

Commerce between rivals: realism, liberalism, and credible communication across the Taiwan Strait

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Abstract

China has become Taiwan's most important export and investment destination. This phenomenon is puzzling to realism as concerns for security externalities should discourage commerce between adversaries. Liberalism also has difficulty in accounting for this phenomenon because an absence of facilitative institutions should discourage commerce across the Taiwan Strait. This paper applies recent theoretical development on credible communication to this seemingly baffling situation. Whereas it has been suggested that commercial ties enable states to signal resolve short of military demonstration, I argue that these ties can also be used to credibly communicate reassurance and commitment to peaceful cooperation.

1 Introduction

Despite continued political impasse and even occasional military tension, Taiwan's exports to and investment in China have thrived in

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recent years. China has overtaken the United States and Japan as Taiwan's most important trade partner, and it has received more capital from Taiwan's investment outflow than the rest of the world combined.

Mounting cross-strait commerce predated the March 2008 election of a Kuomintang (KMT, or the Nationalist Party) government, which replaced the Democratic Progressive Party (DPP) with its professed goal of fostering Taiwan's independence. The latter government under President Chen Shui-bian had sought to limit the island's trade with and investment in China. In reaction, its businesspeople tried to escape official scrutiny, often by resorting to intermediaries located in Hong Kong and elsewhere. This situation has caused some uncertainty about the precise amount of trade and investment undertaken by Taiwan's firms even though there is little doubt about the general magnitude and trend of cross-strait commerce (Cheng, 2005; Kahler and Kastner, 2006; Kastner, 2006).

Apparently relying on unofficial sources, the *Nightly Business News* reported (on July 28, 2006) that China accounted for 40% of Taiwan's exports and 70% of its foreign direct investment in 2005. According to Chinese government sources (Taiwan Greater China Fund, 2006), Taiwan's trade with China reached US\$108 billion in 2006, representing a gain of 18% over 2005. Taiwan's exports to China rose 16.6% to US\$87.1 billion and its imports from China grew 25.3% to US\$20.7 billion. Though lower than the estimates given by the *Nightly Business News* for 2005, these official figures still confirm the significance of the China market as it accounted for over 28% of Taiwan's exports in 2006. Taiwan's government reported that in 2006 it approved 1,090 investment projects in China for US\$7.6 billion, a 27% jump over 2005.¹ Reflecting the commercial boom, 1 million Taiwanese businesspeople and their family members now live and work in China (about 4.5% of the island's population).

The figures show that Taiwan's commercial ties with China are both highly salient and asymmetrically important to its economy.² Smaller

1 The amount of investment approved is not the same as the amount actually invested. Yet many Taiwan firms do not seek official approval before investing in China. Business evasion of government regulation is likely responsible for a serious underestimation of trade and investment volume. For Taiwan's official trade and investment statistics, see Council for Economic Planning and Development (various years).

2 As Brooks (2007, p. 223) noted, 'China has had great success attracting FDI [foreign direct investment] on its own, and hence has little incentive to invest in consolidating economic

economies tend to be open economies because, unlike their larger counterparts, they have a greater need to trade in order to make up for resources they lack domestically. Moreover, they face a more daunting and costly challenge to achieve self-sufficiency for the simple reason that their domestic resources and market are more limited. To the extent that heavy partner concentration and asymmetric dependence are correlated with small economic size, they have more serious political implications for Taiwan than China. This observation implies that ultimately, the opportunity costs resulting from lost trade or investment are not so much about economic size per se but rather concern the availability of alternative commercial partners to make up for the prospective shortfall and the substitution costs associated with this switch.

Were it not for their political difficulties, one would have naturally expected intense commerce between the two sides of the Taiwan Strait according to standard formulations such as the gravity model of trade and the theory of comparative advantage. Rather than relying on these formulations for benchmarks, Taiwan's commerce with China should be contrasted with the relations between other enduring rivals (e.g. North and South Korea, Syria and Israel, and Cuba and the United States). Given these dyads' political antagonism, one would expect scant commerce between them. Taiwan's burgeoning commerce with China is baffling because it has occurred despite ostensible efforts by previous administrations under the KMT and especially the DPP to slow it down and divert it. This phenomenon presents a hard case to be accounted for by realism and liberalism. Realism would not have predicted this thriving commerce given Taiwan's vulnerability to Beijing's attempt at political hold-up. Liberalism would have expected institutional uncertainties, such as those pertaining to property rights and contract enforcement, to hamper commerce. These institutional uncertainties are more palpable to businesspeople from Taiwan than those from other countries because they are considered 'compatriots' rather than 'foreigners'. They therefore face additional uncertainties due to a different set of rules and regulations being applied to them. One can intuitively grasp why China would rely on cross-Strait commerce to promote its goal of eventual political reunification, but it is more difficult to explain Taiwan's behavior. In this paper,

integration with other developing countries for this purpose'. Whereas Taiwan's investment has focused heavily on China, China has thus far not invested in Taiwan.

I address this puzzle from Taiwan's rather than China's perspective. The thrust of my argument is that civil society, especially the business community, can develop dense commercial ties abroad such that it becomes more challenging for current and future politicians to reverse these ties or roil political relations. Thus, Taiwan's ongoing and expanding commercial ties with China represent an important form of signaling and commitment to ensure cross-Strait stability.

I advance three claims in this analysis. First, both realism and liberalism are too pessimistic in their assessment of impediments that obstruct profitable commerce. Second, thriving commerce across the Taiwan Strait stems from a combination of factors, described by Caporaso (1981) as 'pull', 'push', 'facilitation,' and 'conversion', that do not belong neatly to either the traditional realist or liberal catalog. Third, one crucial, often overlooked factor in this ensemble has been the role that entrepreneurs and entrepreneurial activities have played in signaling reassurance and building confidence. This last claim takes up most of my analysis. It echoes functionalist and neo-functionalist hopes or expectations (e.g. Haas, 1958; Mitrany, 1966),³ although I formulate and elaborate my arguments in terms of strategic and credible communication emphasized by recent rationalist explanations for war (Fearon, 1995; Gartzke *et al.*, 2001). Moreover, the level of commercial activities offers an objective leading indicator of political relations and also influences these relations. This last remark is significant because it contends that commerce needs to be endogenized in explanations, so that it is not only a dependent variable but also an independent variable. In other words, the state of commercial relations is itself a reflection of current and expected future political relations. States and firms would not have entered into the former relations had they suspected that the latter relations would be put in jeopardy.

2 Realism

Commerce produces income and efficiency gains. These gains, however, have security externalities such that a potential enemy can apply them to improve its military capabilities.⁴ To the extent that the two sides stand

3 I thank one of the anonymous reviewers for calling my attention to this functionalist connection.

4 Morrow (1997) argued that a state is unlikely to allocate all its gains from trade to its military. During peacetime, states typically devote less than five percent of their national

to gain unevenly from their economic exchanges, realists expect security-minded states to eschew commerce. As emphasized by writers such as Gowa (1994) and Grieco (1988, 1990), concerns about security externalities and relative gains would especially hamper trade between states that perceive each other as potential adversaries. Given these realist expectations, one would not have expected Taiwan to enter into commercial dealings with China that involve huge, asymmetric, and long-term financial commitments that increase its economic vulnerability.

Taiwan's heavy commercial dependency is baffling to those familiar with Nazi Germany's use of trade to extend its political influence in the Balkans (Hirschman, 1945). The Balkan countries' gains in more favorable trade terms came at a cost of being eventually held up for political concessions. More recently, Papayoanou (1999) studied security interactions among countries with different levels of economic salience to each other. He concluded that high economic salience tends to undermine a state's credibility to deter and resist aggression. Extensive and interlocking commercial interests between a potential aggressor and a potential defender have the effect of making the former less inclined to take the latter's deterrence threat seriously, as well as of increasing the latter's political difficulty to actually mobilize domestic support to resist aggression. Still other analysts have studied how states had tried to influence their commercial partners' domestic politics, such as the policies of economic engagement of Britain and France aimed at various interest groups inside Germany, Japan, and Russia prior to World War I (Papayoanou and Kastner; 2000; Lobell, 2007). In contrast to these subtle applications of economic statecraft, Beijing has been transparent and consistent in advancing its sovereignty claim over Taiwan.⁵ If so,

product to defense spending. Therefore, the security externalities of trade have a relatively insignificant effect on military balance, especially in the short term. By increasing its own defense spending even modestly, a state can easily neutralize its counterpart's greater return from trade. To anticipate the following discussion, the flip side of concerns for security externalities is the hope and expectation that increasing communication and exchanges would build confidence and promote cooperation over time. Besides the functionalist and neo-functionalist literature, studies on the formation of security communities are pertinent (e.g. Deutsch *et al.*, 1957).

- 5 Therefore, one does not face the question whether Beijing has been trying to surreptitiously 'set up' Taiwan commercially in order to extract political concessions subsequently. This was the logic behind Hirschman's (1945) analysis of Germany's attempt to use foreign trade to extend its political influence. Hirschman's reasoning would require an asymmetry of information – the assumption that the potential victim is unaware of an attempt at

how can one explain the close and rising commercial ties across the Taiwan Strait? Surely, public officials and private businesspeople in Taiwan are aware of the security externalities of these commercial ties. They can also be assumed to be strategic – that is, their past and ongoing decisions to trade with and invest in China would have presumably tried to anticipate and thus take into account the economic ramifications of different political contingencies.⁶

Even belligerents in the midst of war have traded with each other (Barbieri and Levy, 1999; Levy and Barbieri, 2004). It is also true that Taiwan will incur an opportunity cost in terms of economic competitiveness if it eschews commerce with China, whereas its competitors (e.g. South Korea, the Southeast Asian countries) are able to gain a relative advantage by doing so.⁷ Therefore, concerns about relative economic gains by third parties and foregoing large, cumulative gains in the future might have inclined Taiwan to initiate commerce with China.⁸ These considerations, however, do not quite seem adequate to account for the huge size and heavy asymmetry in Taiwan's exports to and investment in China, nor the speed at which these transactions have taken off in recent years.

Realist concerns about the security externalities of commerce can be ameliorated under certain circumstances. Thus, as Liberman (1996) has noted, such concerns will have less of an effect in discouraging commerce between states that are physically distant from each other, that have not had past conflicts, that have their military defense enjoying an advantage

setting it up (Baldwin, 1985; Yarbrough and Yarbrough, 1992, p. 80). This would not be the case here as Taiwan's officials and businesspeople understand China's agenda all too well.

6 International dispute should not cause trade to fall if its effects have been expected *ex ante* (Li and Sacko, 2002).

7 This remark suggests that trade competition and relative economic gain are not just bilateral matters. There is also another aspect to this comment. Taiwan's businesspeople may hope that China would be self-deterred from taking hostile actions against their commercial ties in the event of a political rupture, because Beijing is sensitive to the repercussions that such actions can have on investors and traders from other countries. I am indebted to an anonymous reviewer for this reminder. The latter supposition, however, depends critically on whether foreigners perceive Taiwan to be a special case that does not lend itself to generalizing about China's overall foreign policy. Kang (2007, p. 94) has argued '... East Asian states do not use China's actions toward Taiwan as an indicator of how it would behave toward the rest of the region'.

8 People tend to act according to their anticipation of future opportunities and threats (Copeland, 1996).

over offense, that interact in a multi-polar international system, and that share similar ideological and regime orientation. These factors, however, do not characterize the relation between Taiwan and China. One can agree with the observation that security externalities should matter the least for dyads characterized by lopsided capabilities (and, conversely, concerns for these externalities should be the most salient for states that are closely matched in capabilities),⁹ but still be puzzled by Taiwan's extensive and dependent commercial ties with China. After all, Taiwan did at one time ban all commercial contact with China. Its historical reversal would require an explanation.

3 Liberalism

This explanation can be more easily provided by liberalism, which does not share realism's assumptions about the primacy of security concerns and the primacy of a unitary state in the conduct of international relations (Moravcsik, 1997; Legro and Moravcsik, 1999). Liberalism can argue that Taiwan's commercial overtures to China were led by the private sector with the state reacting to business initiatives. Given liberalism's attention to multiple, contesting social interests that seek to influence a state's policy, and its emphasis on the state's response to these interests, it seems only natural to surmise that Taiwan's democratization process empowered businesses at the expense of its formerly powerful 'developmental state' (Gold, 1986). According to this reasoning, the end of martial law, increased electoral competition, and intensified pressure brought on by accelerating economic globalization promoted opportunity as well as willingness on the part of Taiwan's enterprises to turn to China.

This reasoning is not wrong but overlooks one critical consideration emphasized in standard liberal accounts. Even when opportunities exist and even when both parties stand to gain from profitable exchange,

9 Some may argue that with respect to the cross-Strait military balance, especially in defensive capabilities, Taiwan is not currently faced with a severe disadvantage relative to China. As stressed already, however, it is the long-term security implications that concern realists. Moreover, both mass and official opinions have reached a less sanguine assessment of Taiwan's military position. Recent polls show that about sixty percent of the public believed that the island could not defend itself in a war against China, and Taiwan's defense ministry had concluded that China would have gained a military superiority by 2006 (Ross, 2006, p. 383).

commerce can still fail to occur because of an absence of facilitative institutions. Institutions are necessary to reduce information and transaction costs, provide assurances about property rights and contractual enforcement, and discourage opportunistic behavior in general (e.g. Coarse, 1937, 1960; North, 1990; Hansenclever *et al.*, 1997). Thus, for example, despite communist Hungary's economic liberalization, it failed to attract foreign direct investment before the Cold War's end because this reform lacked credible commitment (Brooks, 2007). Shifting political balance between the state and society in Taiwan and mounting pressure from global competition create opportunity and provide incentive for its businesspeople to search for markets and investment prospects abroad. This observation, however, does not explain their decision to focus so overwhelmingly on China given the impediments, even disincentives, to trade and invest stressed by liberal institutionalists (e.g. Morrow *et al.*, 1998). Why would Taiwan's businesspeople want to assume the political and economic risks involved in trading with and investing in China? It is not obvious that a comparative advantage in language, culture and geographic proximity would necessarily override concerns about corruption, legal uncertainties, and the danger of political hold-up.¹⁰ The history between North and South Korea, and East and West Germany supports this skepticism.

While realism explains why security-minded states are wary of entering into commercial relations with each other, liberalism focuses its attention on the opportunity costs of disrupting trade (or investment) after such relations have already been established. The standard liberal account argues that an aversion to the opportunity costs of lost trade (or investment) inclines both partners to eschew conflict (Russett and Oneal, 2001). It seems, however, hardly realistic to expect these opportunity costs to be distributed equally between the two sides of a commercial relation. In the absence of this condition, the side with lower opportunity costs will gain a negotiation advantage over the side facing higher opportunity costs, and the former can drive a harder bargain (such as on political issues) with the latter. This was of course the basis for Hirschman's fundamental insight about the use of trade to extend political influence. This recognition of uneven opportunity costs also undermines the liberal

10 The comparative advantage of geographic proximity has been hampered by Taiwan's ban on direct trade and until recently, direct travel (except for special holidays) with China.

belief that commerce necessarily deters conflict because opportunity costs should only matter in influencing the terms to be negotiated by the parties to settle their conflict, and not the probability of whether they will have a conflict in the first place (Gartzke *et al.*, 2001). Moreover, how much people care about the opportunity costs of lost commerce can only be answered in comparison with their valuation of other desiderata (such as national aggrandizement, regime legitimacy, political autonomy; Chan, 2006).

Liberalism expects commerce to create domestic stakeholders who would acquire a vested interest in maintaining and even expanding further economic discourse. This perspective, however, sometimes overlooks the fact that international commerce creates winners as well as losers (Rogowski, 1989). Trading with and investing in China, as in other cases of foreign commerce, has the effect of redistributing domestic income and influence. Therefore, political liberalization in Taiwan and intensification of globalization work to the advantage of some industries, sectors, and interest groups but can be threatening and detrimental to others. Farmers, manufacturing labor, domestically oriented businesses, and the military would be candidates in the latter category in Taiwan's political economy. Can they not be expected to counter-mobilize to oppose economic overtures to China? Why has the state not done more to support these groups, such as rice and fruit farmers and workers employed in the apparel and footwear industries, against commercial competition from China? It seems evident that the Taiwan state has been more receptive to the interests of export and investment capital than those of the employers and employees of firms with a domestic orientation.

4 Synergism

Thriving commerce across the Taiwan Strait suggests that both realists and liberals are overly pessimistic about the probability of economic exchanges occurring. Realists appear to have assigned too much weight to security externalities, and despite their assertion that the pursuit of military security will always trump the benefits of economic interdependence (e.g. Ross, 2006), trade and investment can occur between political rivals and even military adversaries in the midst of a war. Liberals also appear to be too gloomy about the prospects of commerce in the

absence of robust institutions and in the face of substantial information and transaction costs. After all, commerce across the Taiwan Strait has taken off even in the face of considerable uncertainties about banking agreements, dispute resolution mechanisms, and obstacles thrown by the government ban on direct travel and restrictions on trade and investment. The enormous amount of commerce occurring across the Taiwan Strait offers strong contrary evidence, suggesting that the standard concerns of realists and liberals (such as those regarding security externalities and institutional uncertainties) may be overstated.

Rather than relying on any monocausal explanation, deepening economic relations between Taiwan and China can be traced to a confluence of factors. Political liberalization in Taiwan, China's turn to economic reform and international openness, Taiwan's shifting comparative advantage, the pressures of global competition and, of course, the natural complementarities between the two sides due to history, culture, physical proximity, and factor endowments are all indispensable parts of an overall explanation. A particularly salient aspect of this explanation is the role played by Taiwan's societal and economic interest groups that led the way to establishing and later expanding commercial ties with China, often against the state's injunctions and obstructions. Facing the decline of labor-intensive manufacturing and waning shares in the US market, Taiwan's entrepreneurs turned increasingly to China. These push factors were complemented by pull factors from China, including its incentive packages for attracting Taiwan's investors. Cultural and physical proximity and family ties offered facilitative conditions, whereas the development of physical infrastructure, provision of low-cost and abundant labor, and expansion of a consumer market in China added reinforcing 'conversion' factors. This collection of considerations was able to override concerns presented in standard realist and liberal accounts that are supposed to hamper economic exchanges.

Once these exchanges start to take off, they gain momentum and develop stakeholders who have an interest in sustaining and further expanding them. Significantly, these exchanges become a form of investment in the stability of cross-Strait relations, a leading indicator of the future state of these relations, and even an insurance against political rupture. They disclose officials' true intentions and preferences, reducing the noises introduced by their domestic partisan competition. As expanding commercial exchanges signal reassurance and build confidence, they

contribute to further expansion, thus causing a positive feedback loop. I turn to the issue of credible communication which, unlike the other factors mentioned above, has not been accorded sufficient attention in explanations of the booming cross-Strait commerce.

5 Credible communication

Officials are interested in the wealth-enhancing effects of international commerce but are wary of the possible political and security vulnerabilities produced by it. Businesspeople pursue profit but are wary of jeopardizing their capital. Both have to balance prospective rewards with risks. I argue that the market is efficient in pricing these variables, incorporating all of the business community's hopes and fears.¹¹ Market transactions reflect current and expected future cross-Strait relations, and signal the intentions and preferences of both private and public actors.

Rationalist theory postulates that wars happen because the belligerents could not reach a settlement to avoid conflict (e.g. Fearon, 1995; Gartzke, 1999; Wagner, 2000). The parties' private information about their intentions and preferences hinders a negotiated settlement of their dispute. The nature of private information is such that the parties are wary of disclosing it. Public statements by states, however, are not credible because officials often engage in deliberate misrepresentation (such as by exaggerating their resolve and disguising their preferences). Moreover, officials are well aware that their counterparts may renege on promises. In the absence of a credible guarantee that an agreement reached today will actually be honored in the future, they are wary of trusting their counterparts. Thus, private information, misrepresentation, and the commitment problem hamper efforts to avoid war.

Costly and risky actions persuade foreign skeptics to take one's professed intentions and preferences more seriously. Such actions distinguish those who are committed to their announced position from others who are just bluffing. When officials avoid costs and risks, their declarations are likely to be dismissed as 'hot air' or 'cheap talk'. The preparation, deployment, and actual use of military forces have often been used by officials to communicate their high resolve and firm policy commitment.

11 This remark does not imply that the market is infallible, only that it reflects the state of collective knowledge at any given time.

With the onset of globalization, they now have available another way to signal their intentions and reveal their preferences. They can demonstrate the priority being given to their political and security objectives by showing a willingness to suffer a stock market panic, massive capital flight, or severe recession (Gartzke and Li, 2003a, b). Less resolved and committed officials would be reluctant to pay serious economic costs. Such costs would offer especially credible evidence of resolve and commitment if they result from the actions taken by third parties (such as investors and entrepreneurs) not subject to the officials' control.

The private sector, however, does not just react to political events. It can communicate credible signals in its own right to alleviate concerns about the commitment problem. This problem stems from the difficulty states have to reassure each other about their intention to continue cooperation despite future changes affecting their relations. The commitment problem also applies to domestic competition such as when political rivals face the prospect of power shifts caused by internal or external developments (Walter, 1997; Powell, 2006). Taiwan's cross-Strait commerce is consequential not only for its relation with China, but also for its domestic alignment of political and economic interests.

5.1 Interstate signals

In studying signaling behavior, scholars have attended to states' communication of their deterrence threat. Their focus has been on how states can disclose intentions and demonstrate resolve in a foreign crisis. Extending recent scholarship (Gartzke, 2003; Morrow, 2003; Reed, 2003; Stein, 2003), I argue that thriving cross-Strait commerce signals reassurance in the face of noises introduced by domestic partisan politics and given the severity of commitment problem. Whether Taiwan decides to pursue or reject commerce with China, either course implies enormous opportunity costs. It faces a trade-off between economic growth and political autonomy. Rising cross-Strait commerce implies that Taiwan's previous DPP administration is more likely an 'economics first' than a 'politics first' type (Benson and Niou, 2007). In view of this rising commerce, the DPP's pro-independence statements are likely to be construed as cheap talk intended for domestic consumption and partisan mobilization. Notwithstanding these statements, rising cross-Strait commerce signals a costly commitment to refrain from destabilizing future relations.

To elaborate, leaders can choose to pursue those policies that promote national security or domestic popularity but have the concomitant effect of alarming the market and undermining economic performance, or other policies that stabilize the market and enhance economic welfare but necessitate the easing of international tension and partisan bidding in domestic politics (Gartzke and Li, 2003a). Gartzke and Li (2003b, p. 131) remarked, ‘the interdependence of state and market makes leaders’ talk costly and hence, more credible. Leaders engaged in political competition must choose between making competitive political claims and appeasing market concerns about stability and profitability’. This trade-off is especially acute for Taiwan in its relation with China and given its small, open economy faced with intense pressure from globalization. Taiwan’s leaders (like others who live in a world of mobile capital, flexible production, and hypersensitive currency and bond markets) cannot effectively and credibly communicate with China’s leaders without also disclosing this communication to the private sector. When Taipei talks to Beijing, businesspeople in Taiwan and abroad are also listening. A demonstration of political resolve toward China cannot but have the effect of unsettling the market and alienating investors. This *ex ante* cost imposed by the market presents a disincentive for leaders who would otherwise misrepresent their intention to seek the island’s independence even at the risk of fighting China. By making this misrepresentation more costly, market forces incline officials to reveal their true preferences and intentions. Outsiders can therefore infer whether Taiwan’s officials are fully committed to their political objectives and willing to run the risk of challenging Beijing by watching the extent to which these politicians initiate costly actions that antagonize investors and hurt the island’s economic welfare. The expected reactions of the domestic and international market is ‘bound to carry the most credibility with observers’ because all that is required is for these third parties to follow their own egoist incentives in responding strategically to the political information made available by officials (Gartzke and Li, 2003a, p. 567). The actions of the business community are more credible because unlike government officials, entrepreneurs are unlikely to sacrifice profit for the sake of political posturing or ‘cheap talk’. Naturally, when leaders avoid serious actions that upset investors or moderate their intervention against market forces, their self-restraint is also informative.

Absent scholars' ability to access officials' private information, the collective judgment of investors and traders offers an unbiased and timely indication of current and expected future market and political conditions. When officials interfere with market forces for political reasons, they signal their willingness to sacrifice economic performance for security reasons. By their action, or inaction, leaders disclose their true valuation of political objectives relative to economic objectives. To the extent that leaders are willing to jeopardize one set of objectives over the other, outside observers can be more informed about the sincerity of their declared intentions and the intensity of their announced preferences. The credibility of this information is the greatest when an action (or inaction) is evidently costly to the relevant leaders.¹² This causal attribution contends that when leaders decide policies, they can reasonably anticipate the market's reaction to their decision. When they knowingly engage in or repeat behavior that has market consequences, these market consequences reveal their motivation.

The DPP administration in power during 2000–08 was widely seen to favor the island's independence (Rigger, 2001). Like other politicians, however, the DPP officials had to balance their political appeal to core constituencies and their concern for Taiwan's macro-economic performance. They therefore faced a trade-off between policies that would antagonize China, and those that would accept expanding commerce with China for the benefit of Taiwan's economy. Although it has openly disavowed the DPP's more confrontational approach to dealing with China, the recently elected KMT government faces a similar choice between political compromise and economic sacrifice. How can Beijing, and other outside observers, discern whether Taipei cares more about political gratification or economic gratification?

As mentioned earlier, Papayouanou (1999) showed that extensive economic ties undermine a state's deterrence threat against its commercial partner. The credibility of this threat is weakened by both the perceived opportunity costs of rupturing these ties and by the prospective difficulties to be faced by officials when trying to mobilize a domestic coalition

12 Thus, for instance, when officials support economic sanction by imposing an export ban against a target country, they are likely to be serious because this self-denial carries tangible economic costs for their constituents who are exporters. Conversely, if a sanction takes the form of banning imports from a target country, it is less likely to be taken seriously and may even be perceived as protectionism wrapped in a popular political cause.

to implement this threat.¹³ For Taiwan, cross-Strait commerce has also created ‘hostages’ that represent collaterals subject to forfeiture should bilateral relations rupture (Yarbrough and Yarbrough, 1992). Fixed assets located on the mainland offer an obvious example. Furthermore, capital equipment and distribution networks designed specifically to meet the production or marketing requirements on the mainland would have little alternative use, and would thus present a non-salvageable loss in case of commercial suspension.¹⁴ Production capacity intended for consumption abroad (whether the actual production takes place in the home or host country does not matter) would be left idle if the intended foreign market becomes closed. Joint ventures and strategic incorporation of one’s firms in cross-border production chains offer still another illustration of ‘hostage taking’, or ‘hostage giving’, as both partners would be hurt if their integrated production is disrupted.¹⁵ Projects involving large sunk costs and an extended time horizon for profitability are especially significant because they imply confidence in stable economic and political relations. Conversely, footloose industries with low capitalization and outdated technology can be easily relocated to other countries, and therefore do not imply the same level of commitment to and confidence in the host country. Naturally, heavy and asymmetric dependence on a foreign market signals expectation of and preferences for maintaining stable relations since there will be severe economic dislocation should access to this market be denied. One can reasonably infer this motivation of businesspeople and, in the absence of their decisive intervention to counter such commercial trends, the officials’ intentions as well.

13 Therefore, officials who fail to act now to curtail commerce are not likely to be credible in their professed determination to stop it later when conflict escalates to a more serious stage. Their current inaction reflects poorly on their future resolve because their actions would be more costly and difficult down the road. The point is that highly resolved officials would rather act sooner so that they would not have to pay a higher price later. Indeed, upon learning that its target is highly resolved to resist its demands, a powerful state sometimes pulls back from military confrontation with a weaker opponent. See the discussion on Prussia’s encounter with Switzerland in 1856 in Bueno de Mesquita *et al.* (1997).

14 Yarbrough and Yarbrough (1992) cited the example of Japanese investment in automobile manufacturing designed to meet U.S. safety and pollution standards.

15 Attempts at hold-up can come from either other firms or governments. Intrafirm trade has been widely used to overcome the risk of being held up by other firms. I focus here on the danger of being held up by a government for political rather than economic gain.

How can Taipei establish a reputation to deter Beijing? How can it commit to resist Beijing's demands (Fearon, 1997; Powell, 2006)? Previous administrations under both the DPP and the KMT had tried to slow down and divert Taiwan's commerce with China. Despite their ostensible efforts, this commerce has continued to expand at a rapid pace and in the lopsided manner already noted. Why had the DPP administration particularly not done more to arrest or even reverse the ongoing trends given the enormous economic and political opportunity costs? It appears that Chen Shui-bian's administration was not willing to pay a heavy political and economic price for interfering with market forces and opposing the island's internationally oriented capital with a vested stake in promoting cross-Strait commerce. According to the rationale presented here, cheap political talk intended for the DPP's domestic supporters coexisted with reassuring signals to China stemming from growing commercial ties. A threat by the DPP to pursue *de jure* independence would have been more credible had it acted resolutely against cross-Strait commerce. A more resolved DPP would have wanted to show that it was willing to jeopardize the island's economy in order to pursue its political agenda. While it is understandable that the DPP officials would like to gain on both the political and economic dimensions, a highly resolved party determined to seek Taiwan's independence from China would have wanted to send a strong and unambiguous message to Beijing that it would give priority to this political objective. It would not have subordinated its long-term political goal of independence by pursuing current economic gains, thus undermining Beijing's perception of its resolve and altering the domestic distribution of interests and influence to the detriment of its announced political goal. It is of course true that severing cross-Strait commerce would have devastating consequences for Taiwan's economy, but these consequences would not likely be any less severe if a DPP administration were to openly declare *de jure* independence and they would become more severe with the passage of time. A reluctance to pay current costs undermines perceived commitment to pay future costs. Compared with its DPP predecessor, the KMT administration under Ma Ying-jeou appears even more to be the 'economics first' rather than 'politics first' type.

As Taiwan's trade with and investment in China increase in financial scale, multiply in number, and become more integrated into production chains and supply and distribution networks across the Taiwan Strait, they have the practical effect of forging a larger, common economic

zone. These commercial ties take on features characteristic of dedicated assets described above. Production aimed at export to a foreign market requires specialization based on comparative advantage and seeks to capture economies of scale. More is produced than the domestic market can absorb. The resulting surplus production capacity becomes vulnerable to opportunistic behavior by one's partner. The adverse behavior in question does not have to take the form of outright expropriation or market closure. The other side can impose requirements for domestic content, safety and pollution standards, alleged dumping violations, and countervailing duties in order to extract commercial or political concessions. Some of these adverse actions are well known to Canadians when they find themselves in trade disputes with the United States. Taiwan's commercial ties with China share a basic structural similarity with Canada's relation with the United States. In addition to their asymmetric size relative to their largest commercial partner,¹⁶ a much larger portion of Taiwan's and of Canada's economy is dedicated toward China and the United States, respectively, than vice versa.

This discussion modifies the liberal claim that the opportunity costs of lost commerce incline states to be more peaceful. It argues rather that the decision to undertake trade or investment needs to be endogenized. States, and firms, that expect peaceful relations select themselves into intense commercial relations in the first place. Moreover, intense commercial relations provide a credible signal about peaceful intentions and an aversion to destabilize ongoing relations. Naturally, intense commercial relations do not materialize overnight. The accumulation of vested interests in these relations, however, has an effect separate from that of signaling peaceful intention. Economic exchanges create stakeholders who are motivated to pursue further cooperation (e.g. Long, 1996). It makes any subsequent attempt by the state to mobilize support against its commercial partner more difficult to organize (Papayoanou, 1999, p. 18). In short, a potential political reversal becomes less likely as commerce gathers momentum. Therefore, interstate commerce can have both screening and constraining effects on states' peaceful relations.

¹⁶ Small size does not necessarily imply a disadvantage in playing the game of hold-up. Yarbrough and Yarbrough (1992, p. 26) cited the confrontation between General Motors and its supplier Fisher Body that ended with the former succumbing to the latter's pressure.

5.2 *Signals from domestic interests*

When Taiwan started its commercial dealings with China, its actions had the effect of enlarging its trade area. This enlargement increased its factor mobility, especially its capital mobility. Capital being more mobile than labor, this development has had the practical effect of increasing the bargaining power of owners of capital over workers. One reaches the same conclusion by way of the Stolper–Samuelson theorem. Cross-Strait trade increases the real returns of the owners of the more abundant factor of production, and decreases the real returns of the owners of the scarcer factor of production. Taiwan's workers have to compete with China's larger pool of labor, exercising a downward pressure on their wages. Furthermore, since land is a scarcer production factor in Taiwan, those whose incomes are tied to it (such as the rice and fruit farmers) have suffered a relative decline in their real returns.

Hiscox (2001) has shown that when inter-industry factor mobility is high, class coalitions are likely to develop and domestic political conflict tends to follow the broad cleavages between capital and labor. Conversely, when production factors are tied to specific industries (that is, when factor mobility is low), domestic struggles tend to be waged between narrow industry-based coalitions. These observations about domestic factor mobility can be generalized to cross-Strait commercial dealings with the obvious implication that the island's financial flows to China have had the effect of abetting and sharpening class cleavages on the island. At least compared with the days of martial rule before Taiwan's democratization, there has been a sharp rise in the incidence of farmers' protest, labor unrest, and widening income gap between the rich and poor. With the onset of competitive and expensive electoral races, campaigns for executive and legislative offices have become more dependent on and dominated by big money, with many wealthy businesspeople assuming legislative seats and taking up the role of powerful lobbyists seeking favorable government treatment. Being strong advocates of further commercial liberalization with China, the interests of large, internationally oriented firms have gained new influence in Taiwan's political process.

The process of globalization increases the importance of capital assets and financial flows relative to merchandise trade and, moreover, the salience of currency exchange rates compared with interest rates in a country's macro-economic circumstances. These changes led Frieden (1991) to

deduce increasing disparities in the incentives of multinational firms, financial institutions, and exporters of tradable goods on the one hand and those commercial groups with a more domestic orientation and located in the non-tradable sector on the other. The former interests would be in favor of monetary expansion and a stable (even depreciating) currency, whereas the latter interests would benefit from fiscal expansion and currency appreciation. These interests would have divergent preferences for a reliance on international coordination versus a state's political autonomy and policy discretion in managing its economy. The upshot is that while standard liberal accounts emphasize how commerce can affect the economic incentives of domestic actors, it should also be recognized that economic opening and liberalization have real effects in changing the political balance among various interest groups (Long, 1996). One can infer from a state's management of its political economy (such as with respect to its decisions on currency valuation, money supply, investment tax, import tariffs, and export subsidies) the relative influence of competing domestic groups.

Naturally, some groups have been relative winners and others have been relative losers as a result of Taiwan's expanding commercial dealings with China. Farmers, unskilled labor, and small and medium-sized firms selling non-tradable goods and services to the domestic market have seen an erosion of not only their income but also their influence. Conversely, multinational corporations and large financial institutions have gained political influence. These changes in the distribution of domestic influence correspond not surprisingly to those divergent interests pertaining to and real returns stemming from Taiwan's economic intercourse with China. Significantly, the economic winners and losers tend to follow geographic and political divisions. The so-called pan-green coalition, led by the DPP with a pro-independence orientation, is more popular among voters in the countryside and the southern parts of the island. Conversely, the pan-blue coalition (led by the KMT) is more in favor of closer cooperation with China, professing an interest in eventual reunification in the indefinite future. It enjoys stronger voter support in the urban centers in the north, even though it has also won elections in the central and eastern parts of the island. Thus, economic, geographic, and political cleavages appear to have become more overlapping recently.

The alignment of domestic interests belies the conventional view that Chen Shui-bian's administration is willing to roil cross-Strait relations in order to appease the DPP's political base. Rather, as Kastner (2007)

argued, thriving cross-Strait commerce points to the triumph of powerful economic interests with an international orientation over political resistance and security concerns. Moreover, as Leng (1996, p. 127) remarked, ‘the [Taiwan] state has been “chasing” the market mechanism instead of “governing” it. What the state has done is to partially legitimize the existing [commercial] situation rather than to act as a guide to Taiwanese businesspeople’. Significantly, those institutional impediments stressed by liberals (e.g. property rights, contract enforcement) have not deterred cross-Strait commerce. Taiwan’s entrepreneurs would not have taken on the political and market risks of doing business with China without some confidence in Beijing’s institutional reform to liberalize its economy.

As implied above, cross-Strait commerce has tended to advance the interests of the KMT’s political supporters more than those of the DPP’s traditional constituents. Moreover, ongoing trends of cross-Strait commerce are likely to shift the political balance to the further detriment of the DPP’s avowed agenda. In view of those rising domestic interests with a stake in continuing and even expanding cross-Strait commerce, it would also be more difficult for a future administration, whether under the DPP or the KMT, to mobilize support to oppose Beijing’s attempt at political hold-up.

5.3 Market signals

We do not have direct evidence on Chinese leaders’ interpretation of Taipei’s policies or on Taipei’s true preferences and intentions. The literature on ‘private information’ and ‘misrepresentation’ (e.g. Fearon, 1995) makes abundantly clear the difficulties involved in taking at face value officials’ public statements. We can, however, seek indirect evidence from market signals to corroborate the interpretations advanced here. The behavior of financial markets represents the collective judgment of all entrepreneurs and investors. There is a voluminous literature on the efficiency of financial markets (e.g. Malkiel, 1985), showing that they incorporate instantaneously and fully all information that is known and knowable. Therefore, the market prices of stocks, bonds, and currencies are ‘fair-game’ variables that adjust quickly to news about current and prospective economic performance, including political opportunities and shocks that can be expected to influence this performance. One can

accordingly judge the sincerity of political pronouncements by the market's reaction to them. When a government's actions and statements unsettle the market, one may infer that the business community is seriously concerned. An absence of market reaction suggests the opposite interpretation.

Before it lost the March 2008 election to the KMT, the DPP government had announced in June 2007 its intention to conduct a referendum on the question of whether Taiwan should apply for United Nations membership using the name 'Taiwan' rather than 'Republic of China'. This referendum was scheduled concurrently with the then upcoming presidential election. The DPP's initiative was highly controversial because it was seen by some as an attempt to move the island closer to *de jure* independence.¹⁷ Both Beijing and Washington warned the DPP against trying to unilaterally alter the political status quo. Others, however, thought that this referendum had a very low chance of being passed, and that it was a ploy to enhance the DPP's electoral prospects in the presidential race. The stock market's reaction to the news of the DPP's referendum was informative in discerning whether this initiative posed a serious political threat to destabilize cross-Strait relations or represented a campaign tactic to mobilize the DPP's political base on election day. Because businesspeople would not want to forfeit profitable opportunities if they suspect that politicians are only engaging in cheap talk, the market will not respond to insincere threats. The market's lack of reaction then 'stands as an indication to other states that the leader [making the threat] is probably bluffing' (Gartzke and Li, 2003a, p. 570).

One need not just rely on trade and investment statistics to assess the state of cross-Strait relations. Other financial indicators, such as stock prices, currency values, interest rates, and real-estate costs, provide more timely information that is less subject to distortion due to business attempts to evade official regulation. One such source of information is 'closed-end' mutual funds of Taiwan's firms with a large business exposure to China. These funds hold a diversified basket of stocks from companies doing business with or in China. Because foreigners cannot

17 Although time does not permit a full discussion, the DPP's goal of achieving political independence for Taiwan involved not so much a binary decision as a scalar motion. It undertook a series of moves that incrementally advanced this goal. The abolition of political institutions transplanted from the mainland, the changing of names of public enterprises, and the revision of textbooks exemplified these moves.

directly own shares of Chinese stocks, these funds provide an indirect way for them to participate in the Chinese market. One such fund is the Taiwan Greater China Fund, comprising a broad spectrum of Taiwanese companies with extensive commercial dealings with China.¹⁸ Shares of such closed-end funds are traded on the New York Stock Exchange. Their prices offer a composite economic indicator and are sensitive to the politics of cross-Strait relations. Table 1 gives the share price of the Taiwan Greater China Fund (stock symbol TFC) over a period of about four months after the DPP's disclosure of its intention to submit the proposed referendum. It also presents the discount amount indicating the extent that this share is being sold below the security prices of the underlying companies,¹⁹ and the Fidelity Investment Company's market index fund that seeks to duplicate the Standard and Poor 500's performance (that is, the market valuation of the largest companies representing the US economy).²⁰

18 Although it is not a large fund by the standard of its capitalization, TFC's broad holdings are especially attuned to cross-Strait commerce. When studying a fund's sensitivity to market or political events, the extent of its price swings rather than the size of its capitalization is the pertinent focus.

19 Table 1 reports the fund prices at the end of each week. Assuming access to the 'tape', one can gain information on trades on an hourly basis and even by minutes. Such finely grained time series would be useful for analyzing the market's instantaneous response to political events. Unfortunately, however, the amount of premium or discount for TFC prices is only publicly available on a weekly basis, thus accounting for my decision to report this lumpy data in a tabular rather than graphic format. Analyses that attempt to pinpoint and measure the effects of specific political news would be interesting and appropriate for future research. Naturally, such analyses would need to statistically control for the confounding influence of concurrent events and ongoing trends. The data and discussion provided here are intended as a gross illustration, not as specific proof. For a classic statement on the quasi-experimental approach to studying interrupted time series, see Campbell and Ross (1968). Incidentally, the stock market is a leading indicator. Thus, for example, security prices anticipate events such as the KMT's electoral victory. This means that with Ma Ying-jeou's approaching election, these prices increasingly incorporate information pointing to his likely victory – so that by the time this event happens, they have typically already reflected it fully.

20 I chose this broad index of the US stock market as a benchmark to contrast it with the TFC as a composite of companies doing business across the Taiwan Strait. The intent is to separate, albeit only very approximately and imperfectly, effects attributable to Taiwan politics and those reflecting the broad international climate for business. Incidentally, the Chinese stock market has fallen quite sharply, losing more than half of its peak value prior to the events being discussed here. The profitability of Taiwan companies, including those represented in the TFC fund, is naturally sensitive to Chinese economic conditions. The *relative* performance of different stock markets informs analysts about local conditions that may have impacted security prices. Clearly, these prices at any given time reflect multiple

Table 1 Share prices of Taiwan Greater China Fund and Fidelity's Spartan 500 index fund

Date	Share price of TFC	Discount percent	Spartan 500 index fund
June 1, 2007	\$6.55	–10.2	\$106.76
June 8	\$6.58	–10.6	\$104.41
June 15	\$6.85	–9.7	\$106.19
June 22	\$6.87	–13.0	\$104.12
June 29	\$6.95	–12.2	\$104.20
July 6	\$7.34	–10.9	\$106.13
July 13	\$7.52	–10.3	\$107.67
July 20	\$7.46	–11.8	\$106.42
July 27	\$7.13	–11.2	\$101.23
August 3	\$7.02	–13.7	\$99.47
August 10	\$7.08	–11.5	\$100.95
August 17	\$6.66	–8.4	\$100.49
August 24	\$7.09	–9.8	\$102.83
August 31	\$7.25	–12.2	\$102.83
September 7	\$7.15	–14.3	\$101.15
September 14	\$7.35	–11.4	\$103.31
September 21	\$7.46	–12.4	\$106.22
September 28	\$7.77	–12.8	\$106.32
October 5	\$8.14	–9.9	\$108.52

The share prices of the Taiwan Greater China Fund (stock code TFC on the New York Stock Exchange) and its discount percent are reported by the *Wall Street Journal* every Monday for the previous Friday.

News reports mentioned the DPP's proposed referendum in mid June, 2007. These reports, however, did not unsettle the market as TFC's share price continued to rise until mid July when it faced a sell-off brought about by concerns pertaining to the health of US financial institutions because of defaulting sub-prime mortgages. TFC's share price and the share price of Fidelity's index fund for the Standard and Poor 500 were correlated at 0.45 (sig. 0.05). Both rebounded from a low in mid August to reach a short-term high by early October. Both time series showed

factors (most obviously the future profitability of the companies they represent), and assigning specific weight to political events would naturally require more rigorous statistical analyses to separate these multiple influences.

strong autocorrelation.²¹ The TFC series does not show any noticeable adverse market reaction to the DPP's proposed referendum. If investors were worried by the risk that this DPP initiative would escalate cross-Strait tension, one would expect the TFC share price to drop and the discount gap to widen. The absence of such market reaction suggests, though hardly proves, that they did not take this proposed referendum as a serious threat to cross-Strait stability, and reflected the business community's judgment that it was being advocated for domestic partisan gain.

Subsequent events tend to support this interpretation. In the January 2008 legislative elections, the KMT won a landslide victory. It captured three quarters of the seats, thereby winning a super-majority. In March 2008, the DPP's initiative was defeated. With a turnout of only 35%, this referendum fell far short because the approval of a majority of *all eligible* voters would have been required for its passage.²² In the concurrent presidential election, the KMT candidate Ma Ying-jeou won impressively, garnering 58.5% of the popular votes compared with 41.5% for his DPP opponent.

This account shows that the market does not only react to political events but also tries to anticipate those events that can have an impact on financial profitability. Businesspeople abhor uncertainty, and dislike political and military tension that can jeopardize their profit and capital. The market's price movements reflect *ex ante* judgments that can have tangible *ex post* consequences. When businesspeople override their natural risk aversion to conclude large commercial deals with or in China, their behavior communicates a collective confidence in the stability of future cross-Strait relations. That is, their decisions to trade and invest must have already fully discounted the perceived political risks. These entrepreneurs are forward-looking, striking deals on the basis of their prognosis of future economic and political conditions. As these deals cumulate and gain momentum over time, they assume a quality of self-fulfilling prophecy. Liberals contend that officials will consequently

21 Autocorrelation for TFC prices was 0.59 (sig. 0.005) and 0.26 (sig. 0.01) with one and two lags, respectively; and 0.60 (sig. 0.005) and 0.25 (sig. 0.009) for Fidelity's index fund prices.

22 The KMT had countered the DPP initiative with a competing referendum that also went down in defeat for the same reason. All referenda in Taiwan have so far been unable to garner the participation of at least half of the eligible voters. I am indebted to an anonymous reviewer for calling my attention to emphasize this reason for their failure.

be restrained from undertaking policies that destabilize bilateral relations. This view suggests that the state and market influence each other reciprocally. The state can ban trade with China; however, once cross-Strait commerce has been initiated, the private sector can constrain the state from escalating political tension.

These last observations should be emphasized in view of the problem that a lack of credible commitment and worries about opportunistic behavior hamper states from reaching a negotiated agreement that would have been mutually beneficial. It has been suggested that public officials and private groups sometimes try to use international relations to bind (that is, lock in) their own government (especially future administrations of their own country) to a preferred policy course (Pevehouse, 2002). Worries about renegeing and defection pertain to not only the side sitting across the table, but also others on one's own side of the table (that is, one's own domestic counterparts and future successors; Putnam, 1988).

6 Countering possible objections

My thesis is subject to misinterpretation, and it is important to answer several objections to it. First, it has been argued that everyone 'knows' Taiwan's economy depends on China in order to thrive or even survive, and those who overlook this fact obviously do not 'get it'. This charge ignores instances when economically dependent states have defied their powerful neighbors or trade partners. North Korea, Ukraine, Rhodesia, Iraq, and Cuba come to mind. 'Politics' evidently trumped 'economics' in these cases. Had economic dependence been the overriding concern, sanctions against them would have 'worked' more effectively and sooner – or would not even have been necessary.

Second, it is plausible to argue that Taiwan is different because, unlike others just mentioned, it is a democracy. This claim, however, points to an enabling but not compelling reason. Taiwan's businesspeople can choose to trade with and invest in, say, the United States, Japan, and Southeast Asia. Economic and political liberalization is a necessary but insufficient condition for their commercial turn to China. Obviously, their action reflects a collective belief that commerce with China is more rewarding than other possibilities. Why have the considerable obstacles and hazards advanced by realism and liberalism not given them more pause? Presumably, they are optimistic about the political future of

cross-Strait relations or else they would not have risked their capital. When I refer to signaling, I include business decisions reflecting and communicating unbiased (though hardly infallible) prognosis about, among other things, what politicians may or will do to impede, endanger, or encourage commerce.

Third, I have refrained from citing extensive statements in the public domain (both in Chinese and English), or remarks made in conversations I have had with scholars, businesspeople, and officials in Taiwan, Hong Kong, and China. I have not done so because they report common knowledge, and articulate concerns and preferences already presented by liberalism and realism. Not surprisingly, the consensus business view was to ask Taiwan's government to ease restrictions on commerce and communication across the Strait.²³ Conversely, DPP officials expressed concerns about the security externalities of this commerce and wanted to limit and slow it down. Scholars took positions along the standard liberal and realist lines, and their views also often follow partisan and regional cleavages. I have not devoted space to observations from these public and private sources because they represent well-known views and, being unremarkable in this sense, they do not offer value added to this discussion.

Fourth, and moreover, talk is cheap whereas actions (such as those undertaken by businesspeople) speak louder. The relevant parties' public concerns and preferences are hardly a mystery to each other (or to an informed observer such as this paper's readers). What is not obvious, however, is the strength of their commitment to their announced concerns and preferences. Officials are rightly skeptical about each other's sincerity, suspecting an incentive to misrepresent true preferences and intentions. Voters are also wary about whether politicians will honor their pledges. Because officials are known to engage in misinformation and verbal posturing, their public statements cannot be taken seriously. Rather, what they do or fail to do is more informative about their true but often hidden motivations. Isolated incidents, such as the DPP government's prosecution of businesspeople who have transgressed its regulations and campaign speeches made by candidates seeking public office,

23 Until Ma Ying-jeou's administration negotiated successfully with Beijing to permit regular direct flights across the Taiwan Strait starting in July 2008, travelers had to transit through another place such as Hong Kong.

can be misleading unless confirmed by consistent and tangible action. Again, although officials do sometimes try to communicate sincerely in public or private media, the question is how in the absence of tangible and costly action, one can separate these occasions from other times when they are just posturing (that is, engaging in ‘cheap talk’). The costlier and riskier these actions are, the more credible is one’s sincerity and resolve because bluffers would hesitate to pay this price.

Fifth, the last remark responds to the argument that thriving cross-Strait commerce indicates the previous DPP government’s inability rather than unwillingness to stop or limit it. The claim of inability is subject to self-serving framing and justification. Beijing has claimed that it is unable to protect foreign intellectual properties because of its weak law enforcement and the craftiness of counterfeiters. Are foreigners inclined to accept this claim that widespread intellectual piracy is due to China’s inability rather than its unwillingness to crack down on this transgression? One can offer other examples such as whether the United States was unwilling or unable to win the Vietnam War. When politicians do not implement their announced preferences and intentions, they are not likely to acknowledge duplicity or bad faith to the media or their constituents. They instead defend their decision by pointing to factors allegedly beyond their control. They frame and justify their failure to act as expected or promised by offering reasons due to circumstance rather than disposition (i.e. their inability rather than unwillingness; Mercer, 1996). The larger point is that if policy making were easy, leaders would not have to choose between alternative values. Tough trade-offs, however, force them to reveal their true preferences. Were the DPP leaders the ‘politics first’ type or the ‘economics first’ type? An unwillingness to pay the economic and political price of overcoming opponents favoring commercial expansion with China does not mean an objective incapacity or impossibility (such as Mongolia cannot have a navy). It discloses politicians’ real order of preference.

Finally, my argument is *not* that the previous DPP government (or for that matter, the current KMT government) had necessarily wished to communicate to Beijing a peaceful intention or a desire for conciliation. Rather, whether or not it had wanted to, the objective development of cross-Strait commerce during this administration conveyed this message. Because talk is cheap and because the ongoing trend points to Taiwan’s ever increasing dependence on China, this situation signals a

commitment not to destabilize relations. The pertinent question is not how Taipei would have acted in the ideal world where it can pursue its preferences freely; rather, the challenge to officials and academic researchers alike is to discern how states would act under constraint. In drawing the necessary inferences, deeds provide more credible evidence than words.

7 Implications

It is difficult to prove a negative contention, as that in the case of this paper, that cross-Strait commerce communicates credible commitment to refrain from actions that can destabilize bilateral relations. The hypothesis suggests a non-event, the non-occurrence of conflict across the Taiwan Strait. This is not to say that states with dense commercial relations have not fought in history. After all, the major belligerents in World Wars I and II happened to be each other's most important economic partners.

Although a case study cannot offer conclusive evidence for empirical generalization, one can derive important testable implications from the above discussion. Contrary to conventional wisdom, one would expect from this discussion that dyads with asymmetric trade ties are less likely to fight. The logic is not to argue so much that lopsided capabilities discourage conflict, but rather that states concerned about the political vulnerability of their asymmetric trade would not have selected themselves into such relationships in the first place. Existing research tends to support this supposition that asymmetric trade is *not* conducive to conflict (Barbieri, 2002).

One may also generalize from this discussion of the Taiwan case a hypothesis that states experiencing declining commercial relations are more apt to get caught in conflicts than others whose economic exchanges are growing. Again, there appears to be some systemic-level evidence that supports this hypothesis (Mansfield, 1994). The rationale behind this hypothesis is not so much that economic hard times cause conflict, but rather that states cannot communicate as effectively about their intentions and preferences when they lack strong commercial ties to signal credibly. In the absence of these ties, they will have to resort to military means to communicate their intentions and preferences. This reasoning suggests that it is not so much the size of existing commerce

that influences the prospects for future cooperation. Rather, the direction and speed of change in this commerce are more predictive because they project to the future and not point to the past (as already mentioned, states and markets behave in anticipation of future prospects). Anticipatory adjustment implies that declining commerce should foreshadow political tension.

Nevertheless, a third testable implication is that when administrations engage in economic policies that tend to work to the relative disadvantage of their core constituents, their actions are more credible (because they are knowingly accepting a heavier political cost). For example, a US administration controlled by the Democratic Party (which traditionally draws electoral support from big labor) would be sending a more credible conciliatory and reassuring signal to China in concluding an open-trade agreement with Beijing than in the case of a Republican administration (whose core supporters tend to be big business with its known interest in foreign trade and overseas investment).

Still a fourth implication is that policy stasis is less informative than policy reversal. When a state decides to allow commercial relations that were previously banned, its decision conveys important new information. Thus, were Washington to legalize US trade with and investment in Cuba, this move would be highly significant politically. One may therefore expect that the probability for dyadic conflict can rise or decline sharply when states signal their intentions and preferences by initiating or terminating commercial relations.

As a final observation, it should be said that realism is not wrong to suggest that states would not enter into intense commercial relations if they expect to be adversaries in the near future. As well, liberalism is not wrong to argue that traders and investors would be discouraged by an absence of robust institutions providing legal transparency and ensuring property rights. Both state and market in fact act anticipatorily. Neither would have entered into intense and especially dependent commercial relations if they had expected to being held up for economic or political ransom. Thus, commerce would have been reduced *ex ante* if either had expected hostility. That in the case of Taiwan's commerce with China, trade and investment are increasing by leaps and bounds is in itself highly informative. Thus, quite separate from its possible causal effect in reducing conflict, 'trade itself reflects interstate cooperation and conflict' (Stein, 2003, p. 112). This paper shows that one can draw strong

inferences when the state and firms behave contrary to conventional expectations about circumstances under which commerce would have been hampered. Their contrary behavior, as in the case of Taiwan's strong and growing commercial ties with China, offers important insights that can inform theory and policy.

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