress on projects in China's less developed interior rather than in the industrialized coastal regions. Moreover, Japan insisted that thermal power stations built with yen loans will from now on include equipment to control sulphur dioxide emissions which are not only harming China's environment, but that of Korea and Japan.\textsuperscript{62} As a result of Japan's pressure, both countries signed in December 1993 an agreement for the protection of the environment. This is the first agreement in which China admits the existence of acid rain and other air pollution in China.\textsuperscript{63}

Finally, Japan's ODA to China has helped and will continue to help Japan establish a greater economic interdependence with China, in the hope of discouraging it from disrupting the stability of the region. What is more, Japan has effectively used aid as a foreign policy tool

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and as a way of encouraging others to adopt Japanese economic and organizational practices. Japanese bureaucrats are proud of the role the state has played in its economic development. They will increasingly seek recipients including China and other Asian countries to follow its path to development. Japan has demonstrated an enthusiasm for using its ODA as a way to indirectly influence Chinese behavior and integrate it into the regional economic system. As Robert Gilpin well observed, “The long-range purpose of Japanese bilateral foreign aid in the region is to promote the commercial interests of Japanese firms and to encourage Asian countries to adopt the Japanese economic model” (1993, 33). There is little doubt that Japan will continue to use the economic tools including its ODA to China to serve its national security, broadly defined.

However, for Japan, the most significant development from using its economic power including the ODA is not only for narrow economic aims, but also for wider political and strategic goals, including international prestige and recognition. This appears particularly pertinent to Japan which has an intense aspiration to become a political power in the world community. Japan has been carving out a political and diplomatic role commensurate with its economic clout. As early as March of 1988, Japanese Prime Minister Takeshita called for a defensive capability matching its economic power. In 1992, Japan provided 18 percent of all ODA in the world. Enormous aid giving allows Japan to satisfy to some extent the outside demands for more international burden sharing, but also provides Japan with more opportunities to influence economically as well as politically the fate of recipients. After all, aid can well lead to political influence. In addition, “Sino-Japanese relations have been dominated by economic matters. However, the intrusion of political factors and demands of a changed international setting will inevitably complicate the relationship and increase the
likelihood of conflict" (Hee 1993, 319). In this sense, Japan's ODA to China has particularly its political significance.

PURSUIT OF POLITICAL AND STRATEGIC GOALS THROUGH ODA

Japan selected projects for its ODA to China not only on the basis of potential economic benefits to Japan, but also on the basis of their political and strategic implications. That is to say, Japanese aid can influence China not only economically but also strategically and politically. Although Prime Minister Nakasone claimed during an Upper House hearing on ODA in the National Diet (Japanese Congress) that Japan would not bring strategic considerations into the distribution of its foreign aid, strategic considerations clearly influenced its aid policies. As Article 9 of Japan's post-war peaceful constitution renounces "the right of belligerency," Japan "cannot use military might in pursuit of its overseas policy." As a result, economic cooperation becomes one of few alternative means by which Japanese government could exercise international influence over its Asian neighbors and particularly China.

Japan's soft power derives from its economic, financial and technology power. In the first instance, Japan relied on economic measures to achieve access to and secure supply of raw materials and energy. Increasingly Japan is translating this power into influencing the shape of the international relations and acting as a means to pursue its national interests. The end of Cold War has taken away the relatively simple framework consisting of reliance on the United States but also increased Japan's range of alternatives. The shift of importance from military to economic and technological power has been to Japan's advantage as the world's second largest economy. Foreign Minister Kono Yohei (1995, 13) wrote in 1995 that the end
of Cold War had enhanced Japan's options and Japan was no longer to base its decisions on the demands of the East-West confrontation and on the fact that it is a "member of the West." Indeed, Japan is increasingly using this power for goals which are beyond narrow economic confines, including peace-keeping operations and the request for a permanent seat in the UN.

In the same vein, Japan's ODA to China, together with its investment, has led to the acquisition of Japan of considerable power and influence over China, providing the Japanese government with considerable leverage over the options and bargaining power relative to China.

In essence, Japan's foreign policy is basically built on foreign trade, foreign direct investment, ODA, technology transfers, and other financial flows as well as the domestic economic activities of Japan and the other countries of East Asia; its foreign policy uses economic affluence and manufacturing competitiveness as ways to influence other countries (Inoguchi 1992a, 1992b). Not surprisingly, Business Week bluntly states that Japanese "goal is to extract more Japanese investment and technology with hopes of furthering their own economic power. Bolstering its clout is its disbursal of foreign aid. Japan directs much of its money to Asia so as to carve out a sphere of influence." 66

The use of aid for the pursuit of not only economic but also political interests has clearly been prompted originally by outside and notably America's pressure. Japan felt that it had to counter Western criticism of Japan for not contributing to the maintenance of the international system commensurate with its economic power and to use aid giving as a means to offset US pressure for more defense efforts (Drifte 1996, 123). The aid with strategic connotations has also to be understood against the background of the government concept of "comprehensive security" developed at the beginning of the 1980s.67 The concept was

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prompted by the 1973 oil crisis and the weakening of US power. As a result, wider economic and political-military considerations entered Japanese aid policies. The strategic consideration refers more or less to countries which are strategically important to Japan in terms of raw materials and energy supplies. The latter type of political-military considerations was related to outside demands for more burden sharing. Due to US pressure, beginning in 1991, Japan started to use aid as a leverage to pressure China to practice self-restraint in exporting weapons. So far, what most vividly demonstrates the political and strategical implications of Japan's ODA policy is perhaps the 1992 ODA principles and their actual applications. The 1992 principles directly link Japan's aid with recipient countries' environment, non-aggression, military transparency, and human rights issues.

The principals were, for example, applied in suspending aid to Haiti after the coup in 1991 and in suspending aid to Zaire following the political deterioration (MOFA 1994, 59-62). In 1994 Japan stopped its assistance to Nigeria because of the military's intervention in the process of democratization. More significantly, Japan adopted the principles and suspended grants to China twice against its nuclear tests in the summer of 1995. Nevertheless, the application of the ODA guidelines is clearly very dependent on other considerations. Government spokesmen make it clear that these principles are not to be applied in a "uniform or mechanical way" but rather that the tendency towards fulfilling these principles is to be judged and that there should be "friendly persuasion" and "quiet diplomacy" (Hiroshi 1995, 9-10). Deputy Prime Minister and Foreign Minister, Kono Yohei qualified the application of these principles in the following way, "it is necessary, in this regard, to take account of the trends in individual countries when deciding its assistance, since there are some cases in which it is not realistic in the short term to link aid directly with specific policies by the recipients"
The use of aid suspension to exert influence, however, predates the 1992 ODA principles. In 1984, Prime Minister Nakasone visited Pakistan and more aid was promised. He said, however, that Japan should apply economic power more effectively in its diplomacy and that Japan “cannot refuse to use economic cooperation for the purpose of mitigating tensions” (Yasutomo 1986, 100). Japan completely suspended its aid to Vietnam when it invaded Cambodia in 1978. Perhaps, the most well-known case of aid suspension happened after Tiananmen incident when Japanese government “subjected new aid to China to judicious diplomatic considerations.” (Takagi 1995, 99). The imposed suspension of Japan’s ODA to China for more than one year well demonstrates that “Tokyo’s increasing efforts to translate economic clout into [political] influence and participation.”

“Japan’s economic might and its military vulnerability ought to persuade anybody that it won’t always be a passive spectator to Asian’s strategic currents.” This is particularly true because China poses a more permanent challenge and inevitably becomes a strategic competitor for Japan. In order to exert pressure on China, the possibility of reducing aid is openly discussed in Japan. In March 1991, the Chief Cabinet Secretary Sakamoto Misoli declared that Japan was yet undecided on whether to curb economic aid to China following Beijing’s announcement about a sharp increase in defense expenditures.

Suspension of foreign aid to protest China’s continued nuclear-weapons testing, is another sign of Japan's growing assertiveness in international affairs and clearly shows how Japan emphasizes economic instruments to reflect its power. In August 1995, China’s test provoked an unprecedentedly firm Japanese reaction. Tokyo slashed grant aid to China from $70 million a year to only $5 million. That, in turn, provoked an unusually outspoken Chinese
response. Chinese Premier Li Peng called this aid cut as “military blackmail” and said that it was wrong for Japan, sheltering under the US nuclear umbrella, to object to China modernizing its own nuclear arsenal.\textsuperscript{72} The move is the second time in four months that Japan, the world's largest foreign-aid donor, has used its assistance to apply diplomatic pressure on China. Japan made a symbolic cut in grant aid in May 1995, when China resumed nuclear testing just days after more than a hundred nations, including Japan, permanently extended the Nuclear Non-Proliferation Treaty. Although this is hardly inflicting economic damage to China, it is a clear departure from the past cautious behaviors of Japan.\textsuperscript{73}

China experts in the Japanese Foreign Ministry hope that the suspension of grant aid in 1995 was only a temporary reaction to China's nuclear tests, but it is likely that ODA will be used as a stick to punish Chinese expansionist military behaviors. As key members of the Japanese Diet had made clear well before the nuclear tests, Japan should begin using its generous ODA to “take a clear position of expressing concern over China's military build-up.” (JFOIR 1995, 23) However, the Japanese fear that the Chinese response to further cuts in financial aid will be much fiercer and that Chinese officials may “play the anti-Japan card” and encourage popular resentment of the Japanese. If that happens, they fear, relations may go into a downward spiral. Finally, it is very clear to Japan that strong, public Japan's pressures on China in a variety of areas including the military expending could greatly increase the likelihood of strongly anti-Japanese conservative nationalists gaining control of the Chinese political system. In this light, Japan has to be cautious with the use of ODA to seek influence over other issues and particularly what Beijing calls “internal issues” such as military spending and human rights.
SUMMARY

This case study has found that international structural changes – the relative decline of Japan's economic power in respect to the economic rise of a nationalistic China, and the diminution of the Soviet military threat – largely account for Japan's greater sensitivity to relative gains in its ODA ties with China. In the absence of such changes, it is inconceivable that relative gains concerns or policies associated with them would have emerged as prominently as they did in the reformulation of Japan's ODA policy to China in the earlier 1990s. That Japan consciously sought to recast the agreement in order to minimize the gaps in economic benefits in China's favor is further enhanced by the fact that it tends to use ODA to pursue its both economic interests and political and strategic objectives.

Obviously, two factors combine to induce Japan's increasing concern for relative gains and account for the reduction of its ODA commitment to China especially in the fourth yen loan package. The first is system changes associated with the end of Cold War and Japan's perception that a powerful, non-status quo China has replaced the USSR as its most worrisome foreign policy problem. The second is Japan's record to have utilized its ODA to seek its national security, broadly defined. By forcing China to accept a shorter ODA coverage, Japan is in a better position to strive for relative advantages and to use the increased bargaining power to address China's possibly detrimental behaviors toward Japan. The major findings of this empirical analysis will be further discussed in the concluding chapter.
NOTES

1. ODA normally consists of capital grant assistance, technical cooperation, capital subscriptions, government loans to developing countries, or contributions to UN agencies and international financial institutions. ODA donor countries are coordinated by the Development Assistance Committee (DAC) of the Organization for Economic Cooperation & Development (OECD), which now has 21 members. Japan became a member of the DAC in 1961.

2. All the value of the US dollar is calculated on the basis of the exchange rate at that time.


7. According to the U.S. Foreign Assistance Act, the United States cannot provide any kind of government development aid to China due to the fact that China is a communist state.


11. "Textbook controversy" began in summer 1982 when China launched a strong campaign of criticism against Japan for its revision of its past behaviors in school textbooks. China officially blamed Japan's Education Ministry for a move to "distort" Sino-Japanese history by watering down and glossing over past war atrocities in the process of screening Japanese school textbooks of history. See, "Japan's Screening of Textbook Distorts History and Beautifies Invasion," *The People's Daily*, June 30, 1982. Kodaryo case started with February 26, 1987 when the Osaka High Court recognized Taiwan's ownership of a student dormitory in Kyoto called the Guanghua Hostel, or Kokaryo in Japanese. Chinese leader Deng Xiaoping pressed the matter from the viewpoint that the case was not a legal, but a political question: It was basically related with the problem of "one China, one Taiwan" or "two Chinas." Yasukuni Shrine problem was related with Japanese Prime Minister, Nakasone's visit in 1985 to the Yasukuni shrine in Tokyo for the war dead, including war criminals during the Second World War.
12. According to some scholars, Japan's increase of loan aid to China simply has followed a basic pattern, "when a problem occurs, China opposes Japan, and Japan makes concessions in order to remove immediate frictions, but avoids removing serious, long-standing frictions inherent in the basic structure of relations between the two countries" (Ijiri 1990b, 299; also 1990a, 660-1. According to him, the long-standing frictions are the basic stratum of "frictions and distrust" in substance. See also Ladd and Bowman (1996) and Taylor (1985).


18. From the 1980s the ODA budget was given preferential treatment with Japan's national budgeting process as was the defense budget.

19. The main institution deciding ODA is the Ministry of Foreign Affairs (MOFA). The three bodies carrying out ODA are the Japan International Cooperation Agency (JICA) under the MOFA, the Export-Import Bank of Japan and the Overseas Economic Cooperation Fund (OECF). Apart from these bodies, other ministries and agencies are also involved, making the decision-making process very cumbersome and nontransparent. ODA budget is funded from three sources: the General Account, the Fiscal Investment & Loan Program, and notes for capital subscriptions appropriated for contributions to international financial institutions.


25. Regarding the opposite views, see, for example, Hudgins (1993), Tresize (1989), etc.


29. Other important factors to stimulate China heavy military spending is obviously related with some major events of the late 1980s and early 1990s which dramatically increased the power and prestige of China’s conservative nationalists and the military. The major factors include the incapacitation of Deng Xiaoping, who tended to exert a pro-US and moderating influence, the “jarring effect” on PLA of the Gulf War, which demonstrated US superiority in high-tech weapons, and buying army loyalty in the wake of Tiananmen (e.g., Nathan and Ross 1997).


32. Their figures take all those factors into account such as PPP proceeds from arms sales, cost of R&D, nuclear weapons development and soldiers pensions, and the cost of the People's Armed Police, etc.


57. For a full text of the ODA Charter, see *News & Views from Japan*, June 29, 1992.


60. *Asahi Shimbun*, December 1, 1979; Lee (1984, 121).

61. According to Japanese Foreign Ministry, five areas are listed as top priorities in Japan's official investment in China. They are, 1) economic infrastructure, especially transportation, communication, and electrical power generation, 2) agriculture, improving both productivity and supply system, 3) environment, pollution reduction and environmental impact of studies
for new enterprises, 4) medicine, especially in rural health care, and 5) education, concentrating on improved methods of basic education and training of middle-level educational administrators.


CHAPTER V

CHINA’S REJECTION OF THE FLYING GEESE PATTERN

AN OVERVIEW OF THE FLYING GEESE PATTERN
OF ECONOMIC DEVELOPMENT

To clearly understand what the flying geese pattern (yanxing moshi) of economic development means, we’d better begin with the analogy of flying geese itself and Vernon’s product cycle theory (Vernon 1966, 1971). The metaphor of flying geese was first proposed by the Japanese economist Akamatsu Kaname in the late 1930s (Akamatsu 1961). Based on his study of the textile industry in Japan, Akamatsu suggested that the diffusion of new products and technologies to developing countries begins with their imports from advanced countries. With imported techniques and capital goods, “homogeneous industries” are gradually established. In the third stage of the cycle, local capital goods industries develop export capabilities and interstate trade becomes increasingly common. In this light, he argues that the industrialized process follows a “wild-geese-flying pattern of successive appearance of import, domestic production, and export.” As he notes, “[w]ild geese are said to come to Japan in autumn from Siberia and again back to north before spring, flying in inverse V shapes, each of which overlaps to some extent” (Akamatsu 1961, 205-6).

Vernon’s product cycle model similarly evolves through three stages. It predicts a staged shift of production-based investment and trade from the US to other industrialized countries and then to developing countries. Focusing on the behavior of individual firms, Raymond Vernon (1966, 1971) examines how the life cycle of individual products affects the competitiveness of firms and ultimately leads to the location of manufacturing production...
across national borders. In the first stage, a firm in a relatively advanced country (i.e., the US) uses its innovative technology to manufacture a new product that is initially targeted at home market. In the second phase, with production technology becoming more standardized and demand for the product more sensitive to price, firms begin competing to improve productivity and achieve economies of scale and some even begin exporting the product. Finally, in the third phase, when the technology is fully standardized, firms are compelled to relocate their production facilities to developing countries where abundant supplies of cheaper labor are available in order to reduce costs and maintain competitiveness.

Beginning in the 1970s, some economists, primarily Japanese ones, attempted to synthesize their arguments into a model of East Asian regional economic development. They incorporated Akamatsu's discussion of industrial diffusion across nations with Vernon's model of product cycle of foreign investment and trade to account for the pattern of industrial diffusion from Japan to Asian NICs, to ASEAN, and most recently to China. Some scholars argue that today, investment needs to be seen in the context of export-oriented industrialization and the flying geese pattern of economic development (Croix et al. 1995). American economist Peter Petri (1988, 1992) has also adopted the flying geese theory in suggesting that East Asian developmental trajectories have followed the Japanese path more closely than would have been explained by neoclassical (i.e., Hechscher-Ohlin) arguments about relative factor endowments. In part, this was because Asian NICs and particularly South Korea and Taiwan consciously set out to model their industrialization after Japan.

However, the product cycle explanation of East Asia's industrialization was popularized by Bruce Cummings. In a now classic article, Cummings (1984) convincingly argues that Asian economic development cannot be understood outside the context of "the
fundamental unity and integrity of the regional effort" that began with Japanese colonialism. He applied the analogy of flying geese to the East Asian situation: Countries are said to follow one another in a developmental trajectory in which the latecomers replicate the developmental experience of the countries ahead of them in the formation. Eventually, the flying geese analogy as incorporated with the product cycle model has become a widely accepted way of conceptualizing industrial diffusion across East Asia and a basic useful economic framework for understanding manufacturing investment and trade in the region.

JAPAN'S ACTIVE PROMOTION OF THE FLYING GEESE PATTERN

Increasingly, Japanese economists and officials use the flying geese model and advocate that "the development model adopted by the Japanese may be regarded as a suitable development strategy for newly industrializing economies today" (Yamazawa 1990, 27). Ryosei Kokubun (1986) further argues that the special features of what he terms "Japanese-style direct foreign investment" are what enables less developing countries (LDCs) to imitate Japan's development pattern. Japan, of course, is the "lead goose" in this regional division of labor, followed by NICs, then ASEAN-4, then China, and so on. As the product cycle is repeated for increasingly sophisticated products, the development experience of Japan will be replicated in a succession of sectors and countries. In other words, as it flies forward, becoming more and more technologically advanced, Japan pulls the entire V-formation along by successively shedding industries in which it no longer holds comparative advantages. Through FDI, these industries ultimately find a new home among the "follower geese," i.e., developing countries in Asia. Over time, those LDCs master the new technology, upgrade their own industrial structures, and they themselves begin shedding outdated industries to
even less developed countries.

Japanese government officials are also active in advocating the flying geese model and enthusiastically employs the analogy. In 1980, Ojimi Yoshihisa, then a MITI vice minister, told a gathering of Western leaders that the development process in Asia was one of "progressively giving away industries to other countries, much as a big brother gives his outgrown clothes to his younger brother. In this way, a country's own industries become more sophisticated" (Abegglen and Stalk 1985, 260). The Committee on Asia-Pacific Economic Research under Japan's Ministry of Finance (MOF) recommended in a clear possible language, "it is necessary that what Japan used to do should be done by the Asian NIEs, what the Asian NIEs used to do should be done by ASEAN countries" (FAIR 1990, 64). Given the importance of China's economy, Japan's International Institute for Global Peace (IIGP) admitted that regional cooperation could not be meaningful without China's participation and as leader, Japan should facilitate China's integration into the region (Tatsumi 1990, 12-3).

In the mid 1980s, a dramatic increase in the value of the yen, triggered by the Plaza Accord, undermined the cost competitiveness of virtually all manufacturers that exported from Japan.¹ In order to maintain international competitiveness under the high yen, Japanese began to heavily invest in the NICs and then in ASEAN and increasingly China, setting up or expanding production facilities and exporting some of their output back to Japan. Meanwhile, the Japanese government appeared to be more and more interested in promoting the flying geese model in Asia.

Ministry of International Trade and Industry (MITI), for example, set up an advisory group that called for public and private efforts to thoroughly integrate the economy of the
Asia-Pacific region. An authoritative MITI report bluntly states that by serving as innovative leader that will “push forward the frontiers of world demand by actively promoting the development of new products and new technologies,” Japan will be able to ride the crest of Vernon’s product cycle (MITI 1988; 1989, 237-8). That is, Japan will be able to maintain its lead goose position in the regional economic order of V-formation. Similarly, Ministry of Finance created its own think tank to examine regional trade and investment policies. In the preface to its interim report, the thinking tank saluted the rise of the Asia-Pacific region as “one large economic zone and center of growth” (FAIR 1989). The Economic Planning Agency (EPA), which, like MITI and MOF, plays a pivotal role in Japan’s government-business network, used the flying geese analogy to exhort Japan and Asia to “plan for adjustments in their industrial structures that reflect shifts in comparative advantage” (EPA 1989, 158).

In November 1986, the participants from Japan External Trade Organization (JETRO) at the Beijing Conference on the “Asian-Pacific Economy Towards the Year 2000” encouraged China to shift to export-led growth and invite Japan’s sunset industries to Chinese export zones, thus linking China to Japanese industrial policy and to the regional industrial product cycle at the second or third tier. Two JETRO officials argued that the Japanese design was to “achieve a high level of industrialization by increased complementarity and reduced competition in the regional economy” (Masahiko and Hishida 1987, 4-6). Similarly, the policy announced by MITI Minister Tamura in Bangkok in January 1987 called for integrating other Asian countries, especially ASEAN, more closely with Japan’s economy. The five-year economic plan, released by the Japanese EPA in May 1988, “calls for the construction of an international division of labor through more imports, more FDI, and more
ODA.” That is to say, Japan plans to manipulate capital, technology, and trade to construct a regional division of labor tightly coordinated from Tokyo.

However, what describes the flying geese model in the most explicit and detailed way is a major policy analysis commissioned by the EPA in 1988. The report identifies Japan, the NICs, and ASEAN as upper-, middle-, and lower-grade economies. It calls for a regional organization, the “Asia Brain,” to coordinate aid, investment, and trade policies so that these three layers can function together as one organic unit. The EPA report frankly states,

A smoother movement of production and technology from upper-grade states to middle-grade states, and from middle-grade to lower-grade states is expected, and along with this, industrial adjustment efforts by each country will be required . . . . Japan has overwhelmingly comparative advantage in machine tools, textile machinery, food-processing machinery, other machinery parts, automobiles, and motorcycle sectors, and at present these sectors will not require intraregional restructuring. But it is desirable to carry out a smooth production restructuring in office equipment, electronic musical instruments, and semiconductors [i.e., from Japan to the Asian NICs]. In addition, in personal sundry goods, veneer boards, and wood products, production restructuring is required between the Asian NICs and ASEAN. Knit, spun, and woven goods, and plastic will have to be reallocated among the Asian NICs (EPA 1988, 126-7).

ABSOLUTE GAINS FOR CHINA’S ECONOMY

At the first glance, economic development in Asia does seem to follow the flying geese pattern of economic development. After 1985, when endaka, the skyrocketing appreciation of the yen, began to stuck at its competitiveness, Japan's FDI first flew into Asian NIEs, then ASEAN, and more recently into China. By the end of the 1980s, firms from NICs began to invest in the Southeast Asia in a large scale, setting up labor-intensive manufacturing facilities of their own. In 1991, Taiwan was the leading foreign investor in Malaysia and
Indonesia, and second largest investor in China (ITC 1993). Not to be outdone, Thailand, Malaysia and even the Philippines began to invest in low-cost countries such as China and Vietnam. As a result, a production process appears to be spanning across the region.

Publicly, Japanese officials made it clear that Japan would not be the sole beneficiary of this new division of labor; that all of Asia would proper. “For the expansion and maintenance of Asian growth,” concludes Kayoko Kitamura (1991), a senior researcher at the Japanese Institute of Developing Economy, “the international division of labor should be advanced. With Japanese businesses at the helm, each region and nation has to cooperate to solve international and compete without friction.” The 1988 EPA similarly advocates, “with a view toward setting up this gigantic economic cooperation with an appropriate role in international society, Japan’s exhibition of leadership in creating this ‘Asian Brain’ would be a great contribution with respect not only to the Asian region, but also to international society as a whole” (Arase 1990, 270-5). It is true that cooperation can, under certain conditions, reduce a firm’s transaction costs and thus, in the aggregate, enhance a nation’s long-term development prospects (Ping Deng 1998, 24).

After 1989 Tianmen Incident and with the end of Cold War, international structure system and Asian international relations changed dramatically. As economic growth becomes the primary concern in its foreign policymaking, China began to readjust its policy to focus on Asia-Pacific region and has become enthusiastic about regional economic cooperation. Sino-Japanese economic cooperation is propelled by their complementary economic structures. Japan has technology and capital; China has natural resources and labor. Japan could supply capital equipment and consumer goods in exchange for China’s natural resources and agricultural products (Arnold 1990, 121-46). In this sense, bilateral economic
cooperation is mutually beneficial and to some extent is a natural fit. For Chinese firms, the
benefits to participate in the flying geese pattern are large, especially in the early stage of the
network formation. They may receive invaluable infusion of capital, technology, and
managerial guidance from Japanese firms. This industrial diffusion is especially useful for
Chinese firms that face uncertainty and risks as they try to adopt successively more advanced
technology. The contributions made by Japanese government, including ODA, also help
increase these gains.

Indeed, following Japan’s flight path, some Asian countries have achieved, or are
about to achieve, economic “lift-off,” an upward trajectory that has allowed them or soon will
allow them to escape the mire of perpetual less developed status. The Asian NIEs,
particularly South Korea and Taiwan, have already accomplished economic feat and are now
in the intermediate position of catching up to the most advanced countries; the ASEAN-4 and
coastal China are moving into the tier of the NICs (Chow 1993, 202). They are being pulled
forward in part by Japanese capital and technology or by membership in the flying geese
model. Their experiences seem to confirm the central assumption of the model, i.e., Japan can
embrace relative weak nations, creating a syndrome of development.

Furthermore, more outwardly oriented economies usually achieve higher rates of
savings and investment, and greater efficiency in the use of investment resources, both of
which contribute to higher rates of growth (Deng et al. 1997, 32). Efficiency gains may
accrue not only from economies of scale but, more importantly, from the stimulus that
competition provides for technical change and managerial efficiencies (Feder 1983, 138-9; see
also Ping Deng 1998, 24). The World Bank (1993, 22-3) strongly believes that success in the
promotion of manufactured exports provides a powerful mechanism for technological

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upgrading and thus a source of rapid productivity growth in the high performing economies of East Asia. Nicholas Lardy, an authority on China’s economy, convincingly argues that “China has had rapid export growth, but this has depended to an unprecedented degree on foreign invested firms” (1995, 1081; also 1994).

In particular, Chinese analysts themselves show acute awareness of the layered flying geese as the main future sources of technology progress. They also argue that although the regional economy has three tiers, there is mobility within it that allows China to catch up with Japan, the industrial leader. After all, China's economic structure itself is diverse and can fit into different levels of regional integration in Asia. China can participate in the vertical structure of economic integration and accumulate capital and management expertise. As the coastal areas complete the import-substitution phase of industrialization, the depth and scope of regional integration will expand to inland areas. That is, as they move to higher levels of development by attracting advanced technologies and industries, the more developed coastal provinces can transfer more capital and technology to the interior provinces. As Europe and North America integrate further into trade blocs, China's economic future lies in the regional integration in Asia (Leu et al. 1994, 122-6; Liang 1993, 404-8; Wang 1986, Zhang 1988).

In early 1988, Chinese Party Chief, Zhao Ziyang launched a controversial and ambitious coastal strategy (1988, 80). It largely accepted the flying geese model of economic development, acquiescing, at least nominally, to a position somewhere between the second and third tier. The strategy consists of three steps: first, the need for the coastal regions of China to emulate the rapid, export-led growth of East Asian economies; second, the policy of doing this by importing raw materials and encouraging the development of both labor- and skill-intensive industries (especially electronics); and third, the use of foreign capital to
accelerate the first and second stages. In essence, Zhao's strategy would allow China to contribute to the structuring of the Asia-pacific economy toward increased complementarity within the industrial product cycle; it intended for the coast region to pursue an export-led growth strategy, with the hope of eventually seeing advanced technology transferred there following the logic of the product cycle (Li 1988; Yu 1989, 190). However, Zhao planned to link the coastal area to the international division of labor, eventually integrating the entire country into the regional economy; that plan essentially placed China at the bottom of the pattern in trade competition with ASEAN (Ma and Duan 1988, 154-64).

CHINA'S RESISTANCE OF THE FLYING GEESE PATTERN

Tiananmen Incident and subsequently Zhao's removal marked a turning point in Chinese attitude to the flying geese pattern. From Tianmen to the present, with increasing influence from the military and domestic conservative forces, China has seldom mentioned the flying geese model of economic development dominated by Japan in public and has sought joint hegemony with Japan in an East Asian economic order. China's resistance to Japanese regional leadership with the flying geese formation was criticized by some Western analysts as unrealistic given their relative economic power (Drifte 1990, 99).

The Chinese analysis and criticism of Japan's international role in general and the flying geese model in particular have been carried out in restricted publications only for government references. Yet, China's rejection of participation in the Japanese-style economic cooperation is self-evident. The Chinese basically hold that the flying geese model was a logical response to US-Japanese trade conflict and the sharp rise of the yen; Japan simply needs Asian economies to develop a coordinated mechanism so as to serve Japan's domestic

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and international structural adjustment. Some Chinese scholars explicitly stated that the vertical division of labor (chuizhi fengong) of the flying geese pattern would be unacceptable to China unless Japan were willing in the future to relinquish its present role as “head goose” (yan tou). If it could not do that, other countries including China would be unwilling to participate in this unequal regional cooperation (Xi 1989, 49-53).

Concern over Japanese dominance of Asian economic development drove China’s initiatives to incorporate first the Soviet Union in 1985 for trilateral cooperation with Japan, and then Korea in a “Northeast Asian Economic Circle,” which later came to focus on the Tumen River Project. The Chinese initiatives for Sino-Japanese-Soviet economic cooperation were basically in response to Soviet leader, Mihail Gorbachev’s policy launches: 1986 Vladivostok and 1988 Krasnoyarsk Speeches (Jia 1989). The Chinese, in their discussions of Soviet regional participation, viewed the USSR as a potential collaborator rather than a competitor. In their point of view, the Soviets would join China, NICs, and ASEAN in resisting Japanese dominance and exploitation of the Asia-Pacific region. However, beyond incorporating Russia for balancing Japan in the two of the regional triangular structures, China does not view Russia as having a major role to play or ever participating in the core regional structure involving US, Japan and China.4

On top of that, Beijing has sought joint economic hegemony with Japan in Asia. In 1990 Beijing Institute of International Studies felt that China’s candidacy for regional leader was viable as Japan’s, and that the new political and economic order in the region required the joint efforts of Japan and China in a multi-centered arrangement rather than a Japanese dominated vertically structured hierarchy, i.e., the flying geese pattern (Shi 1990, 8-10). The idea of joint hegemony over the regional economic order was expressed by China’s Premier
Li Peng in January 1991 when he told a visiting Japanese Diet delegation that both countries had positive roles to play in the building of a regional economic order, implying they had equal responsibility. Two months later, Chinese minister of Foreign Economic Trade & Economic Relations, Li Lanqing, frankly suggested to the head of MITI that East Asian economic sphere be created with both nations at its center in a joint hegemony.⁵

Finally, Beijing uses both multilateral regime (i.e., APEC) and subregional regimes (e.g., ASEAN, the Greater China Economic Integration, the Sea of Japan Economic Zone, the Northeast Asian Economic Zone, etc.) as a means to assert China’s regional power and undercut Japan’s dominant position. China hoped that those regimes would prevent an excessive dependence on Japan’s economy. Although rarely acknowledged explicitly, the real value of the subregional regimes to China is to undermine the flying geese model (Christoffersen 1996, 1069-71).

In essence, the subregional regimes in Northeast Asia and Southeast (ASEAN) divide Japan’s flying geese formation into two segments. Although it generally remains silent on those destructive effects, China continues to argue that the dominant trend in East Asian economic cooperation is toward subregionalization rather than a multilateral regime with many different cultural traditions and values. The Chinese hold that the subregional regimes are more viable economic circles because each brings together culturally homogenous areas. These arguments are well demonstrated in a policy speech given by President Jiang Zemin at the 1994 APEC Summit Conference in Malaysia. In the speech, Jiang argues that “given the significant disparity in levels of economic development, difference in political status and development priorities, cooperation should proceed step by step in a gradual, pragmatic, phased and prudent manner in order to achieve optimum results.”⁶ Meanwhile, China appears
intent on cultivating Greater China economic ties that share common values, historical traditions and cultural connections, then integrate into the regional economies in Asia, and finally reach out to more developed countries in the world (Hu 1996).

**KEY FACTORS AFFECTING CHINA'S RELATIVE GAINS CONCERNS**

Why China officially refuses to participate in and even tries every effort to undermine the flying geese model championed by Japan, an otherwise mutually beneficial economic cooperation? The central hypothesis of this chapter is that China’s uncooperative decision is because of relative gains concerns that are mainly derived from its belief that the cooperative pattern will put China in competitive disadvantage and thus hurt its long-term economic growth and possibly its political status. *In essence, the flying geese model of economic development is Japan's grand strategy and it "guaranteed that China would never assume the leadership position it sought within the hierarchical East Asian order"* (Christoffersen 1996, 1073; emphasis added).

After all, the nature of the flying geese model is a three-tiered V-formulation of industrialization takeoffs and export-led growth; based on the level of development and technological capacity of the relevant countries, Japan is at the head, NICs constitute the second tier, and ASEAN-4 and China at the third and lowest tier of the product cycle. As the flying geese model perpetuates the inequality and disparity in Asian economic development, China’s aspiration to climb up the technological ladder would be stymied, thereby being detrimental to its long-term economic growth. Furthermore, to endorse the flying geese model would damage China’s highly nationalistic self-image because that means China has accepted Japan’s international primacy in the region.
Japan's economic status, financial and technological capacity obviously make it the economic leader in the regional cooperation. As the leading goose, Japan is the biggest beneficiary. If the flying geese model were implemented, the production pattern in the region would be basically characterized by a vertical division of labor and a core-periphery structure in the regional economy would be preserved. That will not only benefit Japan's economic competitiveness in the world market, but also largely insure that Japan stays in the lead indefinitely.

Moreover, despite of advocating that it is its responsibility to assist in the lower level countries' industrialization and incorporate them into the regional economy, Japan seems to be only interested in maintaining this hierarchical division of labor and creating different economic circles around its economy. Indeed, by controlling access to capital, intermediate goods, and technology, Japanese MNCs have largely shaped Asian structural dependence and maintained the lead in the most high-tech aspects of production. The Japanese dominance over manufacturing equipments and intermediate goods has in turn strengthened their export drives. Thus, Japan can maintain sizable trade surpluses with virtually each East Asian economy. Given those painful facts, along with Japanese war time crimes, East Asia in general and China in particular will be loath to follow Japan's lead, even as they depend on Japanese investment, aid, and technology (e.g., Dower 1994).

On the other hand, China's integration into the regional structure would put it in an inferior position in regional economic competition and development, whereas China tends to favor a more positive position in regional economic integration (e.g., Jin 1992, Cheng 1990, Ma and Duan 1988). Economically, the inferior status reflects China's position as a natural third level participant which is still heavily dependent on raw material trade and seeking inflow
of foreign capital. Although the flying geese model might bring China economic prosperity in the short run, it will lead to a periphery position in the regional structure in the long term. It will also leave little chance for China to upgrade its technological level and get to the top in the future.

To make the matter worse, although the flying geese pattern is basically related to economic issues, it has obviously political significance. The intrusion of political and historic factors and demands of a changed international setting will inevitably complicate the relationship and increase the likelihood of conflict. If it participated in the model with Japan as the “head goose” and China “follower goose,” China would recognize and almost accept Japan's leadership in the international relations in Asia. That would definitely be a hard blow to China's highly nationalistic and confident self-image. However, China has a strong sense of being Asia's naturally dominant power, and that perception has been further strengthened by its astounding economic growth during the past two decades. Largely because of strong nationalistic passions, China will not accept any permanent subordination to Japan; politicians in China who appear to submit to Japanese leadership are pilloried as traitors.

SERVING JAPANESE MNC'S INTERESTS AND STRATEGIC GOALS

In the years after the Plaza Agreement, enormous changes occurred in the regional investment and trade flows in East Asia. Although dramatic appreciation of Japanese yen did not reduce the US trade deficit, it did undermine the competitiveness of domestic manufacturing in Japan and the profitability of Japanese exporters. At a time when the Japanese currency was reevaluating, the currencies in China and Southeast Asian countries were depreciating, mainly due to the fact that their currencies were more or less pegged to
the US dollar, thereby making them more attractive as a base for cheap production and export 
platforms for Japan.

Table 5.1 Labor Cost Differentials in Selected Countries, 1990 
(Relative to the US average hourly labor cost of $10.02)

<table>
<thead>
<tr>
<th>Countries</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>139%</td>
</tr>
<tr>
<td>The US</td>
<td>100%</td>
</tr>
<tr>
<td>Taiwan</td>
<td>46%</td>
</tr>
<tr>
<td>Korea</td>
<td>32%</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>30%</td>
</tr>
<tr>
<td>Mexico</td>
<td>30%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>9%</td>
</tr>
<tr>
<td>Philippines</td>
<td>7%</td>
</tr>
<tr>
<td>China</td>
<td>4%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>2%</td>
</tr>
</tbody>
</table>

Source: Data from Werner International in Textile Monthly, 

Japanese currency appreciations were compounded by changes in relative wages. As an illustration, Table 5.1 has made a comparison of the average hourly labor costs in spinning and weaving in 1990 among various countries. Although the estimation evolves the problems such as conversion to a common currency and tells nothing about the productivity of the labor force in the related countries, it does tell us the enormous wage differentials between Japan and other Asian countries, thus providing Japanese investors fresh impetus to be tilting towards Asia.

The stronger the yen, the greater the pressure it is on Japanese firms to shift manufacturing to Asia as attractive outlet for much of Japan’s manufacturing and exporting
activity. Japan's FDI in Asia increased rapidly after 1986. In the four-year period of 1986-89, its FDI there grew at an average annual rate of more than 50 percent; its investment in Asia manufacturing exceeded the cumulative total between 1951 and 1985. In the 1990s the flow of Japanese investment further accelerated. In 1990, it invested $10 billion in manufacturing in ASEAN and $8 billion in the NICs (Tran 1992, 44; Urata 1993, 278). In 1994, 36 percent of Japanese manufacturing and nearly three quarters of the projects went to Asian NICs, ASEAN-4, and China (MOF 1995, 2). Furthermore, small and medium-sized Japanese firms are increasingly active in East Asia; in 1994 81.3 percent of their investing overseas opted to go to Asia (MITI 1995, 416).

The Japanese capital flow into Asia appears to maintain the strength. A survey conducted by Japan's Export-Import Bank suggested that, over the coming three years, three-quarters of Japan's new FDI would go to Asia. Given the fact that labor in China is even cheaper than in other parts of Asia (see Table 5.1), and the potential for sales in China is far bigger than elsewhere, China as Japanese cheaper production base seems more alluring. As a result, it is not surprising that for the past three years the Japan’s Export-Import Bank's annual surveys have found China to be the most popular country for Japanese firms to invest in. Japan's investment in China, which had fallen behind that of others in the late 1980s, rose sharply from a cumulative total of 3.5 billion in 1991 to $10.5 billion at the end of 1995, and annual pledged investment leapt from $457 million in 1990 to $7.6 billion in 1995. Japan's new investment in China is now nearly as large as its combined new investment in NICs and approaches that in ASEAN-4.

More importantly, Japan's manufacturers invest in Asia for grand strategic purposes. The strategic purposes are aimed at achieving economies of scale, scope, and networking by
capitalizing on the region’s deepening division of labor. By definition, manufacturing production is a multistage process with each stage requiring a different level of technological skill (Ping Deng 1998, 22-3). Recognizing this, many Japanese multinational corporations (MNCs) are breaking the production process into discrete pieces, retaining at home what adds the most value to the product such as the design, R&D, and precision testing, while parceling out the rest of the work to different host countries in Asia according to their technological levels (Tran 1992, 36). Japan usually supplies the high-tech inputs; NICs supply the high-to medium-tech inputs; the ASEAN-4, as well as China, supply the medium-to low-tech inputs. In this light, Japanese manufacturers view Asia as one integrated but technologically stratified economy. As an editorial of The Far East Economic Review well observes, the Japanese “have come to view Asia as an extension of their industrial machine, producing goods for both their domestic and world market.”

In addition, “willing or not, the ASEAN economies have become an integral part of a production that is emerging in the Pacific region, with Japan as its core” (Soesastro 1989, 7). That argument has been largely supported by a 1990 JETRO’s comprehensive survey. The survey found that 38 percent of Japanese manufacturing affiliates in Thailand, 39 percent in Malaysia, and 43 percent in Singapore considered themselves part of a production network based on a regional division of labor dominated by Japan (Takeshi 1992, 98-9). This painful fact has become obvious to Chinese analysts who are paying close attention to how Japan has been embracing Asian economies via the flying geese model.

As the 1980s wore on, high yen made it increasingly difficult for Japanese firms in Asia to continue to import parts from Japan. To maintain competitiveness, they had to begin purchasing locally produced parts. That, in effect, helped Japanese firms build a new kind of
network, based on a denser set of interfirm relationships. As they turn more and more to Asia as an alternative site for export-oriented manufacturing, Japanese firms can establish a comprehensive type of network. Affiliates assemble high-tech parts imported from the parents in Japan and less sophisticated components from other affiliates in the region. Manufacturing activities are thus strategically placed in technologically appropriate sites according to Japanese firms' own division of labor and each country's strengths (Hatch and Yamamura 1996, 27-32).

Matsushita, headquartered in Odaka, a Japanese electrical and electronic giant, which bears such brand names as National, Panasonic, Quasa, and Technics, has gradually integrated East and Southeast Asia into a tightly integrated network. According to its corporate strategy, Malaysia serves as its regional production base for air conditioners and refrigerator, Thailand as headquarters for washing machines, Singapore as the center for color TV sets, and so on. This strategy enables its Asian operations to achieve economy of scale, scope, and networking, allowing it to manufacture and export products that could compete more effectively in global markets (Hatch and Yamamura 1996, 3).

As of April 1995, Sony had 15 manufacturing affiliates in Korea, Taiwan, Malaysia, Thailand, and China with around 30,000 employees, producing billions of dollar worth of audio and video goods, semiconductors, and computer parts. Sony's success in the region is based largely on intranetwork cooperation. For instance, to manufacture VCRs at its assembly plant, Sony uses integrated circuits and other sophisticated components imported from Japan and printed circuit boards and other semifinished goods imported from Singapore; it purchases tape decks and other basic parts, from local suppliers in Malaysia (Pangetsu et al. 1992, 32). Hitachi is spreading just as widely across Asia, producing TV sets, VCRs, air
conditioners, and semiconductors in many different locations. It is now getting a tighter grip on this vast network, linking all its Asian facilities with the headquarters through a computerized local network (LAN).14

Japanese automakers are no less ambitious. Toyota is producing mass-producing gas engines in Thailand, diesel engines in Indonesia, steering parts in Malaysia, and transmissions in the Philippines. Its regional center in Singapore coordinates the movement of auto parts among Toyota affiliates throughout Asia.15 In the same vein, Nissan has announced plans to assemble “the first truly regional, strategic vehicle” in Asia. The vehicle, “the NV” included 180 parts from Nissan’s Thai facility, 20 from its plant in Thailand, 15 from its Malaysian affiliate, and 10 from its operation in the Philippines, but Nissan in Japan only supplied the engine block.16 Suzuki, which has long produced motorcycles on a country-by-country basis in Asia, was increasingly interested in a regional approach. As one of its corporate executive claimed, “if we could realize a division of labor among our production bases in Asia by letting each plant specialize in a certain type of motorcycle or component, and have these facilities supply each other with products, this would be far more cost effective.”17

The production process of Japanese firms can be referred to as the regionalization of Japan’s domestic alliance structure, or “the Asianization of the Japanese economy.” Asian countries might function as partners in a regional production alliance, but not equal partners, and not likely to become so in the foreseeable future. As Hatch and Yamamura (1996, 9) states, “The NICs, the ASEAN-4, and, increasingly, China’s coastal economy have become embraced by Japanese technology. Rather than autonomous agents, these economies are functioning more like subcontractors, or junior partners, in an export-oriented, keiretsu-like alliance dominated by Japan.”

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As Japanese firms are increasingly embracing East Asia in a *keiretsu*-like production alliance to enhance their international competitiveness, it is imperative for the government to launch a responding economic strategy to serve national interests. After all, economic power and manufacturing competitiveness underpin Japan's comprehensive national strength to influence other countries. Specifically, Japan's foreign policy is built on foreign trade, FDI, ODA, technology transfers, and other financial flows as well as the domestic economic activities of Japan and the other countries of East Asia (Inoguchi 1992b). As Japanese MNCs have supplied the actual bonding agents, capital and technology, for the regional production, their government is expected to use its influence in Japan and in the region to help build the overall framework of regional cooperation.

It is no longer controversial to suggest that the government was a driving force behind Japan's economic success in the early postwar period. Using all the carrots and sticks at their disposal, government officials played a central role in the rapid growth of the Japanese economy between 1950 and 1973 (e.g., Johnson 1982, Fallows 1994, Yamamura and Yasuba 1987). Indeed, domestic and external factors have reduced government agencies' power and influence. Bureaucrats may no longer have the financial tools and political autonomy to "govern" the nation, but still have considerable clout. As Larau Tyson (1991, 297) argued that "there has been no dramatic change in Japan's industrial policy objectives" and that the bureaucrats still strive to "encourage competitiveness in targeted industries because of special economic benefits they are expected to generate for the entire economy."

Moreover, the LDP is the party of economic growth and global competitive success. The party's general message of growth and political economic prestige reinforced the incentives to give key industries what they wanted in return for their political and monetary
support (Inoguchi 1983, 1988). In the point of view of China’s analysts, Japan’s reemergence as a great power had been interpreted as the goal of a three-part grand strategy long pursued by LDP leadership: first, become an economic superpower; next, a political superpower, by using increased economic aid and coercion and securing a UN permanent seat; and finally, a significant military power that would vie for regional power and project force around the world (Christensen 1996, 41-2).

Paul Krugman and others cautiously suggested that governments could improve national welfare by pursuing strategic trade policies such as subsidizing or protecting targeted export industries (Krugman 1986b, 1991, Crossman 1986). If governments can pursue strategic trade, why cannot they also pursue strategic investment? Edward Graham and Paul Krugman (1989, 54) have acknowledged that governments might be able to complement their own strategic trade policies with strategic investment policies. In the same vein, Dennis Encarnation (1992, 31-2) has suggested that the high transaction costs and large economies of scope associated with foreign direct investment constitute additional market failures, inducing governments to pursue such strategic investment policies.

In the Chinese perspective, the Japanese government plans to use the flying geese pattern for strategic investment in Asia to regionalize economic development and consolidate Japan’s economic power. It applies the model best to manufacturing industries, especially high-tech industries such as auto and electronics. In essence, Japan clearly understand that economic activity is a source of power as well as well-being, and indeed, probably the most significant source of power; that in a world in which military conflict is unlikely, economic power will be increasingly significant in determining the primacy or subordination of states (e.g., Huntington 1992, 1993).
Indeed, Japanese government continues to move aggressively to secure the nation's innovative capacity. During the 1980s and into the 1990s, MITI continues directly or indirectly (e.g., via its Agency for Industrial Science and Technology) to support nine high-tech projects receiving at least 10 billion yen in public funds. The projects included high-speed computers, advanced robot technology, interoperable data bases, advanced material processing, and advanced products (Tyson 1991, 298-9). In short, Japan still places "unrelenting emphasis" on strategic, high-tech, high-value-added industries. The purpose, according to MITI, is to enhance Japan's "autonomy and bargaining power" (Dietrich 1991, 63).

Government also actively promotes and guides Japan's overseas investment. "The Reserve for Overseas Investment and Related Expenditures," for example, allowed firms to invest in foreign mineral and energy ventures a five-year tax holiday on profits equivalent to 100 percent of exploration costs and 40 percent of overall investment. Japan's Export Import Bank loaned funds to finance equity ownership in foreign joint ventures, and to help companies purchase equipment in Japan for overseas operations (Harwit 1996, 979-80). From 1990 through 1993, the Export-Import Bank of Japan financed about $27.8 billion of overseas investment.\(^{18}\) MITI, eager to promote overseas investment, insures against losses due to many of the commercial, as well as political, risks associated with overseas business activity. In November 1993, it adopted new policies making it easier for small and medium-sized firms to set up factories overseas.\(^{19}\)

Furthermore, Japanese government often uses its foreign aid to stimulate FDI by providing technical training to workers and financing the construction of airports, roads, dams, and other infrastructure projects primarily in Asian countries. Through such agencies
as the Japan External Trade Organization (JETRO), the Japan Overseas Development Corporation (JODC), and the Institute of Developing Economics, the Japanese government collects and disseminates information about economic and political conditions in different host countries.

INCREASING DIFFICULTY TO OBTAIN TECHNOLOGY TRANSFER

In public, Japanese officials and economists advocate that it will be beneficial for Asian countries if they are incorporated in this new division of labor. First NICs, and then ASEAN-4 and China, are expected to catch up with the lead goose (i.e., Japan), turning the V-formation (wedge-shaped pattern) into a straight, horizontal line. As Saburo Okita, a former Japanese Foreign Minister (1990, 2) wrote, “because the geese that take off later are able to benefit from the forerunners’ experiences to shorten the time required to catch up, they gradually transform the pattern from a V-formation to eventually horizontal integration.” He had similarly argued earlier that Japanese foreign direct investment would enable the LDCs in Asia, in due time, to “raise their economies to the level and quality of Japan’s” (1978, 168). Yutaka Kosai, president of the Japan Center for Economic Research, is even more sanguine. In his words, technology transfer via Japanese FDI is “disrupting the pattern of ‘flying geese’” in Asia and “widening the changes for success of a ‘leapfrog’ development strategy” (1995, 2).

Theoretically, based on intraindustry trade and other forms of “working sharing,” as Japan transfers more and more its technologies, and as it absorbs more and more of Asia’s manufacturing exports, the vertical division of labor is giving way to a horizontal division of labor (MITI 1992, 129-30). Contrary to the sanguine assumptions, however, Asia is not
likely to achieve technological parity with Japan any time in the near future, largely because
technology transfer from Japan is a painfully slow and relatively controlled process. Japanese
firms essentially are using their technological power to forge vertical tie with Asian firms and
thus carefully control the process of technology transfer. As Japanese firms shed their old
(relatively low-level) technology at a deliberate (relative low) pace, Japan flies further and
further ahead of the regional division of labor and the V-formation grows steeper and
steeper.\textsuperscript{20} Growing evidence indicates that the division of labor in Asia, based on the
technology capacity of each country, is becoming more but not less vertical.

A Thai research group examining the transfer of technology to Thailand concludes
that Japanese electronics manufacturers are achieving such a rapid rate of technical progress
that, even though they constantly transfer old technology to Thailand, “new technology piles
up” in Japan. “Thus, year after year, the technological gap between Japan and Thailand
widens” (Kenkyujo 1992, 320). After the early 1970s, following the Japan’s leadership,
technology transfer to Asian NICs has slowed down (Chow and Kellman 1993, 49). Even
Korea, the second most technologically advanced nation in Asia, cannot keep pace with Japan
and is far behind the lead goose. In 1990, in terms of export capability, its degree of similarity
with Japan was still only 51.4 percent. This means that Korea’s exports competed with
Japan’s in only about half of the markets to which Japan exported (Chow and Kellman 1993,
42; Tatsuo 1994).

Compared with other advanced countries, “Japanese companies are slower in the
localization of managerial and technical personnel, slower in promoting them, and slower in
training. Japanese firms also appear more reluctant to set up design and R&D units in the host
countries” (Yue 1991, 64). Officials throughout Asia expressed profound frustration with
their own inability to pry technical know-how from Japan. Park Woo-hee, president of the Korea Academy of Industrial Technology, has even called Japan the “black hole” of the innovating universe, forever sucking technology in but never spitting it out (Park 1992). Malaysia’s Business Times published a particularly grumpy editorial, criticizing Japanese companies for business practices that block the effective technology transfer. The reason for Japan’s exceptional unwillingness to transfer technologies is well confided by an executive of a large Japanese semiconductor manufacturer, “[f]or us, production in Asia is an integrated operation. That means we must preserve our factories in Japan as the ultimate base for high-tech production. The result is that we have technology that cannot be transferred.”

Technology transfer usually takes in two ways: FDI from MNCs or license of technology to overseas firms. The technology transfer through licensing is often referred to as “unbundled” technology because it, unlike that via FDI, does not come with a bundle of management sources that continues to exert control. When issuing license of technology transfer, Japanese appear to be extraordinarily cautious. In many cases, they share only mature or standardized technology and are reluctant to transfer most sophisticated core technology. Using a multiple regression analysis, two Korean scholars found that, although Korean firms pay a higher price (per agreement) for technology from the US, they actually end up receiving a better deal. This is because US technology comes with fewer collateral charges, e.g., service and “guidance” fees. Moreover, because of being at an earlier stage of the product life cycle, Korea can use American technology over time to increase exports. Adjusting for these facts, Japanese receive a larger monopoly rent on the use of their technology (Lee and Kim 1987). In addition, Japan frequently controls the pace of technology by restricting export markets and requiring exclusive use of Japanese machinery and
component parts. The case of Heung Yang Company, a Korean electronics manufacturer, well illustrates this point. It used Sony technology to produce a color TV with a built-in VCR. But according to the terms of its licensing agreement, Heung Yang Co. was unable to export the video unit to any markets in Europe.23

Scholars have argued that FDI serves as an especially effective mode of technology transfer. It is likely to "bring about a more effective transfer than other channels since it involves a sustained relationship between the transferor and transferee" (Tran 1992, 1-3; see also Ping Deng 1998, 23-4). Yet, Japan often blocks or at least constrict these traditional avenues of technology diffusion. An important blocking feature is well concluded by Dieter Ernest (1994, 26), "the closed nature of Japanese regional production networks has constrained the opportunities for host country firms to develop their own technological and organizational capabilities that are necessary for a continuous upgrading of their production efficiency and product mix." The fact that Japanese affiliates in Asia retain an unusually large number of expatriates in management positions constitutes a crucial part of the closed nature of Japanese production networks.

In Asia, it is very common to complain about the failure of Japanese companies to promote local managers to top position.24 As Chi Kwan, an economist at the Nomura Research Institute, says "Japanese companies in Asia still tend to be micro-managed from Japan, with lots of Japanese in top jobs."25 The closed nature of Japanese network is also illustrated by what Japanese firms emphasize on-the-job training. That emphasis produces company specific knowledge that is not easily transferable as general knowledge. Accordingly, written materials (blueprints and manuals) explaining how to operate machinery or conduct management procedures is very rare in Japanese affiliates (Yamashita 1991, 17,
More significantly, Japanese firms are building a production process based on a regional division of labor, thus locking Asia up in the vertical, quasi-integrated networks. Accordingly, the production process is broken into pieces, which are parceled out to each country according to its technical ability. In this way, Japanese manufacturers achieve economies of scale and scope, as well as what is called "economies of networking" (Hatch and Yamamura 1996, 108). That give them a powerful edge against international competitors. But local firms integrated into the lower strata of these coordinated networks are denied the opportunity to understand the overall production process or the underlying technology. They serve only "as cogs in the wheel, stamping out standardized parts and exporting them to other production bases across the region" (Hatch and Yamamura 1996, 108). "It's like ikebana [Japanese flower arrangement]," says Kawasaki Masahiro, former head of Japan's National Institute of Science. "After it's all done, you can't see how it was really done" (Normile 1993, 91). As Japanese firms can be effective in retaining at home those activities creating the most value, Japan is much better able to minimize the phenomenon of "hollowing out" – the massive export of a nation's manufacturing and innovating capacity (Fumio and Kiba 1994, 22). In short, by locating discrete pieces of the production process at different sites throughout the region, Japanese manufacturers can thwart the ability of potential Asian competitors to master and appropriate the entire package of technology, the source of their competitive advantage.

Whether the vehicle of technology transfer is FDI or technology licensing, Japanese firms usually transfer only "how," but not "why" technology. "How" technology refers to the superficial technology that can be learned in a short period of time. On the other hand, "why"
technology includes the most advanced core technology by which the most value-added part of the product is created; it is usually retained in Japan. That is why local firms remain dependent on Japanese engineers, and why Japanese *keiretsu* firms remain the primary conduit for technology transfer. In a survey of 133 firms in Asia, the Nikkei Research Institute of Industry and Markets found that 70 percent of Japanese firms had transferred such “how” technology, but only 25 percent had transferred the technology to develop new products (i.e., “why” technology) (Urata 1993, 288-9; Guisinger 1991). Similarly, a survey of Japanese firms in Southeast Asia conducted by a Hiroshima University found that 74 percent had transferred operational technology, but only a fraction of them had passed on skills related to production management (28%) and technology improvement (11%); almost none had transferred design or product development technology (Kinbara 1989).

In addition, the external environment will tend to ensure that Japan will not only maintain but actually increase technological lead in Asia. In the 1950s and 1960s, when it mobilized its national campaign to catch up with the West by adopting new technology, Japan was lucky. The US, then guided by a geopolitical strategy of containing Communism in Asia, encouraged its companies to license new technologies to Japan. The US simply wanted to do everything it could to help revitalize and strengthen Japan. Today, developing countries are not so lucky. The United States is no longer able to or willing to sacrifice its economic interests, and Japan has few political interests for which it would sacrifice its economic interests. Even Japanese firms investing in the US “have been prone to keep top management, high value-added products, and research and development operations at home, often preferring to build ‘screwdriver’ assembly plants [abroad] that pay lower wages” (Omestad 1989, 134-5).
Business environment is also less hospitable for challengers. Increased technological complexity has produced greater barriers to entry (in the form of both higher start-up costs and knowledge requirements); steeper learning curves and increased specialization make companies (and governments) increasingly reluctant to transfer technology. The World Bank accurately points out (1993: 319), “there is some evidence, and a growing subjective sense, that arm's-length licensing is decreasing as an option for closing technology gaps.” Furthermore, as R&D (Research and Development) becomes increasingly more nonlinear, abandoning production of certain mature products carries the risk of losing technology and management know-how in manufacturing techniques or component manufacturing that might have been critical to seemingly nonrelated future production (Bernard and Ravenhill 1995). Therefore, as expanding into Asia, Japanese firms are expected to secure that their know-how does not spill into the laps of potential rivals and especially China. In this light, Japan will increase its technological lead and fly further ahead in the regional hierarchy of industrial structure.

LESS ECONOMIC GAINS TO CHINA COMPARED WITH ASEAN-4

China’s economic relations with ASEAN countries are basically more competitive than complementary. At similar stages of development, both need huge capital to invest in infrastructure and directly compete for foreign capital inflows. Moreover, because of competition on similar products in the same markets, their trade clash is detrimental to the regional economic cooperation (Chow 1993, 200). China’s position within the regional economy is essentially placed at the third tier with ASEAN as a supplier of raw materials mainly from interior China. Also, in such industries as textiles, apparel, and construction
materials, they are directly competing with each other (Cheng 1994). China now welcomes transfers of labor-intensive and technology-intensive industries from both Japan and NICs and transfers some matured industries to its inland regions. Those efforts are inevitably in conflict with ASEAN countries' modernization drives. On top of that, China is entering into direct market rivalry with Korea in steel, machinery, chemical and shipbuilding industries, although its economic relations with Asian NICs are more complementary.

There is little doubt that the most significant aspect of China's economic relations with industrialized countries in general and Japan in particular is technology transfer and capital flow. This is the vehicle for China to move up the technology ladder and to elevate its position in the regional economic structure. Without high technology, it would be difficult for China to become a truly global power. Given the fact that Japan is extraordinarily reluctant to transfer technologies to the NICs and ASEAN whose economies are much more integrated with Japan basically through the flying geese pattern, China is clearly aware that Japan will not be generous to assist China's technological upgrading even if it is embraced in the Japanese-type development model.

Exploitation of cheap labor and the pressure of the strong yen inspired Japanese move to China, but to reassure that they would retain the upper hand over potential Asian rivals and particularly China, Japanese firms are desperate in relenting key technologies and skills for themselves. This is particularly true when we consider the fact that Japan is sensitive to China's power aspiration and its potential economic challenge. The vast majority of Japanese feel that China is seeking hegemony in East Asia and such ambitions are hard to achieve mainly because of lack of technological capabilities (Nelsen 1995, 82).

As China is more likely to be Japan's peer rival and thus long-term economic threat,
Japan prefers to let more private direct investment flowing to Southeast Asian countries so as to secure the technological lead of Japan over China. Even with the sharp rise of the yen, Japan's direct investment in China remained weak through the 1980s and it is only a distant fourth largest foreign investor in China. Despite the recent surge of its FDI in China, Japan's cumulative investment in China is still far behind that in the Asian NICs and ASEAN countries (see Table 5.2).

Table 5.2 FDI Flows from Japan
(In billions of U.S. dollars)

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</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>$1.27</td>
<td>0.30</td>
<td>0.44</td>
<td>0.35</td>
<td>0.58</td>
<td>1.07</td>
<td>1.69</td>
<td>6.16</td>
</tr>
<tr>
<td>NICs</td>
<td>$2.58</td>
<td>3.26</td>
<td>4.90</td>
<td>3.36</td>
<td>2.21</td>
<td>1.92</td>
<td>2.42</td>
<td>29.82</td>
</tr>
<tr>
<td>ASEAN-4</td>
<td>$1.03</td>
<td>1.96</td>
<td>2.80</td>
<td>3.24</td>
<td>3.08</td>
<td>2.50</td>
<td>2.40</td>
<td>36.59</td>
</tr>
<tr>
<td>U.S.</td>
<td>$14.70</td>
<td>21.70</td>
<td>32.54</td>
<td>26.13</td>
<td>18.03</td>
<td>13.82</td>
<td>14.73</td>
<td>177.10</td>
</tr>
</tbody>
</table>

Source: Japanese Ministry of Finance (MOF); figures are for fiscal years ending March 31 (e.g., Fiscal Year 1993 ends March 31, 1994).

Table 5.3 Japan's FDI to China and ASEAN-4, 1987-91
(In billions of U.S. dollars)

<table>
<thead>
<tr>
<th>Country</th>
<th>Japan's FDI</th>
<th>Total FDI</th>
<th>Japan's FDI as % of Total FDI</th>
</tr>
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<tbody>
<tr>
<td>China</td>
<td>$2.89</td>
<td>$27.91</td>
<td>10.35%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>4.07</td>
<td>6.00</td>
<td>67.83</td>
</tr>
<tr>
<td>Malaysia</td>
<td>3.37</td>
<td>13.33</td>
<td>25.28</td>
</tr>
<tr>
<td>Philippines</td>
<td>0.87</td>
<td>3.11</td>
<td>27.97</td>
</tr>
<tr>
<td>Thailand</td>
<td>4.35</td>
<td>9.81</td>
<td>44.34</td>
</tr>
</tbody>
</table>

Sources: Japanese FDI figures from MOF; total FDI figures from IMF,
Balance of Payments Yearbook, various years.
Furthermore, as Table 5.3 clearly indicates, Japan's FDI to China as percentage of China's total FDI flow is much lower, when compared to that of ASEAN countries. In terms of cumulative total, Japan's FDI in China is also far behind that in Indonesia, Thailand and Malaysia.

Japanese reluctant investment attitude and behaviors towards China are well reflected in two key industries, automobiles and electronics. Japanese auto companies have consistently eyed China with some ambivalence and have long been away from China. The underlying reason is the concern about technological spill-over and potential economic rivalry. As a scholar on China's automatic industry acutely observes,

> Market forces seemed to indicate auto exports to China could continue into the foreseeable future. The fear of creating a frightening competitor seems to have been more profound. The emerging nations of Southeast Asia, with their relatively small potential markets, presented less of a challenge to Japanese car makers like Toyota than did populous China (Harwit 1996, 993; also 1994, 39-41).

Regarding the electronics manufacturers which have heavily invested in China, their top priority is similarly to guard the home against China becoming so sophisticated as to challenge the home industries. Japanese manufacturers are intent on preserving leading-edge technologies such as development of high-definition presentation and wide-screen picture tube technology safely within Japan's borders (Pearson 1991, 89). No wonder, a leading Chinese technical newspaper commented that "the Japanese industrialist's main goal in unceasingly increasing parts production in China is to lower production costs, [and to] gain access to the Chinese or world markets." Even Hitachi, the first Japanese electronics maker to create a
joint venture in China, which is widely regarded as the role model of Sino-Japanese joint ventures, adopts the typical Japanese strategy for moving electronics manufacturing capability to developing nations. That is, the Japanese utilize low-wage labor, tap the domestic market, raise quality to a level for export to third countries, and keep the most useful technologies and managerial skills for themselves (Harwit 1996, 987-8).

In a word, political and economic factors peculiar to China has largely shaped Japan’s investment patterns and treat their ventures differently from those in the smaller nations of the region. This means that Japanese firms will be more jealously guarding their technology against spilling over to China. However, to gain high-tech transfers is the key for China’s foreign economic cooperation. But regarding the advanced technology transfer, Japan’s record and future behaviors can only disappoint China’s expectations. Karatsu Hajime, a former bureaucrat and business executive, now professor of technology development, has advocated nothing less. “What Japan should do in investing abroad is obvious: Keep production know-how firmly in its own hands and manufacture at whichever location offers the most advantage. As long as we do this, the Japanese economy will not be affected negatively in the least.”

STRUCTURAL TRADE DEFICITS

Between 1985 and 1993, Asia’s trade deficit with Japan ballooned, rising from $9.3 billion to $54.2 billion; Asia’s surplus with the West also grew rapidly, from $28 billion to nearly $70 billion. According to Neoclassical economists, this is highly predictable. As Japan has been using foreign direct investment to shed industries in which it is losing comparative advantage, this has triggered a short-term surge in Japanese exports of capital goods to the
region. But as Japan’s foreign investment in Asia falls and local firms become increasingly competitive, host countries will import less and less from Japan, and export more and more to Japan. As a result, Asia’s trade deficit with Japan and trade surplus with the West will gradually and even eventually turn into the opposite direction. In other words, before long, the V-shaped flying geese pattern will turn into a straight line and Asian countries will maintain trade balance with Japan. Yet, the data suggest that Japan is beginning to regionalize its policies and practices. And if pursued with any success, Japan will not only further widen the technological gap, but also exacerbate the existing trade deficit.

Because Asian manufacturers have grown increasingly dependent on Japanese capital goods and technological components to sustain their competitive position, Japan will simply export an increasing amount of those goods to Asia. Even if local firms can steadily enhance their own technical capabilities, they will continue to rely heavily on their dominant “partner” for such high-tech inputs. “This is because they are quasi-integrated into an alliance structure that is coordinated by parent firms and keiretsu suppliers in Japan . . . . Asia will simply end up importing ever more sophisticated technology from Japan” (Bernard and Ravenhill 1995, 177).

As dominant firms in Japan dictate the flow of high-tech products and determine value-added goods, through intranetwork channels, to appropriate processing sites in Asia, most of Asian countries, except for China and Indonesia, which have used petroleum and natural gas to maintain trade surplus, have run up a serious trade deficit with Japan. A case in point is Taiwan. Although occupying 20 percent of the world market for notebook computers, Taiwan has done so only by assembling Japanese components: the liquid crystal display screen, the nickel-cadmium battery, and various semiconductors, i.e., virtually all of
the high value-added parts. Similarly, in 1991 Taiwan accounted for 39 percent of global production of computer monitors. Yet, the key component, the cathode ray tube, is procured exclusively from Japanese suppliers, and these tubes represent 30-35 percent of the total cost of a monitor. Not surprisingly, in 1994, Taiwan recorded a $13 billion deficit with Japan (IMF 1995).

To worsen Asia’s trade imbalance, Japan receives only a very limited share of Asia’s manufactured exports. In 1993, Japan received less than 10 percent of the region’s total flow of such exports (Table 5.5), while Hong Kong alone absorbed far more of the region’s manufactured exports (Hatch and Yamamura 1996, 180). Moreover, Japan’s status as an importer of Asia’s total exports has actually faded. In 1993, it received only 12.5 percent of the region’s combined exports, while in 1980 received 22.2 percent of Asia’s exports. Similarly, the Japanese market’s share of manufactured exports from China in 1992 was actually below what it was in 1980. In 1992, Japan imported just 9.7 percent of Chinese manufactured exports, while for 1984 and 1980 the figure was 10.8 percent and 11.0 percent, respectively (Bernard and Ravenhill 1995, 205).

<table>
<thead>
<tr>
<th>Year</th>
<th>Asia</th>
<th>United States</th>
<th>E.U.</th>
<th>Japan’s Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>$40.29 (23.6%)</td>
<td>$64.81 (37.9%)</td>
<td>$20.58 (12.0%)</td>
<td>$170.78</td>
</tr>
<tr>
<td>1990</td>
<td>80.25 (28.9%)</td>
<td>88.85 (32.0%)</td>
<td>52.27 (18.8%)</td>
<td>277.30</td>
</tr>
<tr>
<td>1991</td>
<td>95.78 (31.5%)</td>
<td>89.82 (29.5%)</td>
<td>58.32 (19.2%)</td>
<td>304.19</td>
</tr>
<tr>
<td>1992</td>
<td>113.36 (34.5%)</td>
<td>97.80 (29.8%)</td>
<td>63.78 (19.4%)</td>
<td>328.33</td>
</tr>
<tr>
<td>1993</td>
<td>121.56 (34.9%)</td>
<td>103.47 (29.7%)</td>
<td>62.30 (17.9%)</td>
<td>348.56</td>
</tr>
</tbody>
</table>

Sources: UN Commodity Trade Statistics, various years; OECD Trade by Commodity Statistics, various years
Table 5.5 Destination of Asia's Manufactured Exports
(In billions of US dollars and % of World Total Exports)

<table>
<thead>
<tr>
<th>Year</th>
<th>Asia</th>
<th>Japan</th>
<th>U. S.</th>
<th>E.U.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>$14.19 (19.7%)</td>
<td>$6.13 (8.5%)</td>
<td>$20.15 (27.9%)</td>
<td>$13.64 (18.9%)</td>
</tr>
<tr>
<td>1985</td>
<td>22.85 (20.6%)</td>
<td>8.90 (8.0%)</td>
<td>43.16 (39.0%)</td>
<td>14.08 (12.7%)</td>
</tr>
<tr>
<td>1990</td>
<td>89.42 (29.6%)</td>
<td>30.69 (10.2%)</td>
<td>86.88 (28.8%)</td>
<td>51.23 (17.0%)</td>
</tr>
<tr>
<td>1991</td>
<td>115.39 (32.6%)</td>
<td>35.27 (10.0%)</td>
<td>94.28 (26.6%)</td>
<td>63.25 (17.9%)</td>
</tr>
<tr>
<td>1992</td>
<td>139.83 (34.4%)</td>
<td>37.79 (9.3%)</td>
<td>108.92 (26.8%)</td>
<td>68.25 (16.8%)</td>
</tr>
<tr>
<td>1993</td>
<td>171.08 (37.3%)</td>
<td>44.24 (9.7%)</td>
<td>121.11 (26.4%)</td>
<td>71.27 (15.5%)</td>
</tr>
</tbody>
</table>

Sources: UN Commodity Trade Statistics, various years; International Economic Data Bank, Australian National University.

Increases in Japan’s manufactured exports to Asia and unfortunately decreases in Asia’s manufactured exports to Japan are well reflected in Table 5.4 and Table 5.5. From Table 5.4, we can also conclude that Asia has become Japan’s most important export destination and the trend is expected to continue. From Table 5.5, we know that since 1985, intra-Asian (excluding Japan) exports have gradually substituted the US as the largest manufactured export destination of Asia.

A key reason for Japan to import only a fraction of Asian products is that despite a massive outflow of investment due to the impact of 1985 Plaza Accord, Japanese firms have never abandoned their home base. The government has prodded Japanese companies to constantly upgrade domestic operations (MITI 1989, 237-8; see also Calder 1988). And they have. Domestic spending on plant, equipment, research, and product development in the late 1980s was equal to a quarter of Japan’s GNP (Kozo 1994). When the Victor Co. of Japan (JVC) expanded its production of compact color TV in Thailand, it did not abandon its home...
base. Instead, it began to produce wide-screen, projection-type TVs and tuner-equipped big-screen TVs in Japan. After shifting its production of window-type air conditioners to Malaysia, Hitachi immediately retooled its Japanese assembly lines to begin manufacturing more sophisticated inverter-type units. When Cannon boosted its production of relatively simple cameras in China, it opted to upgrade its domestic operations by focusing on high value-added models, such as the EOS 100. As Casio began producing more of its pocket calculators and other standard goods in China and Southeast Asia, it simultaneously began producing more cutting-edge goods, such as electronics organizers, at home. Murata Manufacturing built new facilities in China and Malaysia to produce ceramic filters, an important component in cellular phone, but decided to retain at home the most technologically demanding sector of making ceramic powder.  

Table 5.6  Japan's Production & Exports of Electronic Equipment  
(In billions of Japanese Yen)  

<table>
<thead>
<tr>
<th>Products\Year</th>
<th>Domestic Production</th>
<th>Exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer electronics</td>
<td>¥3,669</td>
<td>¥4,912</td>
</tr>
<tr>
<td>Industrial electronics</td>
<td>3,817</td>
<td>7,614</td>
</tr>
<tr>
<td>Electronics components</td>
<td>3,333</td>
<td>6,027</td>
</tr>
<tr>
<td>Total</td>
<td>10,819</td>
<td>18,553</td>
</tr>
</tbody>
</table>

Sources: MOF data, reported by Electronic Industries Association of Japan (EIA), 1991; Facts and Figures on the Japanese Electronics Industry 91, 14, 18.

As a result, many Japanese firms have benefitted from a process in which production has been upgraded from less sophisticated finished goods to consumer goods incorporating more advanced technologies. The fact that Japanese firms exported some technologies to
most of the region's industries, but have not exited from production of consumer goods is well illustrated by the Japanese electronics industry.

As Table 5.6 indicates, the total value of both Japanese domestic production and exports of electronic equipments in 1990 have increased from 1985. Particularly striking is the rapid growth in the value of components exports and industrial production since 1985, up by as high as 64.3 percent and 48.9 percent respectively.

Even after the bubble economy burst and the yen soared to record levels of less than 100 yen to 1 dollar, Japanese electronics firms continued to invest heavily in domestic production. In 1994, for example, Fujitsu announced plans to expand production of 16-megabit dynamic random access memory chips at its plant in Iwate Prefecture, while Toshiba announced a plan for a new factory in Shiga Prefecture to produce liquid crystal display (LCD) panels. Actually, capital investment rose sharply as high-tech firms sought to maintain their competitive edge over rivals in the US and Korea. Furthermore, Japan's trade barriers are infamous. Trade barriers and particularly informal barriers such as government guidance to the firms raise the price of foreign goods or keep them out altogether. They also force Japanese consumers to buy more costly domestic alternatives. Three Japanese economists estimate that in 1989 the prices of some foods and consumer goods in Japan were several hundred percent higher than import prices; the whopping high domestic prices were overwhelmingly attributed to Japan's notorious infamous trade barriers related to the non-transparency and closeness of Japanese markets (Sazanami et al. 1995).

In short, for the past decade or so, largely due to the unwillingness of Japanese firms to abandon domestic production and to import manufacturing goods from abroad and particularly from Asia into Japan on a large scale, Japan has constantly enjoyed trade surplus.
not only with the U.S. but with almost all other Asian countries, and the gaps tend to
increase. By any measure, its imports, apart from primary products, are extremely small
compared to other industrialized countries. Although Japan has opened to more imports,
imports as a percentage of products sold in Japan are constantly under 14.5 percent
(Huntington 1993, 74). Moreover, an increasing percentage of Japan's imported consumer
goods come from overseas Japanese factories. The evidence has no doubt justified China's
long complaint that the Japanese put too much emphasis on selling consumer goods while
failing to buy Chinese products. It has also confirmed a widely noted conclusion made by Paul
Krugman in earlier 1990s, "it seems fair to argue that, in the general debate, the view that
Japan does import less than one might have expected wins on points" (1991, 3).

Trade deficit can become a more sensitive issue and is often characterized with
political significance. This is particularly true with Sino-Japanese relations. Chinese leaders
still remember very well that students launched large scale of demonstrations against Japan's
"economic invasion" when China ran a more than $6 billion trade deficit with Japan in 1986.
Experiences with Asian NICs and ASEAN clearly indicate that the flying geese pattern are
more likely to establish the hierarchical nature of regional production alliance, thus deepening
the structural dependence upon supply of Japanese technological components and machinery
equipments and running a serious trade deficit with Japan. In this sense, it would be fortunate
for China not to have been embraced so tightly by the Japanese-dominated model. Currently,
the trade balance is favorable to China. According to Japanese Ministry of Finance, Japan ran
a record bilateral trade deficit with China of almost $14 billion in 1995.
ECONOMIC DEPENDENCE

The flying geese model is most likely to leave China economically more vulnerable to Japan, thereby decreasing China's economic autonomy. In essence, the model tends to integrate Chinese industry and labor into Japan's own strategic networks across Asia. Relative gains concern convinces great powers including China to avoid becoming dependent in the first place. Economic dependence means that crucial economic sources could be cut off during a crisis, politically and economically. Superficially, both China and Japan hail bilateral relations as friendly and cooperative, but the "friendship and cooperation" in the relationship are often disturbed by the basic stratum of "frictions and distrust" in substance (Ijiri 1990a, 639). This conflicting relationship reinforces China's sensitiveness to its economic dependence upon Japan.

This keiretsu-style production alliance is not a bad thing and certainly beats slow or no development, the fate of most LDCs. Largely due to Japanese capital and technology, NICs, ASEAN and China are, in contrast, enjoying enviable rates of economic growth. They have made deep inroads into both North American and European markets, supplying them with high-quality and price competitive products. Asian economies under this pattern are like the small or medium-sized Japanese firms that belong to vertical keiretsu dominated by the large manufacturers to whom they supply parts. The subcontractors benefit enormously from membership in this corporate group, which provides a guaranteed market for their products, as well as ready access to the capital and technology needed to manufacture them. Through interfirm cooperation of this sort, these subcontractors − like the economies of Asia − become increasingly competitive.

However, Asian economies could eventually become "captive" economic development

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and the benefits of cooperation could be increasingly unevenly distributed. In other words, much like low-level subcontractors in a vertical *keiretsu* in Japan, Asian economies might eventually find themselves stuck in a subordinate role and more and more of the gains of cooperation captured by Japanese firms; Japanese firms could end up with an even tighter grip on their own technology, allowing them to earn monopolistic “rent” on its use (Hatch and Yamamura 1996, 36).

This is likely to occur as Japanese business and government elites penetrate host governments more and more deeply, securing policies that serve to strengthen Japan’s control over its production alliance in Asia. And it is likely to occur as Japanese MNCs use their tremendous advantages to capture more of the ‘advanced factors,’ such as skilled labor and supplier contracts, in those host countries (Rapp 1992, 248-9).

That pain might not be fully felt until Japanese stumble in their pursuit of more advanced technology or are faced with the prospect of slower growth. In those situations, dominated firms become even less willing or able to transfer technology and more likely to squeeze the subordinate.

Fundamentally speaking, the pace of technology transfer is largely determined by the pace of Japan’s own technology innovation. If unable to achieve technology efficiency and unable to progressively upgrades its industrial structure, Japanese firms undoubtedly “squeeze” their unequal partners in Asia, much like large manufacturers in Japan used to (and still do, albeit more subtly) squeeze their *keiretsu* suppliers in hard economic times (Fumio and Kiba 1994, 21). Evidence suggests that a limited form of squeezing occurred in the early 1990s, when economic growth suddenly slowed in Japan. That was when MNCs began
requiring Asian affiliates to absorb some of their newly redundant managers in Japan. Fujitsu, for example, declared that it would use “attrition, transfers to subsidiaries and reduced hiring” to cut its 56,000 workforce in Japan about 10 percent.39

Similarly, Nissan Corp. says, “we have too many managers at Nissan Motors in Japan . . . . Our overseas operations give us a convenient way to relieve this excess supply for management staff” (Hatch and Yamamura 1996, 31). That also happened when Japanese auto and electronic assembly firms in Asia began squeezing local suppliers, insisting on paying less for parts and requiring stricter enforcement of quality standards; when some MNCs cited “market standards” as a reason to renegotiate their agreements to sell high-tech inputs to joints (Chiasakul and Silapipat 1992, 233-4). A Malaysia economist reported complaints that “once the company is locked into a particular product, the Japanese start squeezing the Malaysians on price.”40

In general, Asian companies involved in the model are generally becoming less able to resist Japan. “They lose bargaining power just as steadily as Japanese MNCs build increasingly complex networks and deploy increasingly sophisticated technology that is, by definition, increasingly difficult to appropriate” (Jung and Whitmore 1989). On the other hand, Japanese firms would consolidate and expand their regional production networks and achieve economies of scale. Through the flying geese model, Japanese firms have demonstrated a willingness as well as greater technological and financial muscle, to maintain such keiretsu-type relationship for long periods. They can assist, guide, or perhaps even direct the subordinate to use those resources in a particular way, and play an active role in helping them devise plans for future investment and production. And in the aggregate, they have been able to grab larger and larger market shares and more market power, thus becoming
extraordinary competitor in the global markets.

In China, there is a fear that rapidly expanding trade and investment will come to be dominated by large Japanese MNCs (Graham and Anzai 1994, 11). Fear of being squeezed and dominated by Japan has largely stimulated China to extricate itself from Japan's embrace. The Chinese government increasingly welcomes non-Japanese MNCs, thereby ensuring that Western firms are neither excluded from nor relegated to secondary roles in China. In electronics and other related ventures, the Chinese manage to promote "competition" from Americans, Germans, and others so as to guard against Japan's possible dominance.41

Because of the strong sense of Sino-Japanese rivalry and each fear of the other's relative capabilities, China expects to be acutely sensitive to any economic dependence upon Japan. And economic dependence is perceived as diminishing China's policy options or state power. After all, by using its economic power, Japan seeks to become a political power. Moreover, for the past decade, Japan has shown increasing efforts to impose economic sanctions against China and translate economic clout into political influence and participation. After 1989 Tiananmen Incident, Japan put a hold on its government loans to China, thus becoming the only Asian country to join the West to impose economic sanctions against Beijing's military suppression of the prodemocracy movement. Japan is also using its economic power in general and its foreign aid in particular to apply diplomatic pressure upon China. During the summer of 1995, to protest China for the nuclear weapon testing, Japan reduced and cut its grant aid to China twice and constituted another sign of Japan's growing assertiveness in international affairs. Furthermore, in order to exert pressure on China, the possibility of significantly reducing its ODA to China has been openly discussed. Actually, while negotiating the fourth loan package to China in 1994, Japan pressed China on the issues
of human rights, defense spending, nuclear testing and environment, and finally managed to reduce the ODA coverage by two years, in an attempt to better deal with rising challenges from China (see Chapter 4).

POLITICAL IMPLICATIONS AND NATIONALISTIC IMAGES

For Japan, the flying geese model serves a political as well as economic purpose. Not only does it help Japan escape the potentially crushing impact of the high yen, but also reduces the size of the trade surplus attributable directly to Japan, thereby reducing some of the international pressure it otherwise might face. Moreover, in the Chinese point of view, the model may lead to serious political damage to China. First of all, participation in the model is almost equal to accepting Japan’s international primacy in Asia, and that is highly detrimental to China’s nationalistic self-images and perception.

According to Robert Jervis (1993, 52-3), primacy can be simply defined as “being much more powerful than any other state . . . . This in turn implies that the state can establish, or at least strongly influence a broad range of issues, including ‘the rules of the game’ by which international politics is played, the intellectual framework employed by many states, and the standards by which behavior is judged to be legitimate.” In Samuel Huntington’s words, international primacy means that “a government is able to exercise more influence on the behavior of more actors with respect to more issues than any other government can . . . . States pursue primacy in order to be able to insure their security, promote their interests, and shape the international environment in ways that will reflect their interests and values” (1993, 68-70).

As proximity and size make China and Japan natural rivals for leadership in the region,
China has to be deeply concerned not only with how the flying geese pattern and its outcomes directly affecting it, but with whether it is gaining more (or losing less). This is particularly true given the fact that East Asia is typically characterized by the anarchic nature of international politics and the escalation of military spending and arms rivalry have occurred in the context of regional hostility virtually unmediated by cooperative traditions and institutions (Buzan 1995, Mack and Ravenhill 1995). As long as international politics in East Asia continues to be intensely competitive and China still holds strong negative perception of Japan, concern over relative gains favoring Japan via the flying geese model continues to be the natural preoccupation of China. After all, the model is most likely to strengthen Japan’s influence over China, economically as well as politically.

By size and political importance, China is a major player in Asia’s cooperation, and occupies a central geographic position in the development of regional economic cooperation. Indeed, there is little doubt that the single most important state in East Asia is China, which not only occupies 68 percent of land and some 65 percent of population, but has experienced an astounding economic growth for nearly two decades. As an editorial of The Wall Street Journal states,

With 1.2 billion people and an economy growing more rapidly than any other, China is becoming Asia’s economic engine . . . . Although the United States remains by far Asia’s largest export market and Japan No. 1 Asian economy, China is so intertwined with regional investment and trade flows that many believe its importance soon may rival that of the old economic powers.42

In addition, as some authoritative institutions point out that, based upon the measure of the purchasing power parity (PPP), China has surpassed Japan and become the world’s
second largest economic entity; if the current trend continues, China is most likely to become No. 1 world economic power by the year of 2015. Concurrently, the collapse of the Soviet Union in the earlier 1990s removed China’s main regional security threat and increased, virtually overnight, its comparative power in Asia (Ross 1997, 34). Furthermore, with China becoming increasingly powerful and Japan’s power remaining static, their relative positions would shift, expanding China’s input into the setting of international economic rules. In this light, China is not willing to accept Japan’s international primacy in the region (Cotterell 1994, 5-7).

Also, because of the historic “middle kingdom” mind set, China sees itself as the dominant force in Asia. As Gerald Segal (1993, 27-8) correctly points out,

East Asian traditions suggest that China will be unwilling to accept a subordinate role to Japan . . . . Natural order of international relations in East Asia is for China to dominate, even when it is ostensibly pursuing a relationship of equality. It expects Japan to accept a subordinate role -- to mention to pay for the evils done to China. Its regular reference to Japan’s failure to purge its war guilt is evidence that Beijing feels morally justified in putting Japan in an inferior position.

Indeed, Chinese leaders feel they should live up to the great Chinese leaders of the past who unified the country and made it wealthy and powerful. More significantly, the current “economically powerful authoritarianism” in China is not simply a status quo, but it is pursuing nationalist aims (Sutter et al. 1993, also Chapter 4 and Overholt 1996). Chinese nationalism, constantly a strong element in the party's legitimacy, is now the sole ideological glue that holds China together and keeps the Communist Party in power (Oksenberg 1987; Townsend 1992; Whiting 1995). In China, the leadership relying on nationalism to maintain
legitimacy and authority will not be able to make concession to Japan on political issues in exchange for economic gains. Nor will it accept permanent subordination to Japan (Friedman 1996, 302-8).

This is particularly true with the third generation leadership led by Jiang Zemin that is widely regarded as lack of the crucial power resources, authority, and legitimate as Deng Xiaoping held. The textbook controversy in the mid 1980s, like the dispute with the US over the status of Taiwan and the dispute with the Great Britain over the status of Hong Kong showed that Chinese leaders had to put China’s nationalistic self-esteem ahead of other goals, even when this potentially threatened the country’s substantive modernization efforts. Japan sees itself as the capital-rich hub of Asia. Others should then benefit by linking to the Japanese center, as Japan surrenders lesser technologies to followers while it advances to new leading market sectors. In short, no matter how much Chinese leaders might prefer Japan as the center, the potent Chinese nationalism rejects subordination to Japan. Politicians in China who appear to submit to Japanese leadership and international primacy in the region are pilloried as traitors. On top of that, largely stimulated by highly nationalistic passions, China appears to be seeking primacy as the regional hegemon in the creation of a greater Sinocentric east Asian order.

Furthermore, Japan carries a heavy burden of history; war crimes cast a long shadow over its international activities (Buzan 1988). Most Chinese still have strong negative feelings about Japan dating back to the Japanese invasion particularly during the 1930s and 1940s (Whiting 1989, 134-41). As a well known scholar acutely observes,

Chinese attitude toward Japan mix elements of realpolitik with less antiseptic
emotions rooted in China's bitter history of occupation by Japanese imperialists . . . View of Japan with a loathing and it is more a legacy of Japanese atrocities in the 1930s than a byproduct of contemporary Japanese power (Christensen 1996, 40-1).

The widely prevailing negative perception of Japan as a ruthless historical enemy and predator reinforces the real, if unspoken, assumption that a past enemy remains an enemy today. This is particularly true largely because Japan has not truly repented its militaristic past (e.g., Jianyong Liu 1995). Meanwhile, Chinese security analysts, especially military officers, anticipate and fear Japan’s renaissance as a world-class military power in the early next century (Christensen 1996, 41). These arguments seem valid given the fact that Japan is intent on becoming a “normal” country and developing a military commensurate with its economic power.4 As early as in March of 1988, Japanese Prime Minister Takeshita called for a defensive capability matching Japan's economic power.

As economic preponderance could transform at some point into military dominance, China tends to be apprehensive about Japan’s growing economic influence. It is also suspicious about Japan’s carving out a sphere of influence in Asia via technology and investment. Thus, China is balancing against an emergent, remilitarized, and economically dominant Japan. Not surprisingly, China periodically attacks on “Japanese militarism” and the steady enhancement of Japanese power (including military power). Japan’s announcement in January 1987 that its defense expenditure would surpass 1 percent constituted a symbolic threshold for the Chinese; its enhanced defense efforts were deemed unambiguous evidence of ambitions as a “political power” (Pollack 1990, 716; Xi 1987). Nearly all subsequent commentaries from the Chinese side have expressed varying degrees of reservation about the
increase of Japan's defense capabilities and its longer-term consequences.

In addition, China also loudly protested against Japan sending troops as part of UN peacekeeping operations in Cambodia. Although some view this and the corollary effort by Japan to assume increased security responsibility as largely a response to pressure from the US, China tends to see it as the indicator of the emergence of a more powerful and potentially more assertive Japanese state.

In his October 1992 visit to China, Japanese Emperor Akihito "deplored" the "unfortunate period" in which Japan "inflicted great sufferings upon the Chinese people."45 Prime Minister Murayama made a similar apology during his visit to Beijing in May 1995. But those apologies did not appear to relieve the levels of Japanese resentment and hostility against Japan. Although Murayama asked for "forward-looking ties" with China and pleaded for an understated approach to the 50th Anniversary of Anti-Japanese War in August 1995, the Chinese (no doubt goaded by the Japanese Diet's refusal to pass a resolution of apology for the War) used the occasion not only to celebrate victory in the Great Patriotic War, but to dwell on Japanese crimes and atrocities against the Chinese people, stimulating rising nationalism to turn against Japan. Obviously, the war legacy does not leave Japan in a position to adopt leadership in the region.

In short, as in many Asian nations, there is some parallel and perhaps more worrisome fear in China that the flying geese model will create excessive dependency on Japan. And in the extreme, the model would be tantamount to the recreation of the notorious "Greater East Asian Co-prosperity Sphere" that Japan attempted to create by force during the late 1930s and earlier 1940s. A senior Chinese scholar expresses a common sentiment in China: "Japan's view is always a flying geese formation with Japan as the head goose. Our memories are long,
so aren’t about to fly in Japan’s formation."

CHINA’S LOCAL ECONOMY AND “DEFENSIVE COOPERATION”

From the detailed discussion in the last section, it is not difficult for us to conclude that the key factors that underlie China’s concerns for relative gains in the flying geese model are that the model would be most likely to put China in a competitive disadvantaged position and thus hurt its long-term economic growth and possibly its political status. Such relative gains concerns have directly contributed to Beijing’s official rejection of the otherwise mutually beneficial cooperation. At the same time, the above discussion has also strongly implied that a large proportion of Chinese local economies especially in the coastal region have been integrated in the \textit{de facto} flying geese model of economic development which is characterized by the hierarchical division of labor with Japan as the “head goose.”

Indeed, although Chinese officials are extremely cautious about China’s integration into regional cooperation led by Japan, much of Chinese coastal manufacturing and especially that in the four special economic zones (SEZs, that is, Shenzhen, Shandou, Zhuhai and Xiamen) in Guangdong and Fujian provinces has been integrated into regional division of labor characterized by the hierarchical order. In other words, those local economies have become an integral part of a production network that has emerged in the region with Japan as its core, and they have been imitating Japan’s development pattern. In many cases, China provides labor to manufacture products from imported material using imported machinery and working for foreign management. Guandong acts as Hong Kong’s workshop and Hong Kong as Guangdong’s shop window. Fujian and Taiwan have also now evolved into a similar pattern. As much of capital, technology, and trade is manipulated by Japanese firms, such
regional division of labor is tightly coordinated from Tokyo. As some scholars have argued,

The NICs, the ASEAN-4, and, increasingly, China’s coastal economy have become embraced by Japanese technology. Rather than autonomous agents, these economies are functioning more like subcontractors, or junior partners, in an export-oriented, keiretsu-like alliance dominated by Japan (Hatch and Yamamura 1996, 9; see also Chan and Clark 1992).

As Japan becomes more and more technologically advanced, China seems to be willing to absorb the industries that Japan no longer holds comparative advantages and successively gives away in a large scale. China’s strategy of export-led growth implicitly encourages its local economies to invite Japan’s sunset industries to Chinese export zones, thus linking China to Japanese industrial policy and to the regional industrial product cycle at the second or third tier. For instance, as Japan’s Cannon Company opted to upgrade its domestic operations by focusing on high value-added models, such as the EOS 100, it boosted its production of relatively simple cameras in China. Similarly, as Casio Company began producing more cutting-edge goods, such as electronics organizers, at home, it began producing more of its pocket calculators and other standard goods in China. As Murata Manufacturing built new facilities in China to produce ceramic filters, an important component in cellular phone, it decided to retain at home the most technologically demanding sector of making ceramic powder. Largely through foreign direct investment, those industries ultimately find a new home among the “follower goose” like China. To summarize, as China pursues an export-led growth strategy to try to get technology transfer following the logic of the product cycle, its coast region has implicitly acquiesced to the flying geese model. In so doing, they have actually accepted Japan role as “head goose” in the unequal regional
cooperation.

There are many reasons to explain why Beijing does not prevent its local economies particularly those along the coast region from participating in the regional economic integration championed by Japan. One reason is that such cooperation is propelled by Sino-Japanese complementary economic structures. Japan has technology and capital; China has natural resources and labor. Japan could supply capital equipment and consumer goods in exchange for China's natural resources and agricultural products. Such cooperation is mutually beneficial and appears to be a natural fit, thereby bringing about enormous absolute gains to China's economic growth. Indeed, the benefits to participate the Japanese-style model have proved to be large. Chinese firms have received invaluable infusion of capital, technology, and managerial guidance from Japanese firms. Moreover, following Japan's development path, some Asian NICs and ASEAN countries have achieved, or are about to achieve, economic "lift-off." This is essentially because Japanese capital and technology help them have made deep inroads into the markets of industrialized countries, supplying them with high-quality and price competitive products.

For Beijing, not trying to block the local economies from joining in the hierarchical economic order led by Japan has also reflected the fact that local governments and private sectors have got increasing power in deciding their own economic activities since Deng Xiaoping initiated the policy of economic reform and opening to the world in 1978. That trend will only gain the momentum in the future. As long as local economies are in line with China's international political standing and long-term growth, Beijing usually do not put the heavy hand of government regulation in their economic behaviors.

More relevantly, the fact that Beijing does not block local economies particularly in
the east coastal provinces to attract Japanese investment and to fit into the *de facto* regional division of labor dominated by Japan has provided some empirical evidence for what Duncan Snidal calls "defensive cooperation" which is essentially based upon relative gains considerations. This theoretical proposition basically argues that "cooperation with relative gains adversaries can be the best choice in a multilateral world, especially as the number of states increases." The underlying logic is that states that do not cooperate may turn out to be in even greater relative disadvantages than it might be otherwise (1991a, 722; 1991b; see also Milner 1992, 484).

Based upon the economic strength and technological capability, China’s position within the regional economy is essentially placed at the bottom of the flying geese pattern in trade and investment competition with ASEAN-4 countries. At similar stages of development, both China and ASEAN-4 states need huge capital to invest in infrastructure and directly compete for foreign capital inflows. In such industries as textiles, apparel, and construction materials, they are directly competing with each other in the international market. Moreover, the most significant aspect of China’s economic relations with advanced countries in general and Japan in particular is technology transfer and capital flows. That is the vehicle for China to move up the technology ladder and to elevate its position in the regional economic structure. Although the Japanese firms are jealously guarding their technology against spilling over to China, technology transfer from Japan has constituted a major source of China’s technological upgrading. As a matter of fact, effective mode of technology transfer largely brought about by Japanese FDI have largely helped many Chinese firms in their own technological and organizational capabilities that are necessary for a continuous upgrading of their production efficiency and product quality.
Under this circumstance, had Beijing not allowed its local economies to be integrated in the vertical division of labor, a large amount of Japan's foreign investment and technology transfer would have flown into other Third World countries and particularly into ASEAN-4 countries. That would be most likely to put China in a more disadvantaged position than it might be otherwise. After all, China’s rapid export growth, a pillar for its economic development, has depended to an unprecedented degree on foreign invested firms, and rapid growth there is largely depended on Japanese investment, aid, and technology. In addition, Beijing is acutely aware that its economic structure itself is diverse and can fit into different levels of development. As they move to higher levels of development by accumulating capital and attracting advanced technologies and management expertise, the more developed coastal provinces can transfer more capital and technology to the interior areas.

Therefore, based upon relative gains concerns, it is in China’s best interests to let its local economies especially along the east coast to participate in the de facto flying geese model. After all, not preventing the local economies from participating in the vertical order of regional cooperation is generally in line with China’s official resistance to the flying geese model. Beijing can publicly argue that China is not subordinated to Japan’s lead and that its key industries are not put in a disadvantaged position of regional competition and development.

The empirical evidence to support the proposition of “defensive cooperation” has no doubt reminded us that any claim that relative gains concerns eliminate cooperation must be carefully scrutinized before it is applied to any particular situation. Put differently, relative gains concerns do not necessarily eliminate the prospects for cooperation; instead, sometimes such concerns have actually enhanced cooperative efforts.
SUMMARY

This chapter has found that, if it had participated in the flying geese pattern of economic development dominated by Japan, China would have achieved substantial economic gains. However, the risk perceived by Beijing (i.e., the central government) is that China would be put in a competitively disadvantaged position, thus damaging its long-term economic growth and possibly political status. In essence, the flying geese model is a three-layered V-formulation of industrial diffusion, with Japan at the head and China at the tail end. It has been vigorously advocated by Tokyo especially in the years after the 1985 Plaza Agreement, in an attempt to serve Japanese MNCs' interests and strategic goals by establishing a hierarchical structure of production networks based on each country's technological strength in East Asia.

Those gains to Japan, however, are highly detrimental to China. Economically, the model might stymie China's aspiration to climb in the technological ladder and make China run huge structural trade deficits, as most East Asian countries have been experiencing for more than a decade. Politically, participation in the model dominated by Japan would imply that China has accepted Japanese leadership in Asia, and that is unacceptable to China's highly nationalistic image. By formally resisting the flying geese pattern structured by vertical division of labor, Beijing clearly demonstrated sensitivity to relative gains favoring Japan, i.e., to fear that cooperation would disproportionately benefit Japan, ultimately to the detriment of its own long-term economic welfare and possibly political status.

On the other hand, Beijing does not appear to block the local economies especially in the east coastal China from being integrated into the de facto regional economic
cooperation which is characterized with the hierarchic division of labor. Such an apparent dilemma in the actual policy outcomes as well as the major findings of this empirical analysis will be further discussed in the concluding chapter.
NOTES

1. The Plaza Accord took its name from the Plaza Hotel, New York City, where five industrialized countries (the US, Britain, France, Germany and Japan) held a meeting on a coordinated strategy to devalue the US dollar against other major currencies in order to reduce huge US trade deficit. As a consequence, the yen jumped in value from 250 to 1 dollar in the summer of 1985 to 150 by the summer of 1986. See Funabashi (1989); see also Ito (1992, 313-62).


3. For numerous positive evaluations on the flying geese model, see Asia-Pacific Economic Co-operation and Sino-Japanese Relations, Documents from the Joint Conference between Shanghai International Relations Research Institute and The National Institute for Research Advancement of Tokyo, Shanghai, 1989.


8. The Plaza Accord did not do what it was supposed to do, i.e., curbing Japanese exports, and thus the US deficit. Japanese exports to the US actually climbed from $66.7 billion in 1985 to $91.1 billion in 1990. The US merchandise deficit was still $124 billion, of which $44 billion was with Japan. See IMF (1992).


11. China’s MOFTEC (Ministry of Foreign Trade & Economic Cooperation) statistics, as quoted in statistics table from the Sino-Japanese Economic Commission [Nichu Keizai Kyokai], Tokyo, August 1996; IBJ Ajia Joho [Industrial Bank of Japan Asia Intelligence Report], no. 75, p. 23.


28. The Economist, “If We Control the Core Technology, We Need Not Fear ‘Hollowing Out,’” November 11, 1994, p. 33.

29. IMF. Direction of Trade Statistics, various years.


32. Unless otherwise noted, for the convenience of discussion in this section, Asia does not include Japan.

33. IMF. Direction of Trade Statistics, various years.


CHAPTER VI
CONCLUSION: FINDINGS AND IMPLICATIONS

Throughout this study, based on a comprehensive literature review of the relative gains problem for cooperation, we have made two central assumptions. First, a state's concerns for relative gains are a severe impediment to international economic cooperation, and the higher the relative gains concerns are, the more difficult it is for a state to be engaged in cooperation, *ceteris paribus*. Second, significant relative gains concerns emerge because of a number of conditions such as competitive political relations, international structural changes, and long-run effects. From the two assumptions, we have developed three major hypotheses. They are: 1) If a state constantly faces military threat and zero-sum political competition from another state, then it will be extremely sensitive to relative gains, thereby restricting economic interactions favorable to the rival state; 2) If a state believes that its economic partner is a rising power in a changed international system, then it will show increasing sensitivity to relative gains favoring the partner and thus seek for its relative achievements of gains and bargaining power; and 3) If a state believes that a cooperative arrangement would put it in a competitive disadvantage and hurt its long-term economic growth and possibly its political status, then it will be acutely sensitive to such relative losses and will not be ready to cooperate. Obviously, these hypotheses concentrate on the causal relationships between certain conditions and a state's sensitivity to relative gains, where the former are independent variables and the latter is a dependent variable.

The hypothesized causal relationships have been tested via three case studies. They are: Taiwan's restriction of its economic interactions with China since 1979, Japan's
reduction of its ODA commitment to China particularly in the fourth loan package beginning in the 1990s, and China’s rejection of the flying geese model of economic development dominated by Japan since the mid 1980s. In so doing, we seek to find empirical evidence on when and under what conditions relative gains concerns may make interstate cooperation more difficult, if not impossible.

As discussed in Chapters 3 through 5, the hypothesized relationships between the conditions and a state’s concern for relative gains in the policy process are strongly supported by the evidence. However, because of the different conditions that have fostered the state’s concern about relative gains, the extent to which relative gains concerns are reflected in the policy process varies. Moreover, as the extent to which relative gains concerns are ultimately translated into policy is shaped and constrained by many other factors, even a high level of relative gains concerns may not be fully shown in policy outcomes. In the Taiwan case, relative gains concerns are extremely high and are vividly reflected in a series of Taipei’s policy behaviors. In the ODA case, relative gains concerns are not high and only moderately affected in the policy outcome. In the flying geese model, relative gains concerns are not very high and the policies associated with such concerns are partially supported. Specifically, relative gains are almost fully reflected at the central government level in that Beijing officially rejects the model, but not shown at the local level in that Beijing does not block local economics from participating in the de facto regional economic integration largely led by Japan.

*Taken into consideration of all the factors mentioned above, we can conclude that the hypotheses in both Taiwan and the ODA cases are strongly supported by the evidence, while the evidence for the actual policy outcomes in the flying geese model (that is, relative*
gains concerns lead to non-cooperation) is mixed. In short, a thorough analysis of the three cases has clearly indicated that relative gains concerns are an important, if not the most important, factor for those cooperation collapse or setbacks. Before we discuss their significant contributions and policy implications, it is important for us to highlight the major findings of the empirical analysis again.

**MAJOR FINDINGS OF THE CASE STUDIES**

From Taiwan's case (Chapter 3), we have found that a deep fear of the negative political consequences of increasing economic dependence on China essentially underpins Taipei's high sensitivity to relative gains in the cross-strait economic interactions and thus takes a restrictive economic polices toward China. As Beijing regards Taiwan as a renegade province, it constantly seeks to isolate Taipei in the international community and has never renounced the “right” to use force against Taiwan should it claims independence, thus threatening the security of 21 million Taiwanese people and the very existence of the Republic of China in Taiwan. On the other hand, Taipei is trying every effort to maintain its de facto independent status and desperately seeks out new ways to enhance its international recognition and the effectiveness of deterrent capabilities. As long as Taiwan lives under the political coercion and military threat from the PRC, this will have a defining impact on Taipei’s economic policies toward the mainland. In other words, as China never renounces its right of using force against the island, Taiwan has ample reasons to take steps to be prepared for war and has to work to insure that China does not take advantage of the cross-strait economic interactions to the disadvantage of Taiwan.

As a result, security-motivated relative gains concerns give a good account for why
Taipei has been consistently restricting economic transactions across the Taiwan Straits and still maintains a ban on direct trade, investment, transport, and communications with China, its now biggest foreign market. By eschewing opportunities for mutually beneficial exchanges, Taipei would be forgoing substantial benefits in order to assure security, broadly defined, over the long term. By so doing, Taipei also appears to believe that it is striving for its fundamental goal in the cross-strait economic relations — preventing China from obtaining advances in its relative capabilities. As Kenneth Waltz well observes, “Conventional states shy away from cooperating for the achievement of even large absolute gains if their uneven division would enable some to turn their disproportionate gain into a military advantage” (1993, 74).

In essence, Taipei is deeply worried about the political dangers of growing economic dependence on China because economic dependence would compromise its pursuit of a legitimate and autonomous international status. As Taipei’s smaller economy is more susceptible to being dominated by the booming PRC economy, a key purpose of Taipei’s restrictive behaviors is not to allow the development of too much economic dependencies on China and thus ensures that Beijing does not achieve irrevocable, binding control over Taiwan’s political fate. Moreover, it is highly possible that Taiwan’s investment could eventually strengthen China’s comprehensive economic strength and a more powerful China would be more capable of threatening the island militarily.

Furthermore, when choosing Guangdong and Fujian as the initial focus of reforms to develop economic ties with Hong Kong and Taiwan, China’s leader Deng Xiaoping had the tacit goal of preparing them for reunification (Zhou 1997, 15). That is, China aimed to use its huge market to absorb Taiwan’s economy and then use its influence on Taiwan’s economic sectors to turn the Taipei politicians around the unification issue. Finally, China has proved
to be wielding its growing commercial clout to bully other countries into isolating Taiwan and
directly dig up Taipei’s foreign policy foundation in order to destroy Taipei’s international
living space. Therefore, facing the zero-sum political competition where one side has
powerful incentives to take advantages of the other side, Taipei’s restrictive economic policies
toward China have clearly reflected strong relative gains concerns. That is well demonstrated
in what Vincent Siew, Taiwan’s prime minister, told a meeting of the American Chamber of
Commerce (AmCham) on October 8 1997, “[n]o matter how alluring the potential economic
gains of removing all restrictions on cross-strait trade and investment, economic
considerations may never override those of national security.”

The findings from the ODA case (Chapter 4) indicate that changes in the international
system exemplified by the emergence of a powerful, non-status quo China in the post-Cold
War era account for the increasing sensitivity of Japan to relative gains in its ODA to China.
Japan’s concerns for relative gains are clearly demonstrated in its pursuit of a shorter ODA
arrangement and bargaining harder and harder for the terms that China could use its yen loans
beginning in the 1990s. The post-Cold War era provides a different environment for Japan
where the need for a strong China to counterbalance the former Soviet Union has virtually
disappeared. In the meantime, China increasingly appears to be neither a normal state nor
satisfied with the status quo; it is instead a highly nationalistic country.

According to public option polls, although China is not regarded as a security threat
to Japan, at least in the near future, paradoxically, the vast majority of the Japanese felt that
China was seeking primacy as the regional hegemon in the creation of a greater Sinocentric
East Asian order (Nelsen 1995, 82; Drifte 1996, 57). Moreover, in private Japanese policy-
makers worry most about three possible adversaries in the post-Cold War era: Russia, Korea,
and above all, China.³ In dealing with such a China that in the coming years “is likely to territorially amorphous, economically dynamic, culturally proud, socially unstable and politically unsettled” (Funabashi et al. 1994, 3), and given that Japan’s national interests in East Asia are on a sharp rise, Japan has to calculate its ODA to China, a crucial part of its China policy, in relative gains terms. As Stephen Krasner (1993, 263) has suggested, ODA can create “asymmetrical opportunity costs of change,” allowing the donor nation to exercise economic power over the recipient. That seems particularly true with Japan’s ODA to China since the enormous yen loans with generous terms in which the repayment will depend on unpredictable political conditions over several decades are highly valuable to China’s economic development.

As a result, some clear relative-gains-seeking behaviors were evident in a series of policy changes in Japan’s ODA to China beginning in the 1990s and were aimed at increasing Japan’s controls and better serving its political goals. Japan embarked on linkage of yen loans with Chinese environmental destruction and used its ODA as an effective diplomatic tool to demand China for more military transparency. In 1994 during the negotiations for the fourth yen loans to China, Tokyo focused on whether and how to change the previous preferential formula for China, under which Japan had made an advance pledge of yen loans to cover a five-year period.⁴ Japan had insisted on annual yen loan review to substitute the previous multiyear package highly favorable to China and finally managed to reduce the five-year loan package to a three-year coverage.

By reducing a longer-term ODA arrangement, Japan can obtain relative achievements of gains and increase its bargaining power relative to a possible expansionist China. The increased leverage could then be used to address other issues such as China’s military buildup
and environmental destruction more effectively. That is certainly in line with what some Japanese leaders argue that Japan should use its generous ODA to “take a clear position of express concern over China’s military build-up” (JFOIR 1995, 23). For example, should China’s behaviors be detrimental to Japan’s national interests and regional balance of power, Japan would be in a more flexible position to address its concerns by reducing its aid or suspending the ODA. Furthermore, with the end of Cold War, facing a more politically uncertain and economically dynamical China, Japan’s overall policy toward China has seen some noticeable changes. As a crucial part of Japan’s foreign policy, its ODA policy toward China expects to be changed responsively so as to show its particularly political significance. This seems to be enhanced by the fact that close bilateral economic relations have so far failed to give Japan the promised leverage over Chinese political decisions and some prominent Japanese figures have advocated the use of ODA and other policy tools to influence errant Chinese behaviors (JFOIR 1995, 45).

In sum, Japan’s seeking more leverage through ODA to deal with a powerful non-status quo China in the post Cold War era can be understood in terms of the significance of relative gains as contrasted with absolute gains. After all, the defining feature of East Asia’s international relations is still characterized with “a remarkable degree of political fragmentation and hostility” (Buzan 1995, 148). This anarchic nature requires Japan to be deeply concerned not only with how its ODA policies and outcomes directly affect it, but with whether it is gaining more bargaining power over China and better serves Japanese national interests. In other words, Japan must be concerned about how it will fare in regional primacy and how to maximize its advantage over rivals like China or at least to ensure that it is not disadvantaged. The underlying reason is that the “concept of anarchy and the security
dilemma lead us to see that the international system not only permits conflict, but can create it: actors may refuse to cooperate with others, not so much because they seek the positive gains of exploitation, but because they fear that their own cooperative initiatives will be mistreated” (Jervis 1988, 349). All in all, should Japan still maintain the original pattern of its ODA to China, even though mutually beneficial in absolute terms, Japan would lose an important means to increase its bargaining power in dealing with a possible expansionist China, whose behaviors could hurt the regional balance of power and Japan’s national interests. Apparently, Japan did not want to lose that leverage because it has proved to be an expert in utilizing its economic power including ODA to seek its national security, broadly defined.

The findings from the flying geese model (Chapter 5) demonstrate that fear of a potent damage to China’s long-term economic interests and possibly its political status essentially underlies China’s acute sensitivity to relative gains and thus officially resists the otherwise mutually beneficial cooperation. As its economic growth is now heavily dependent on trade, foreign investment, and technology transfer, China is fully aware of the significance of being closely integrated to Asian economic cooperation. Yet, despite the lure of capital and technology that the flying geese model might bring to China, strong relative gains concerns prevented Beijing from endorsing the beneficial economic arrangement. In essence, the flying geese model of economic development is Japan’s grand strategy (Ikle and Nakanishi 1990; Christoffersen 1996), and the nature is a three-tiered V-formulation of industrial diffusion and export-led growth. Based on the level of development and technological capacity of the relevant countries, Japan is at the head, Asian NICs constitute the second tier, and ASEAN-4 and China at the third and lowest tier of the product cycle. If the flying geese model were

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implemented, the production pattern in the region would be basically characterized by a vertical division of labor and a core-periphery structure in the regional economy would be preserved. In this light, “the flying geese pattern guaranteed that China would never assume the leadership position it sought within the hierarchical East Asian order” (Christoffersen 1996, 1073).

From the Chinese perspective, as the leading goose, Japan would be the biggest beneficiary. By helping Japanese MNCs establish a hierarchical structure of production networks based on each country’s technological strength, the flying geese pattern of economic development could not only benefit Japan’s international economic competitiveness, but ensure that Japan would stay in the lead indefinitely. In addition, despite advocating that it was its responsibility to assist in the lower level countries’ industrialization and incorporate them into the regional economy, Japan seemed to be only interested in maintaining this hierarchical division of labor and creating different economic circles around its economy. Indeed, by controlling access to capital, intermediate goods, and technology, Japanese MNCs have largely shaped Asian structural dependence and firmly maintained the lead in the most high-tech aspects of production.

Those gains to Japan, on the other hand, could be highly detrimental to China’s national interests, both economically and politically. Although the flying geese pattern might bring China economic prosperity in the short run, it would put China in a periphery position in the regional structure and stymie its aspiration and effort to upgrade its technological level, thus hurting its economic competition and development in the long run. This basically reflects China’s position as a natural third level participant which is still heavily dependent on raw material trade and seeking inflow of foreign capital. Moreover, it is reasonable for China to
believe that Japan has strong hostile intention against its emergence as an economic power because of the rivalry in both geopolitics and geoeconomics. On top of that, more and more structural importation of Japan's capital goods and technological components would be most likely to increase China's structural dependence upon Japan and put China in a position of running a serious trade deficit with Japan. That is the mischief which most other Asian countries have been persistently suffering for more than a decade, mainly due to their closer integration with the flying geese model championed by Japan.

To make the matter worse, although the flying geese pattern is basically an economic issue, it has obviously political significance. With participation in the model with Japan as the "head goose" and China "follower goose," China would recognize and almost accept Japan's international primacy in East Asia. That would definitely be a hard blow to China's highly nationalistic and confident self-image. Yet, China has a strong aspiration of being Asia's dominant power, and that perception has been further strengthened by its astounding economic growth during the past two decades. Largely because of strong nationalistic passions, China is unwilling to accept a subordinate role to Japan; politicians in China who appear to submit to Japanese leadership are pilloried as traitors.

CONTRIBUTIONS AND POLICY IMPLICATIONS

The main findings from the case studies have made some significant contributions, both theoretically and empirically. They also have provided some important policy implications. The significant contributions and policy implications will be discussed in the following.

1. The findings of the case studies have provided solid empirical evidence for some
theoretical arguments about the conditions that are most likely to foster a state's sensitivity to relative gains and thus substantially affect the prospects for cooperation. To a large extent, this study has empirically confirmed a most valuable outcome of debate on the relative gains problem between neorealism and neoliberalism. That is, relative gains concerns matter significantly in a cooperative breakdown or setback, but not unconditionally. The political dangers of Taiwan's growing economic dependence upon China underlay Taipei's relative gains concerns in its economic exchanges with China; changes in international structure in the post Cold War era exemplified by the rise of a powerful non status-quo China and the diminution of the Soviet military threat well accounted for Japan's increasing sensitivity to relative gains in its ODA to China beginning in the 1990s; China's relative gains concerns in the flying geese pattern were essentially motivated by the potent damage to its long-term economic growth and possibly its political status. In the absence of those conditions, it is unlikely that relative gains concerns or the policies associated with them would have emerged as prominently as they did in those three cooperative breakdowns or setbacks.

Moreover, the findings have strongly suggested that the relative gains approach has a formal deductive logic and parsimonious power in analyzing barriers to economic cooperation in East Asia. As the first-ever theoretically-informed empirical effort to analyze the unwillingness of states to be engaged in otherwise mutually beneficial cooperative ventures in the context of East Asia, this study has shown that as a radically different starting point, the relative gains approach has provided a promising direction for inquiry into why states refuse to cooperate or sharply limit their cooperative commitments, even if by so doing they have to abandon substantial benefits in absolute terms. This research has no doubt called to the attention of the cooperation specialists the severely inhibiting effects of relative gains...
problem on economic cooperation in East Asia.

Nevertheless, when we apply the approach into explaining or predicting economic cooperative collapse or setbacks in any particular situation, we have to be careful. A critical point is that we must pay attention to the difference in types of cooperative endeavors and partners themselves. The relative gains approach has demonstrated a powerful theoretical guidance for empirically explaining the three cases mainly because East Asia is typically characterized with the anarchic nature of international relations, the examined partners have at least some strong reservations about each other, and the cooperative adventures themselves have not only economic significance but also strong political implications. Without those factors, relative gains concerns tend to be less prominent and can hardly affect the prospects for cooperation, thereby casting doubt on the deductive logic of the theoretical approach. In short, essentially as part of contextually rich theory of international studies, the relative gains problem for cooperation can not be utilized unconditionally even if it has proved to have a deductive logic and parsimonious power in helping us think about barriers to international cooperation.

Finally, some scholars such as Robert Powell (1991, 1994) and Robert Keohane (1993) argue that to establish the significance of relative gains motivations, states must firmly believe or at least have ample reasons to believe that the advantaged partner has the opportunities and incentives to use the relative gains to its own advantage and to the disadvantage of the other state. This study has found that the criteria are a significant or may be sufficient, but not a necessary factor for a state to worry about relative gains. In the three cases, the extent to which state sensitivity to relative gains appears to be largely shaped by the criteria, but we cannot strongly contend that in the absence of the criteria a state’s
concern for relative gains will not appear. Taipei’s sensitivity to relative gains in the cross-strait economic interactions is no doubt conditioned on its firm belief that Beijing may squeeze Taiwan’s economic dependence on the mainland in order to extract political benefits.

However, regarding the other two cases, we can not conclude that the advantaged partners would have strong incentives to exploit the relative gains to their own advantages and to the detriment of the others, although such possibilities can always exist. It is no doubt that Japanese governmental loans have contributed significantly to China’s economic development as well as its international bargaining power, but there is no evidence to contend that China has exploited the gains to the disadvantage of Japan’s national interests. China’s participation in the flying geese pattern would formally put Japan in a superior position of international competition and development, but that does not mean that Japan has strong incentives to exploit its imbalanced gains against China. Nevertheless, relative gains concerns are evident in all the three cases and significantly affect the prospects for cooperation. In situations such as these, we might draw a right generalization: the more opportunities and the stronger incentives for one’s partner to use its disproportionate gains from a cooperation to hurt oneself, the easier for an analyst to establish the significance of relative gains motivations.

2. This study has basically confirmed that relative gains concerns are a serious inhibition to international cooperation and the higher the relative gains concerns, the more difficult for a state to be engaged in cooperation, ceteris paribus. On the other hand, this empirical investigation has also strongly indicated that relative gains concerns do not always lead to cooperation collapse or setback; sometimes such concerns have actually enhanced cooperative behaviors. In other words, some economic cooperative arrangements and increases in economic exchanges happen mainly due to the consideration of relative gains.
That is what Duncan Snidal calls “defensive cooperation.” In his word, “[s]tates that do not cooperate fall behind other relative gains maximizers that cooperate among themselves. This makes cooperation the best defense (as well as the best offense) when your rivals are cooperating in a multilateral relative gains world” (Snidal 1991a, 722; 1991b). In the same vein, Helen Milner argued, “[i]f you refuse to work with others, they may work together and gain even greater relative advantages over you than they might otherwise” (1992, 484). In essence, cooperation with relative gains rivals can be the best choice in a multilateral world and failure to cooperate may lead to devastating consequences.

This “defensive cooperation” proposition based on the consideration of relative gains is well demonstrated in why Taipei gradually relaxes its economic interactions with China mainly in its labor-intensive investment and exports to China. As Taiwan has been undergoing a fundamental transition from a labor-intensive economy to a semi-technological and capital-intensive one, a massive relocation to the mainland of its low value-added manufacturing allows Taiwan to accelerate its industrial upgrading and constitutes the best hope for growth. Moreover, by taking advantage of the mainland’s low-cost labor and land, Taiwan’s small- and medium-sized business which presently provides the bulk of Taiwan’s investment in the mainland can turn out final products at competitive prices for exports. Furthermore, as Taiwan’s traditional markets either became saturated or increasingly difficult to crack because of protectionism, enormous economic opportunities in Mainland China could not have come at a better time.

Therefore, a wise option for Taipei is to try to manage and channel growing interdependence to maximize its own political and economic advantage. Had Taiwan not invested and traded there, the huge economic opportunities would have been taken by other
countries, and that would be most likely to put Taipei in a more disadvantaged position. In this sense, Taipei gradually relaxed its economic exchanges with China for fear that other states would get ahead by cooperating with China, and that could strengthen China’s relative capabilities over Taiwan than it might otherwise.

Finally, expansion of economic relations could help Taiwan to exploit China on relative gains. A case in point is the issue of Sino-US trade conflict. A massive labor-intensive investment in China has fundamentally reduced Taiwan’s once-lopsided trade conflict with the US, while at the same time sharply increased China’s trade conflict with the US. America’s trade deficit with China, which was nil in 1985, is now second only to that with Japan. In essence, much of China’s trade deficit with the U.S. only reflects a shift of production by Taiwan’s manufacturers into China. Goods that America once imported from Taiwan now count as Chinese, increasing its recorded imports from China and cutting the corresponding figures for Taiwan. Huge trade deficit with China tends to worsen Sino-U.S. relations but improve Taipei’s friendly image in the US, thereby providing ammunition for friends of Taiwan in the US against Communist China and strengthening Taipei’s diplomatic leverage relative to China. However, it is Taiwan’s investment that is indirectly or directly heightening trade frictions between Beijing and Washington. As a business analyst points out, “[a]t least 70% of the growth in China’s trade surplus with the U.S. is in one way or another linked to Taiwan companies.”

Such “defensive cooperation” can also be found in the policy dilemma that while the Chinese central government has officially rejected the participation in the flying geese pattern dominated by Japan, it does not seem to block local economies especially in east coastal China to attract Japanese investment and to fit into the de facto flying geese model of
economic development, although not using the name.

In essence, if Chinese local economies had not participated in such vertical division of labor, a large amount of foreign investment and technology transfer would have flown into other Third World countries and particularly into ASEAN-4 countries. Largely at similar stages of economic development, ASEAN-4 and China have been competing intensively for foreign capital, technologies, and world markets in light-manufacturing products such as textiles, toys, leather goods and electronic appliances. Without the invaluable infusion of capital, technology, and managerial guidance largely from Japanese firms, China’s economic growth would certainly have slowed down, thus placing China in a more disadvantaged position than it might be otherwise. That is, failure to let China’s local economies to cooperate in the regional economic integration may cause China to suffer devastating consequences. However, to maintain economic growth is the key source of legitimacy now for the Communist Party in China.

Based on the relative gains calculation, it is in China’s best interests to allow its local economies to participate in the regional economic integration even dominated by Japan. As the coastal areas in China have moved to higher levels of development by attracting advanced technologies and industries and learning Japanese economic efficiency, they can transfer more capital and technology to the interior provinces, thereby accelerating the whole Chinese modernization drive. After all, a primary objective of China’s foreign policy is to promote domestic economic development. Finally, not blocking local economies to participate in the vertical structure of economic integration not only serves China’s best interests by accumulating capital and management expertise, but also is in line with China’s official rejection of the flying geese model dominated by Japan. By so doing, Beijing may have
achieved two-fold benefits: Maintain its nationalistic self-image and escape any criticism for its subordination to Japan's leadership in Asia, while at the same time minimize the potential damage to its long-term economic growth by not leaving China's key industries in an inferior position of regional competition and development.

As the literature review in Chapter 2 illustrates, one of the weaknesses of relative gains approach is that it is logically based on the assumption of anarchy and thus overemphasizes states' unwillingness to cooperate. The empirical evidence presented in this study has provided some support for the proposition of "defensive cooperation," thereby to a large extent confirming the weakness. As a result, any claim that relative gains concerns definitely mean that "a state will decline to join, will leave, or will sharply limit its commitment to a cooperative arrangement" (Grieco 1990, 44) must be carefully scrutinized before it is applied to any particular situation. On the other hand, the theoretical proposition of "defensive cooperation" is still not well developed. In addition, defensive cooperation is essentially regarded as a passive rather than active cooperation approach; its application to the real world is largely determined by the perception that your partners may find other ways to gain even greater relative advantages over you than if you refuse to cooperate.

3. This theoretically informed empirical study has provided two important policy implications. As prospects for economic cooperation in the region are substantially affected by security-motivated relative gains concerns, the continuation of the US military presence in East Asia is highly necessary. A further reduction of American military presence in the region tends to accelerate the regional military spending and arms rivalry, thus not only stimulating state sensitivity to relative gains but damaging the prosperity and stability in East Asia. At a time of growing regional instability which is further tested by current financial
turmoil in Southeast Asia and South Korea, there appears to be an increasing importance of US alliance to East Asia's security. In this sense, the reaffirmation of the US-Japan security relationship in 1996 has its particular significance because it has strengthened the broader political basis of the region's growth.

With the end of the Cold War, East Asia has been experiencing a substantial escalation of arms build up. According to the U.S. Arms Control and Disarmament Agency, military spending by East Asian countries totaled $165 billion in 1996; that nearly doubled the 1990 spending and equaled to 20 percent of global defense outlays. Whatever the true state affairs, concern about the future US security commitment to the region is acute enough to be one of the strongest motives for the increased arms spending (Calder 1996a, Klare 1993, Simon 1996). The apparent logic is that China may step into the power vacuum and increasingly use force in solving disputes with its neighbors, largely because of its sustained high level of economic growth, the associated rise in military expenditures, and greater assertiveness in its foreign policy. In addition, the revival of Japan's militarism is more likely to come into being without a solid US-Japan security alliance. After all, East Asian and especially the Chinese fear of a breakdown or a fundamental change in the US-Japan alliance is a historically rooted and visceral distrust of Japan.

As already discussed, Japan is acutely sensitive to any Chinese military build-up; without US military presence in the region, such sensitivity only increases, thereby leading to a spiraling armed race. Yet, what is most destructive to Asia's stability is the emergence of military competition between China and Japan. For example, deprived of US nuclear shield, Japan would develop its own nuclear weapons to stay even with China. South Korea would immediately follow suit. So might the Southeast countries and Taiwan, whose military

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budgets have been growing rapidly mainly due to the fear of the increasing assertiveness of China’s external behaviors. Pretty soon, the whole region could be nuclear and nervous. In this light, security-motivated relative gains concerns would further impede the already fragile economic cooperation in the region, and that is no doubt detrimental to the regional prosperity and stability and thus to American national interests. All in all, a continuation of US military engagement in East Asia will play a key role in “dampening regional rivalries and uncertainties rather than inciting them” (Calder 1996a, 127).

Equally significant, as most relative gains concerns in the region are deeply rooted in fundamental national interests such as territorial disputes, formidable security problems, and regional primacy, we expect no formal regionwide economic bloc in East Asia centered on Japan and/or China, like North America centered on the US and Europe centered on the EC, could be created in the foreseeable future, unless forced by, for instance, a strong move towards exclusionist trading blocs in North America and Europe. Yoichi Funabashi, a prestigious Asia scholar, has captured the essence of the issue by arguing that

[i]f Japan attempted to form an Asia bloc without China, China would take active measures to end its political and economic isolation, which would intensify the rivalry between Japan and China. If Japan cooperated with China to head jointly an Asia bloc, tensions would rise as each nation jockeyed to be the dominant partner. Other Asian nations would be frightened of the power a true Japan-China tandem would have, which would also raise tensions in the region (1996, 111).

In short, if states are still concerned that their partners will pose a military threat or their cooperative endeavors will be exploited because of strained political relations, it is obviously impossible for a formal cooperative economic arrangement to come into being.

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Unfortunately, that has been a defining feature of contemporary international relations in East Asia (e.g., Buzan 1995, Calder 1996a, Lee 1993, Simon 1996).

Therefore, when initiating cooperative arrangements in the region, the relevant countries must put a high priority in considering and solving the negative effect of the relative gains problem. As East Asia has proved slow to achieve consensus on a regional economic framework for trade and investment, the prevailing economic cooperative patterns in the region are expected to be characterized with subregionalism or natural economic territories (NETs) where cultural similarity and the private sector play the major role. The phenomenon of NETs appears particularly suited to the East Asian context, where there is a strong predilection for informal agreements rather than legalistic and binding treaties. In addition, NETs allow states to experiment with cooperating with each other, which they approach cautiously given the region’s varying levels of economic development, its different socio-political systems and its complex security and political relationships. Finally, NETs allow states to proceed along with their own paths of economic growth and development without the need to agree on overarching regional goals. Largely due to those advantages, current policies in the relevant countries tend to expand and strengthen, not dismantle, the NETs.

RELATIVE GAINS CONCERNS AND FUTURE RESEARCH

This study does not put much emphasis in distinguishing the impact of relative gains concerns on policy process and policy outcomes. However, the study would be incomplete without making a comparison between the differing impact. By so doing, we may draw an important future research agenda on the issue of international cooperation. A thorough analysis of the three cases has clearly shown that the impact of state concerns for relative
gains varies between policy process and policy outcomes. In general, the influences of such concerns are more evident in policy process than in policy outcome. That is, even if relative gains concerns are salient in the policy process and reflect a state's anxiety over either security or economic welfare or both, they may not be fully reflected in the policy outcome. This is essential because the extent to which relative gains concerns are ultimately translated into policy is shaped and constrained by many other factors, including "defensive cooperation" consideration and particularly domestic factors.

Although it would be difficult to specify which relative gains concerns are higher and which are lower, such concerns in Taiwan's case are generally regarded as the highest among the three examined cases essentially because Taiwan's physical survival is threatened by China, while the relative gains concerns in the ODA case are the lowest because Japan basically seeks to enhance its bargaining power in dealing with the growing challenges from a possibly expansionist China. Concerns for relative gains in the flying geese pattern are in the middle since China is wary of the potential damage to its long-term economic growth and political status. However, the high-level of relative gains concerns in Taiwan's policy process was not fully and unambiguously translated into actual policy outcomes, while the medium-level of relative gains concerns in the flying geese model was fully reflected in Beijing's official policy.

As a result, variations existed in the extent to which policies associated with relative gains-seeking behaviors were adopted. Such policies were adopted fully in the flying geese model, and substantially but not fully in Taiwan's case. They were only to some extent adopted in the ODA case. To account for the variation, we must recognize that when decision makers make policies, they have to balance the influences of relative gains concerns along
with other factors and particularly domestic factors. Domestic factors may shape a state’s sense of vulnerability as much as or even more than systemic factors like relative gains concerns.

In the ODA case, the optimal strategy from a relative gains perspective was to link the yen loan with China’s military spending behaviors and to replace the multiyear yen loans with an annual package, as proposed by Japan at the initial negotiation stage. Had Japan succeeded in changing the previous multiyear aid package to the annual pledge, Japan’s ODA to China would have become an avenue for the annual review of China’s expansionist behaviors such as military build-up and nuclear testing, thus greatly strengthening Japan’s political and economic influence over China. That is almost equal to the US practice to use annual China’s most-favored-nation (MFN) trading status to review such sensitive issues as human rights and weapons proliferation. Should China’s behaviors be detrimental to Japan’s national interests and regional balance of power, Japan could more easily show its economic muscles against China in the next year’s ODA negotiation. However, the actual policy outcome for the fourth ODA package was a compromise which met neither China’s demand for a five-year package, nor Japan’s request for one-year pledge; rather, it provided a three-year (1996-98) coverage totaling 580 billion yen ($5.8 billion). Moreover, Japan did not insist on any Chinese compromise in the security area but emphasized China’s environmental protection. Indeed, the first round of Japan’s fourth yen loans focuses on solving China’s environmental destruction (Nelsen 1995, 85).

Obviously, many factors combined to account for the loss in the translation from relative gains concerns in the policy process to the policy outcome. Strong opposition from the Chinese side appeared to have exerted a decisive influence over the extent to which Japan
pursued policies consistent with relative gains concerns. Immediately after Japan proposed an annual review of its ODA to China, Beijing showed a strong opposition. It was clear to Beijing that a much shorter-term of ODA arrangement would greatly enhance Tokyo’s bargaining leverage over other issues: it would become a diplomatic leverage for the annual review of China’s human rights and military spending, similar to the US practice with China’s MFN trade status. Indeed, China’s official newspaper, *The People’s Daily*, not only strongly supported the long-term loan rather than annual terms, but explicitly indicated Japan’s annual aid pledge would only be conducive to an unstable relationship between the two countries.

Moreover, issues like military spending and human rights have been persistently regarded by China as “internal affairs”; China would oppose any attempt from other countries to intervene in its “internal affairs.” Japan clearly understood that it could not push China too hard on those sensitive issues. After all, nationalistic passions in China are not subordinated to larger economic gains. Japan also clearly remembered how Beijing had directly challenged the US to cancel its MFN status when President Clinton was out to link China’s MFN trade treatment with its human rights behaviors. During and immediately after US secretary of state Warren Christopher’s visit to Beijing in March 1994, Chinese leaders publicly warned America that China was prepared to abandon all trade relations with the US unless it stopped telling China what it could not or must do in its domestic affairs. Although by so doing, China risked to lose not only several million jobs and around 30 percent of its export market, but also the whole gamut of its international objectives. Yet in the Chinese point of view, the alternative – signaling that China could be forced into concessions on principle issues – was seen as even more costly. The result was that the US had no choice, but gave in and delinked China’s MFN trading status with its human rights records.
In the same vein, if pushed too hard, Beijing might also have directly challenged Japan. This is particularly true given that there is a widespread wave of indignation against Japan in China largely because of historical reasons and that Beijing could easily trigger and exploit strong nationalism against Japan. A total collapse of the ODA deal would be most likely to hurt the Chinese side more in relative terms because China was apparently achieving disproportionate gains. However, that result was obviously not in Japan’s best interests, either. Japan would lose an important channel to maintain a stable Sino-Japanese relationship, a central objective of Japan’s foreign policy. Japanese business interests in China would also suffer a hard blow because for many years Japanese government loans had been an effective way to enhance Japan’s competitive economic position in China. That competitive advantage would be ever more important given that Japan’s investment in China sharply rose beginning in the 1990s, in an attempt to compete for a larger share of the booming China market.

Regarding the emphasis on environmental issues, Japan obviously got Chinese concessions. Beijing had argued that it was not practical for China to abide by high environmental protection standards because it had not yet reached that economic stage. However, Japanese request was basically acceptable because China began to pay more attention to solving the pollution problem – the side-effects of China’s rapid economic growth. Furthermore, the politicians of the ruling LDP (Liberal Democratic Party) in Japan had been the firm supporters of the long-term arrangement for yen loans to China mainly for the consideration of maintaining a stable bilateral relationship and enhancing Japanese business interests in China. With the domestic chaos in the Japanese politics in the earlier 1990s, the influences of politicians significantly declined, but their supporting efforts could not be ignored by Tokyo. Mainly due to those reasons, relative gains concerns in the ODA
case, generated by international structural changes, were only partially reflected in the actual policy outcomes.

While relative gains concerns were only to some extent adopted in the ODA case, such concerns were fully adopted in the flying geese case in that they were well reflected in that Beijing formally rejected the otherwise mutually beneficial economic arrangement dominated by Japan. The optimal strategy from a relative gains perspective (though not necessarily from that of overall Chinese interests at least in the short-term) was to abandon it. Given the disparity in the two sides' technological capabilities and financial status, the problem was not the terms of the flying geese pattern, but the pattern itself. In essence, the flying geese model of economic development would put Japan at the head and China at the third and lowest tier of the regional integration. That would largely insure that Japan would stay in the lead indefinitely and China would never assume the leadership position within the regional hierarchical economic order. However, China's interests would be best served by co-leadership of the pattern and least by functioning as the "follower goose." Given China's technological capabilities and financial strength, being co-leadership with Japan in the flying geese pattern is obviously impossible. In this context, China has to abandon the overall cooperative pattern in order to serve its best national interests.

The reason that relative gains concerns were fully reflected in the policy outcome at the central government level was essentially because Beijing was still an authoritarian regime (Lieberthal 1995). Indeed, economic reforms and opening to the world have to a large extent reduced the central government's power. However, as the mainstream China scholars have argued repeatedly, in the area of foreign policy making such as deciding over whether to participate in the regional economic cooperation, Beijing still maintains an unchallenged
power and ultimate authority (e.g., Harding 1994b, Lieberthal 1995, Lieberthal and Oksenberg 1988, Shambaugh 1994, 1996b). Therefore, as it perceived the flying geese pattern dominated by Japan would be most likely to damage its long-term economic development and possibly its international political status, Beijing could easily show its political monopoly to defy any other dissident arguments and formally rejected it.

In this light, even if local governments and private sectors and particularly those of coastal provinces have strong interests in participating in the regional economic integration dominated by Japan, they do not dare to challenge Beijing’s final “judgement” publicly. Moreover, thanks to various historical reasons, there is a strong popular resentment of the Japanese in China, so local economies can not openly argue for the Japanese-style model. If they did, they could be easily accused for accepting a subordinate role to Japan just for economic benefits. That is particularly possible given that China has a strong aspiration for being Asia’s dominate power and that aspiration is further strengthened by its dynamic economic growth during the past two decades (see Chapter 5). As a result, although a large proportion of China’s local economies are engaged in the de facto economic development characterized with the vertical division of labor, their participation is only private and unofficial and often under different names, rather than through formal and official binding treaties.

In Taiwan’s case, the best policy outcomes based on the relative gains concerns alone would be to manage and channel Taiwan’s investment and trade with China to its own best possible advantages, both politically and economically. However, in reality, Taipei had been gradually and cautiously relaxing its restrictions on the bilateral economic relations; government-approved investment in China was on the rise year by year. To some extent, such
policy outcomes passively responded to Beijing's appeal for full-scale economic exchanges. Why high hurdles of relative gains concerns could only be substantially but not fully translated into actual policy outcomes in Taiwan's case? This is essentially because interested firms which have enormous business stake in the booming Chinese economy have played a key role in shaping ways in which Taipei authorities could pursue policies consistent with relative gains concerns.

Taipei authorities have tried to curb investment on the mainland and repeatedly spoken on the danger of too much reliance on China's market because development of economic dependency on China would compromise its pursuit of a legitimate and autonomous international role. However, official Taiwanese efforts to reverse the trend could hardly match the result. After all, business are profit-driven; the China market seemed to be a natural choice especially for those small and medium-sized firms engaging in labor-intensive industries. Those firms sought profits offered by the mainland's low production costs and huge consumer market, and appeared to trade and invest there almost regardless of their own governments' policies (Tseng 1994, 34-5; Yun 1994, 17-9). Taiwanese businesses also capitalized on Taiwan's historical, cultural and linguistic linages with Mainland China and especially with Fujian province across the Taiwan Strait to pursue the highest possible benefits from the huge market potential. Given the existing and growing degree of economic integration, the political and economic costs of halting or even slowing trade, investment and labor flows were simply too high for Taiwanese leadership to bear. As a result, although continuing to ban direct economic relations with China, Taipei has incrementally expanded the cross-strait economic exchanges.

Therefore, Taipei's relaxation of the economic interactions with Mainland China was
mainly reactive to enormous domestic pressure. In so doing, Taiwanese officials were obviously reacting to domestic pressures to further liberalize trade and investment in Mainland China, while being constrained from doing so by security concerns. The loose grip of Taipei authorities will be weakened further as companies expand their Chinese operations. This is because once they make money, firms can reinvest their profits in expansion without Taipei's approval. Therefore, as Taiwanese companies continue integrating into China's economy, the pressure to establish more economic links with the mainland will only mount. In short, such enormous domestic pressures have decisively shaped and constrained Taipei from exploring a full range of policy options pursuant to impeding the relative economic asymmetries that may be more advantageous to China. Equally important, domestic pressures will continue to push Taipei to expand economic exchanges with China. As Harry Harding, a prominent China scholar (1993, 1994a) convincingly argues, political powers in Taiwan may slow or speed up the economic cooperation with the mainland, but can no longer reverse these trends; the long-term, cumulative effects of such trends will be formidable.

Furthermore, the specific policies associated with relative gains concerns will vary, depending on the particular concern that is motivating policymakers. As Taipei feared that much economic dependence on China, although mutually beneficial in absolute gains, would lead to political dangers, it has been striving for reversing the trend by desperately restricting Taiwan's high-value added investment in China and steering business away from the mainland to Southeast Asia. Similarly, as China's concern was that the flying geese pattern would provide Japan with a significant source of international competitive advantage and political leverage over China, Beijing sought to disrupt the Japanese efforts by advocating other forms of economic cooperation and did not allow its key industries to participate in the regional
economic integration characterized with the vertical division of labor. In the post-Cold War era, as Japan was more and more concerned with China’s possible expansionist behaviors that might hurt Japan’s national interests and regional balance of power, in renegotiating its ODA to China, Japan sought to strengthen its relative achievements of capabilities with the purpose of increasing its bargaining leverage over other issues.

Therefore, a careful analysis of those three cases has indicated that while the impact of relative gains concerns was felt in the actual policy outcomes, it was not felt completely; such concerns were partially lost in the translation from international system to policy outcomes. That is, high level of relative gains concerns in the policy process was not necessarily and automatically transformed into policy outcomes; such concerns were forced to compete for attention in the relevant countries’ policymaking process with other factors such as the enormous domestic pressures, fundamental goals of a country’s foreign policy, partner’s reactions, and domestic power structure, etc. As a result, the extent to which relative gains concerns could be reflected in the actual policy outcomes was largely shaped and constrained by those competing factors. In this light, we might well conclude that both international and domestic political factors together help explain why relative gains concerns, usually more evident in the policy process, may not be fully demonstrated in the policy outcome.

In short, the evidence strongly implies that, in fully constructing explanations of relative-gains-seeking behaviors particularly in the policy outcome, we need to move from the international level to the domestic level of analysis and to be attentive to both international and domestic structures as well as the relationship between the two. Along this line, further analytical and empirical investigation of the importance of political risk and cumulative effects
as factors affecting state concerns about gaps in payoffs and thus the severity of the relative gains problem for cooperation is very likely to produce extremely fruitful and insightful results. Indeed, some of the most successful works in understanding international cooperation have come from the mixture of domestic-level and international-level analysis (e.g., Putnam 1988). As pointed out earlier, a serious weakness of relative gains approach is the neglect of domestic political and economic factors. This is essentially because the approach focuses on the international system, and its deductive logic is based upon the assumption of anarchy of international relations. However, in the absence of a domestic-level analysis, relative gains approach may only show a theoretical power for framing and accounting for the phenomena of obstacles as states consider opportunities to cooperate, but can not accurately explain why even high hurdles of relative gains concerns can not be fully reflected in actual policy outcomes.

The main findings of this study are highlighted in Table 6.1. In this table, we have summarized the key conditions that have fostered significant relative gains concerns, relative gains-seeking-behaviors, and the optimal strategies based upon relative gains concerns alone. This table has also clearly shown that relative gains concerns are more evident in the policy process than in the policy outcome. Finally, we have listed the major factors that have shaped relative gains concerns from being fully reflected into policy outcomes.
Table 6.1 Conditions, Relative Gains Concerns (RGCs) and Consequences

<table>
<thead>
<tr>
<th>Cases</th>
<th>Conditions that foster RGCs</th>
<th>RGCs &amp; relative gains behaviors</th>
<th>Optimal strategy based on RGCs</th>
<th>Actual policy outcome</th>
<th>RGCs in policy</th>
<th>Factors shaping RGCs in policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Taiwan case</td>
<td>Zero-sum political relations; physical survival; dangers of economic dependence.</td>
<td>Extremely high. Constantly restricting economic exchanges, shifting business emphasis to other regions, and preventing high-value added investment in China.</td>
<td>Channeling bilateral economic exchanges to Taipei's best interests, politically and economically; avoiding economic dependence.</td>
<td>Restricting economic interactions; banning direct exchanges. Yet, gradually relaxing economic relations; cautiously responding to China's appeal for full economic exchanges.</td>
<td>Not fully, but substantially and clearly reflected in policy outcome.</td>
<td>Huge economic stakes; enormous pressure from business communities; &quot;defensive cooperation&quot;; cultural, linguistic and geo-economic linkages.</td>
</tr>
<tr>
<td>The ODA case</td>
<td>Emergence of non-status quo China; Japan's record to use ODA to serve its national security.</td>
<td>Not high. Sought a shorter-term ODA program and its linkage with other issues.</td>
<td>Replacing ODA with annual pledge to increase its bargaining power; linking ODA with China's military spending, etc.</td>
<td>Reduced previous five-year ODA to three-year pledge; emphasized China's environmental issues.</td>
<td>Moderately, but clearly manifested in policy outcome.</td>
<td>China's intense opposition; some domestic pressure for longer-term loans; Japan's overall China policy.</td>
</tr>
<tr>
<td>The flying geese model</td>
<td>Competitive disadvantage; structural trade deficit; strong political implications.</td>
<td>Not very high. Not mentioning the model; sought other cooperative types or co-leadership with Japan in regional cooperation.</td>
<td>Rejecting the pattern to prevent potent damage to China's long-term economic growth and possibly political status.</td>
<td>Officially rejected the model, but local economies still participating in the de facto regional cooperation largely led by Japan.</td>
<td>Fully shown in central government policy, but not in actual policy at the local level.</td>
<td>Beijing's political monopoly; weak domestic pressure; &quot;defensive cooperation&quot;; absolute gains.</td>
</tr>
</tbody>
</table>

Source: Designed by the author.
1. Clear signs have shown that in terms of trade and investment volume, Taiwan's economic dependence on China has come into being. As discussed in Chapter 3, by 1995 more than 25 percent of Taiwan's exports actually went to China and its mainland investment occupied about 35 percent of its total; the trend has been accelerating. That is why the island's economy was under siege (e.g., Taipei Stock Exchange index was off more than 15%) when China fired missiles to intimidate Taipei's independent behaviors during Taiwan's presidential election in March 1996.


8. As strongly implied in the above discussion, high hurdles of relative gains concerns have actually accounted for why East Asia lacks official mechanisms for regional economic cooperation such as the EC in Europe, NAFTA in North America, and Mercusor in South America. In addition, some of the relevant statistics in Chapter 5 indicates that East Asia is far from reaching the status of a formal economic bloc as some people are worried about (see also Frankel 1996).

9. The term natural economic territories (NETs) was coined by Robert Scalapino (1991). It applies to natural economic complementarities that cross political boundaries. "Natural" does not imply lack of government involvement but can include government action that removes barriers to realize pre-existing complementarities; the private sector plays the major role. So far, nine de facto or nascent NETs have emerged in East Asia, at various stages of development and with differing degrees of public- and private-sector involvement. Southern China NET, which mainly includes Hong Kong, Taiwan and Guangdong and Fujian provinces of China, is the most mature and distinct. Further definition and analyses of the issue, see Jordan and Khanna (1995), Khanna (1995), Myo and Tang (1993), Scalapino (1995), Yue (1993), and Yue and Lee (1993).

11. Based on its unique significance to China's economy and favorable terms of payments, Japan's ODA has certainly brought disproportionate gains to China. If Japan were to stop the yen loan, China would suffer greater losses in relative terms. However, that might lead to disastrous consequences to the overall bilateral relationship and regional stability. If that happened, Japan would be a big loser, too. This is simply because the large scale ODA program has become a crucial part of Sino-Japanese extensive economic cooperation and significantly influenced the bilateral relations. Furthermore, as already discussed, the optimal strategy from the relative gains perspective does not necessarily abandon the cooperation itself, but enhances a state's relative achievements of capabilities in the deal or over other issues.

As the increasing sensitivity of Japan to relative gains in its ODA to China is not very high and a central objective of Japan's China policy aims at a stable bilateral relationship, Tokyo would not think about stopping its ODA to China. Indeed, during this research, we have not found any credible evidence that Japan had considered that policy alternative. Finally, please recall that facing China's new round of underground nuclear tests in May and August of 1995, Japan reduced its aid to China from 7.8 billion yen to about 0.5 billion yen. Such symbolic reduction was sharply criticized by Chinese premier, Li Peng, as "economic blackmail." Should Japan stop its huge yen loan to China (about 200 billion yen annually), that would almost be equal to treat China as an enemy. As Joseph Nye (1995) smartly concludes, if you treat China as an enemy, China would be an enemy. In this light, it is impossible for Tokyo to behave foolishly enough to stop the mutually beneficial ODA and look for diplomatic disasters. That is contradictory to the cautious feature of Japan's foreign policy particularly in dealing with China.

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