THE ECONOMIC AND STRATEGIC RISE OF CHINA AND INDIA

Asian Realignments after the 1997 Financial Crisis

David B.H. Denoon

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Preface

The 1997 Asian financial crisis and the September 11, 2001, attacks on the Untied States have preoccupied analysts of Asia during the past nine years. That is not surprising. The financial crisis turned into a full-fledged recession, which was the worst in Asia since the 1930s. Similarly, the 9/11 onslaught was the first successful attack on U.S. soil since 1941, when the Empire of Japan hit Pearl Harbor. When devastating, unanticipated events strike, it is understandable that policy makers and the press focus on those events and the measures that might prevent their recurrence.

Major crises have another effect, however, and that is to divert attention away from less visible but significant developments occurring at roughly the same time. Thus, this book is meant to highlight other patterns that have received insufficient attention. It is also meant to dispel some of the common assumptions about the 1997 financial crisis and show the linkages between economic shifts in Asia and long-term strategic realignments in the making.

This book attempts to demonstrate the connection between economic and strategic developments in Asia with several interrelated arguments: (1) each of the Pacific Rim states faced slightly different economic challenges, so there was no single cause for the 1997 financial crisis, nor is there is a single explanation for the slow economic recovery from the crisis; (2) China is not the only rising major power in Asia; India is close behind; and (3) many observers are proceeding as if the current U.S. treaties and security agreements will continue indefinitely, whereas in Asia, preparations for changing patrons are already under way.

It is worth noting that many books and articles have appeared claiming that the 1997 crisis was caused by one of the following: the International Monetary Fund, corruption, open capital markets, or poorly regulated financial institutions. What we will see, in Chapters 1 and 2, is that each of these factors contributed to the crash but that none, alone, was sufficient to have brought on a crisis of the magnitude that actually occurred. Also, there were significant differences among the countries affected. South Korea, for example, did not have an open capital market and experienced a crash, nonetheless.

In addition, concentrating on the economic turmoil in Asia has led to inadequate attention being devoted to strategic developments. Although the fascination with China's scope and rate of change is understandable, few Americans know that India has a far more capable navy and air force than China does. Also, with the concentration on counterterrorism and the debates about American empire, many analysts are missing the subtle shifts in contacts and allegiances already occurring in Asia.

The following are the three central themes of this book:

1. A decade after the 1997 crisis, many countries on China's periphery have still not fully recovered, and it appears that their long-term economic growth rates have slowed considerably.
2. The crisis has adversely affected Asian regional institutions (ASEAN and APEC), and this has raised the importance of bilateral relations with the major powers (United States, China, Japan, and India).
3. If these economic and political trends continue, the Asian strategic balance will shift, accentuating patterns already in place and favoring the continental powers, India and China.

The East Asian Summit (EAS) in December 2005 in Kuala Lumpur was a good example of changing perspectives within Asia. It grew out of ideas put forth a decade earlier by Prime Minister Mahathir of Malaysia and built on the framework of ASEAN + 3 (Southeast Asia plus China, South Korea, and Japan) to create a forum of Asian states. Although friction between China and Japan prevented the EAS from making much initial progress, it was notable in *excluding* the United States and *including* India. The prospects for the EAS are uncertain and will be discussed in Chapter 6; however, the mere fact that it took place is evidence that new diplomatic and security ties are developing.

Several qualifications are in order in dealing with a subject as broad as this book entails. When discussing the "relative decline" of the former Asian Tigers, we are not saying that they will be in perpetual crisis. Countries in many other parts of the world would be pleased to have their national incomes grow at 3 percent to 4 percent per year. However, the Asian Pacific Rim states benefited enormously in the 1970s and 1980s because they had average growth rates considerably in excess of 5 percent and were the preferred location for foreign investors. This meant that they got large flows of capital, with new technology embedded in it. Today, China is getting more foreign investment than the rest of Asia combined. Even though most of the Pacific Rim states have higher per capita incomes than China, with the new capital flooding into China, the states with smaller markets will increasingly face competitive challenges.

Of course, not all of these changes were due to the 1997 financial crisis, but the crisis itself and slow recovery proved a major barrier to surmount. Most of the Pacific Rim states face a double burden: they have been restructuring from their pre-1997 excesses, while having lost many foreign investment opportunities to China and India.

Also, the pace of globalization has accelerated. Although neoclassical trade theory would say that open markets will reward specialization even in small countries, it appears there are some real advantages to having a continental-sized economy, and this, further, seems to favor China and India.

In doing a comparative study of this sort, no one country can be treated in depth. Hence, there are many issues that cannot be dealt with in detail, and even more subtleties that cannot be addressed at all. Yet, the intent is to give the reader a sense for the very big changes occurring in Asia, with judgments about their economic and strategic significance.

This book is essentially an interpretive one, focusing on political economy. It takes widely available data and events and presents the reader with an assessment that links economic trends with national security implications. The principal sources for the economic data are the International Monetary Fund, the United Nations, and private forecasters. The political events are documented using major newspapers and specialized journals dealing with Asia. Another useful source was the Pacific Forum's Pac Net, which presents views of a wide variety of Asian specialists on developments in the region. In addition, the author made three trips to Asia, meeting with a broad spectrum of academics, government officials, and researchers in Japan, China, South Korea, Taiwan, Thailand, Singapore, Indonesia, and India. These sources were very helpful. Most of the interviewees requested anonymity, but their contributions are very much appreciated.

A statistical comment as well: this book uses IMF gross domestic product (GDP) calculations, taking the relevant country's exchange rate, for the comparisons. The advantage of this approach is that all countries have an exchange rate, and most states in Asia link their economic planning to export earnings and imports denominated in U.S. dollars. Thus, the dollar is the de facto standard by which most Asian states evaluate their economic performance. The disadvantages of this approach are clear, however: if a country's exchange rate moves significantly vis-à-vis the dollar during the period being measured, the exchange rate conversion will over- or understate the real value of the country's GDP. So, for example, Figure 2.2 tends to overstate the growth of Japanese GDP in the 1960s and 1970s, because the yen was appreciating rapidly during that period. Moreover, if a country has a large unskilled population, many of the services that are billed for in wealthier countries are done for in-kind payments and so are hard for statisticians to measure. Purchasing power parity estimates of GDP help correct for these problems but are not available for all Asian states in all the years we need to make comparisons. Hence, the exchange rate conversion method of GDP estimation is used here.

The saga of China's recent GDP statistics also warrants special caution. In late 2005, the Chinese government announced that it had significantly underestimated GDP in the period after 1993. For most years, the GDP growth rate was raised by 0.5 percent. This meant that the revisions raised the entire period's product by a massive amount: for example, the estimate for 2004 was raised by $280 alone. This underestimate was equivalent to the entire GDP of India. Economists had long suspected that the Chinese government manipulated GDP statistics for political purposes, but the scale of the underestimate was not fully appreciated. It now appears that Chinese officials have wanted to keep their currency exchange rate artificially low and knew that if they acknowledged growth rates of over 10 percent, there would be increased pressure to appreciate the value of the yuan. The Chinese GDP estimates have stayed, surprisingly, in the 9.5 percent to 10.5 percent range since the mid-1990s. The implications of this will be analyzed in Chapter 3, but it clearly goes far beyond a tussle over statistical accuracy.

Finally, Chapter 6 focuses on U.S. security policy and developments in Asia. This manuscript is going to press in 2007. At this time, the insurgency in Iraq is actively continuing and mixed progress is being made in getting North Korea to relinquish its nuclear program. Revelations during 2004 and 2005 about torture at the

U.S.-controlled prison at Abu Ghraib in Iraq and extensive wire-tapping by the U.S. National Security Agency have grievously hurt the United States' image in Asia. Chapter 6 does not attempt to forecast specific outcomes on North Korea and other Asian security issues; however, it does analyze how the principal powers in Asia are likely to respond if the United States continues with its current policies.

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New York University
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Abbreviations

AFTA	ASEAN Free Trade Area
ARF	ASEAN Regional Forum
ASDF	Japan's Air Self Defense Force
ASEAN	Association of Southeast Asian Nations
ASEAN + 3	ASEAN members plus China, Japan, and South Korea
BIBF	Bangkok International Banking Facility
BMD	ballistic missile defense
DPP	Democratic People's Party of Taiwan
FDI	foreign direct investment
IBRD	International Bank for Reconstruction and Development (World Bank)
IMF	International Monetary Fund
KMT	Kuomintang (People's Party of Taiwan)
NATO	North Atlantic Treaty Organization
NPL	nonperforming loan
OSD	Office of the Secretary of Defense
SCO	Security Cooperative Organization (China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan)
SDA	Japan's Self Defense Agency
SET	Security Exchange of Thailand
TAC	ASEAN Treaty of Amity and Cooperation
WMD	weapons of mass destruction

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Chapter 1

Overview

The Context

In the spring of 2005, most Americans got a rude shock. Private Chinese firms bought two staples of the U.S. economy, IBM's personal computer business and the Maytag appliance company.[1] If there was any further need to announce the arrival of China's economic power on the world stage, it was evident when a Chinese government-controlled company, the China National Offshore Oil Corporation (CNOOC), made a bid of $18.5 billion to buy an American oil company, Unocal. In addition to the size of the bid, it was clear that the Chinese government was giving notice that it would use its leverage to trump a lower bid for Unocal, made by Chevron-Texaco, one of the four largest oil companies in the world.[2] Although the Chinese government ultimately withdrew the bid, this episode was a wake-up call demonstrating that China's massive foreign exchange reserves give it the potential to compete actively for the natural resources and technology that it seeks.

Less noticed, but equally important, was the demand on July 5, 2005, by the Shanghai Cooperative Organization (SCO) that the United States set a timetable for withdrawing its military bases from Central Asia.[3] The SCO's statement was a warning to Washington that there were limits to China's patience with having American military power directly on its western border.

Still another sign of China's new prominence was its announcement, in December 2005, that it had understated its gross domestic product (GDP) for the prior year by $280 billion. This "error" (which probably resulted from a policy of conscious understatement) meant that China now had the fourth-largest economy in the world.[4]

Attentive Americans have also been noticing dramatic shifts in U.S. linkages to India. Major financial institutions have already moved or "outsourced" over 40,000 jobs to India, and IBM has stated it will lay off programmers in the United States and hire 13,000 new ones in India.[5] The versatility and might of the Indian military has also been gaining increasing scrutiny.[6] President George W. Bush's trip to India in March 2006 and the ensuing efforts at security cooperation and civilian nuclear exchanges have heightened the profile of India as well.

These moves by China and India are only the beginning of a new era in which power and economic influence are shifting away from the Asian Pacific Rim states (South Korea, Japan, Taiwan, the Philippines, Indonesia, Malaysia, Singapore, and

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Thailand) to their continental-sized neighbors.[7] It is striking that although China and India have per capita incomes less than Thailand's and have only partially modernized their economies, they have selected sectors that are quite modern. This enables both China and India to support large and modern military forces.

The discussion below will highlight some of the problems faced by the Asian Pacific Rim states and then turn to a detailed analysis of why the 1997 financial crisis was such a transforming event in Asia.

During the past decade, there have been four developments in East Asia that have gotten the most attention from the press and governments: (1) the 1997 financial crisis, (2) the spread of militant Islam, (3) the rise of China's economic and strategic prominence, and (4) growing economic ties *within* Asia. Each of these developments has been critical to the region's transformation and will be discussed in depth in this book.

In addition, the tsunami of December 2004 (which devastated parts of Indonesia, Thailand, Sri Lanka, and India) led to a vast loss of life and required a large recovery effort in Southeast and South Asia.

The 1997 financial crisis was the first major setback to the extraordinary surge in economic growth in Asia, which started in Japan in the 1960s, then spread to Taiwan, Hong Kong, Singapore, and South Korea in the early 1970s, and broadened to include Thailand, Malaysia, and Indonesia shortly thereafter.[8] With economic growth averaging over 7 percent per year and population growth dropping, this meant that per capita incomes, for many countries on the Pacific Rim, were doubling approximately every ten years. The crash of 1997 brought this to a halt for most of the countries in East Asia, except China (which had started its own rapid growth in the 1980s). Thus, the financial crash was a traumatic event and will be the starting point for this book's discussion.

The revival of militant Islam in Southeast Asia was encouraged and financed from the Middle East; its significance is that there is now a network of activists in the southern Philippines, Indonesia, Malaysia, and southern Thailand, many of whom favor the creation of a universal, Islamic nation.[9] These extremists have used violence widely in the Philippines, Bali, Jakarta, and southern Thailand. At the moment, they do not pose a direct threat to secular leadership in the region, but they are a challenge to a modernized, open society and reject many of the values that underlay the rapid economic growth of the 1970s to the 1990s.[10]

The rise of China has been so widely reported and debated that it is commonplace to comment on its significance. However, instead of just focusing on the size of the Chinese economy and its exceptional recent growth, we will concentrate on what China's economic power and long-term strategy will mean for the rest of Asia and for the United States.

The United States is still the largest supplier and the second-largest export market for most of the Pacific Rim economies. Yet, because China's market is growing very rapidly and Beijing has maintained such an open trade policy, China has become the new hub for economic dynamism in Asia. China is now Japan's largest trading partner as well as the largest trading partner for many of the Southeast Asian states. As a result, many of the Pacific Rim states are reconfiguring their long-term trade policies to be suppliers to the China market.[11]

Despite the undeniable significance of the trends just mentioned, this book will analyze two other developments that have *not received* adequate attention: (1) the rise of India, and (2) the relative decline of the Pacific Rim states after 1997.[12]

There is now a growing interest in the relationship between the Indian Subcontinent and China. Also, the business press has discovered India's software industry and "offshore" service capabilities. Yet, overall, developments in India have received far less American attention than those in East Asia.[13] This is understandable given the three decades of rising trade between the United States and East Asia and the debates surrounding the Korean and Vietnam wars. Nevertheless, the subcontinent warrants more attention.[14] India now has two aircraft carriers and an expanding navy, a modern air force, a space program, and ballistic missiles to go with its nuclear weapons. India began liberalizing its economy in earnest in 1991 and now has one of the fastest-growing economies in Asia.[15] It still has a host of structural and cultural problems to deal with before it can project its power, but there is no doubt that the Indian elite supports the country's becoming a major global player. Thus, we will try to put the emerging power of China and India in context with other, more visible Asian issues.

The East Asian Financial Crisis: Passing Storm or Transforming Event?

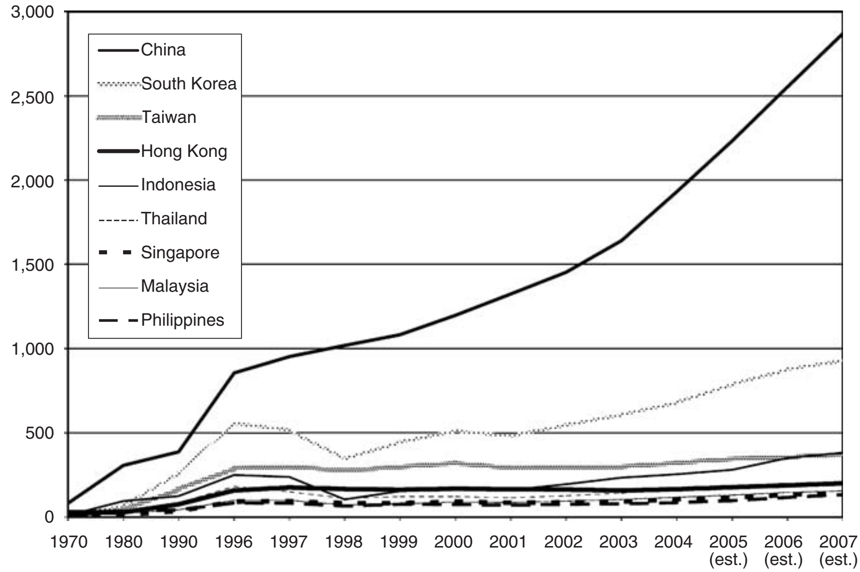
The financial crisis of 1997 hit East Asia like a summer storm. It was fast moving, intense, and powerful. Most importantly, though, it was unanticipated and none of the countries affected had made adequate preparations for the ensuing devastation. For example, just two months *before* the crash began in Thailand, the International Monetary Fund (IMF) issued its annual forecasts and predicted rapid growth throughout 1997 and 1998 for all the principal economies in Southeast Asia.[16]

Nine years after the financial crisis started, most of East Asia was still experiencing the aftereffects of the crash.[17] Although there was a sharp economic recovery in late 1998 and early 1999, most of the region experienced a second downturn, and only five to seven years after the crisis did national incomes get back to the levels of 1996. Economic growth figures for 2004 and 2005 are the best they have been in five years, and it could be that East Asia is finally pulling out of the doldrums. Yet, much of East Asia's growth is based on exports to the United States and China. Should either the United States or China falter, the impact on the rest of Asia would be severe.

The biggest uncertainty in East Asia's economic future is whether Japan can pull itself out of a decade of stagnation. For the country that led the way in the 1960s and developed the strategy of export-oriented growth, stalling so badly in the 1990s has been a key stumbling block. Japan was in recession in 2001, had no growth in 2002, rebounded at a growth rate of 2.7 percent in 2003, but slipped back to a growth of about 1 percent in 2004. Faster growth then restarted with the GDP expanding at a rate of 2.4 percent in 2005 and is expected to be at about 2.7 percent in 2006–2007. Japan is the region's largest economy, had been the largest source of foreign direct investment (FDI) in the 1980s and 1990s, and provided the economic growth model that its neighbors followed.[18] The scale of Japanese and Chinese economies in comparison with their neighbors is evident in Figure 1.1.

Because Japanese politicians and policy makers dealt only partially with the extent of the country's financial sector problems during the 1990s, they reduced the overall chances for a Japanese recovery and are slowing growth prospects for the entire East Asia region.[19] The scale of the Japanese banking crisis is stunning: the government estimates $420 billion of nonperforming loans (NPLs) made, and many observers think that the eventual total to be written off could be significantly larger than that.[20] Japan's ability to lend and invest outside its borders is also declining because its savings rate has dropped from 15 percent to 6.4 percent of GDP in the past decade.[21]

However, deep structural problems are by no means limited to Japan. Much of the East Asian region is suffering from lax standards in lending, weak bank capitalization,



Note:
Japan GDP was 3,053 in 1990 and 4,651 in 2000.

Sources:
IMF, World Economic Outlook (WEO) Database, September 2006.
Chinese National Bureau of Statistics.

Figure 1.1 Total GDP.

and indulgent attitudes by East Asian governments in the early 1990s (when questionable lending helped sustain the economic boom). Although the Chinese economy has not yet had the type of crash experienced by the rest of the region, its banking system is extremely vulnerable. Chinese banks are under great political pressure to lend to unprofitable state enterprises and have little ability to refuse weak creditors. The four largest government banks in China received cash supplements of $33 billion in 1998 and an additional $45 billion in January 2004. Even with these enormous subsidies, these banks are bordering on insolvency, with NPLs of over $500 billion.[22]

There are, however, bright spots in East Asia. Thailand grew at about 6 percent in 2003 and 2004, and Malaysia has reduced its NPLs and restructured its industrial and financial sectors.[23] The problem is that these patterns have not been sustained. Thailand, for example, experienced a nonviolent coup in 2006, leading to the removal of Prime Minister Thaksin and the installation of a temporary military government.[24] If China can maintain its growth rate, doubling its GDP every decade, and Japan recovers, the entire picture would be different. Even so, the uncertainty over these prospects continues to raise major questions about the East Asian economic scene.

Much has been written about the East Asian financial crisis.[25] Our purpose here is not to reanalyze that literature, but to focus on the long-run implications of the crisis. To do that, it is necessary to understand the magnitude of the dislocations precipitated by the events of 1997 and to go beyond a purely economic analysis. The resulting political and strategic adjustments warrant close attention as well. Hence, we will present below an overview of the economic ripple effects and then show the connections to the subsequent political and strategic shifts. Given the complexity of the issues involved and the disparate nature of the data, we will first note the research dilemma this poses.

The Economic Dilemma

Table 1.1 shows economic growth estimates for the 2001–2005 period from a range of sources. The variation in the estimates reflects differing computational methods and degrees of confidence in official sources. It is clear that the major trauma of the 1997 crisis was over by 2004. Yet, as Table 1.1 and Figure 1.2 both illustrate, most Asian states did not return to the growth trajectories of the mid-1990s. China and India are the two principal exceptions to this pattern, and the reasons for their differing performance will be analyzed below.

Thus, one of the key issues that we will face in this book is analyzing which countries have sustainable growth strategies and which are likely to continue foundering in the near future. These fundamental questions are the focus of Chapter 3, and they cannot be resolved merely by assessing macroeconomic forecasts. We need to look at whether the leading sectors have the basic competitiveness and whether the political environments, in the respective countries, will allow the restructuring that is necessary to truly recover from the 1997 crisis.

For example, South Korea's recovery after 2000 was fueled by consumer credit, with about half of the $405 billion in commercial bank lending in 2002 going to individuals. This created a bubble in Korean housing prices, and there is serious concern whether households will be able to service their debt. In 2004, one of the largest South Korean issuers of credit cards, LG Credit, was forced into reorganization, and 16 percent of the Korean population was delinquent on repayments.[26] This has led to a third slowdown since 1997, with growth going down to 2.6 percent in the second half of 2004. Growth recovered to 3.8 percent in 2005 and is expected to be over 4 percent in 2006. Yet, President Roh Moo Hyun was viewed by many as anti-business, and foreign direct investment coming into South Korea dropped dramatically between 2001, when it was $11.3 billion, and 2004, when it was $6.5 billion.[27] In addition, the October 2006 announcement by North Korea that it had tested a nuclear weapon will not make the Korean Peninsula a desirable location for foreign investment.

Even Taiwan, which has long practiced cautious economic policies, has been snared in a bitter debate about the pace of reforms necessary to deal with NPLs in commercial banks and rural credit cooperatives. This led to the resignation of the finance minister, Lee Yung-san, and growing concern about President Chen Shui-bian's seriousness in dealing with restructuring.[28] Taiwan's biggest problem, however, is the slowdown of investment on the island and the massive outflow of capital to the Chinese mainland. The GDP growth in Taiwan is expected to be about 3.9 percent in 2006.

In Hong Kong, growth is recovering from the steep slide in 2001 and is expected to be about 5.7 percent in 2006. However, China's efforts to rewrite the laws on sedition, to tighten Article 23 of Hong Kong's constitution, had a chilling effect. Even though Beijing ultimately backed down, this concerned local and foreign businesspeople and raised questions about interference from the Chinese mainland. Hong Kong's other structural problems (lack of open land and competition from Guangzhou and Shanghai) also affect its prospects.

Table 1.1 Asian economic growth estimates (as of February 2005)

			IMF	World Bank	ADB	Citigroup	Consensus	ESCAP	Local Government
Northeast Asia	China	2001	7.5	7.3	7.3	7.3	7.7	7.3	7.3
		2002	8.3	8	8.0	8	7.9	8	8
		2003	9.1	7.8	9.4	9.3	8.5	9.1	8.5
		2004	9	7.4	9.3	9.4	7.9	9	7
		2005	7.5		8	8.5	8.2	8.8	
	Hong Kong	2001	0.5	0.6	0.5	0.5	2.8	0.6	
		2002	1.9	2.3	2.3	1.9	1.5	1.9	
		2003	3.2	2	3.3	3.2	1.5	3.2	
		2004	7.5	4	6.0	7.7	1.5	6.6	
		2005	4		5.0	4.5	4.6	4.7	
	Japan	2001	0.4	0.4			−0.3	0.4	
		2002	−0.3	0.3			0.8	−0.3	
		2003	2.5	0.6				2.1	
		2004	4.4	1.6		2.8			
		2005	2.3			1			
	South Korea	2001	3.8	3	3.8	3.8	3.6	3	3.1
		2002	7	6.3	7.0	7.0	6.1	7	6.3
		2003	3.1	3	3.1	3.1	2.7	3.1	2.6
		2004	4.6	5.1	4.8	4.6	5.2	5.2	4.8
		2005	4		4.2	3.3	3.9	4.6	
	Taiwan	2001	−2.2	−2.2	−2.2	−2.2	2.2	−2.1	5.2
		2002	3.6	3.5	3.6	3.6	3.3	3.6	
		2003	3.3	3	3.2	4.8	2.7	3.2	3.1
		2004	5.6	4	5.4	5.8	3.9	5.7	
		2005	4.1		4.7	4.1	4.2	4.8	

(Continued)

Table 1.1 (*Continued*)

			IMF	World Bank	ADB	Citigroup	Consensus	ESCAP	Local Government
South Asia	India	2001	3.9	5	5.8	4.4		5.6	
		2002	5	4	4.0	5.8		4	
		2003	7.2		7.3	4	5.8	8.1	
		2004	6.4		7.4	8.2	6.1	6	
		2005	6.7		7.6	7	6.6	6.8	
	Pakistan	2001	2.7	3	2.2			2.5	
		2002	4.4	4	3.4			3.1	
		2003	6.2		5.1			5.1	5.3
		2004	6.3		5.5	5		6.4	5.3
		2005	6		5.8	5		6.6	
Southeast Asia	Brunei	2001	3.1		3				3
		2002	2.8		2.8				
		2003	3.1		3.2				
		2004	1.1						
		2005	2.2						
	Cambodia	2001	5.7	6.3	5.7			5.5	5.7
		2002	5.5	4.5	5.5			4.5	5.5
		2003	5.2	4.8	5.2			6.4	5
		2004	4.3	5.8	4.5			6	5.5–6
		2005	1.9		2.3				
	Indonesia	2001	3.5	3.4	3.8	3.8	2.8	3.3	3.4
		2002	3.7	3.7	4.3	4.3	3.5	4.3	3.7
		2003	4.1	3.5	4.5	4.5	3.8	4.5	4
		2004	4.8	4	4.9	4.8	4.4	4.7	4.5
		2005	5		5.3	5	5.1	4.9	

Lao PDR	2001	5.8	5.7	5.8			5.7	5.8
	2002	5.8	5.7	5.9			5.8	5.9
	2003	5.3	5.5	5.8			5.9	
	2004	5.4	5.9	6.5			6.3	
	2005	5.8		7				
Malaysia	2001	0.3	0.4	0.3	0.3	2.4	0.4	0.3
	2002	4.1	4.2	4.1	4.1	5	4.1	4.1
	2003	5.3	4.6	5.3	5.2	4.6	5.3	4.5
	2004	6.5	5.4	7.1	7	5.4	6.5	
	2005	6.3		5.4	5	5.4	5.7	
Myanmar	2001	11.3	10	11.3			10.5	10.9
	2002	10		10.0			5.5	10.9
	2003	0		10.6			5.8	
	2004	3.6					5.4	
	2005	3.3						
Philippines	2001	1.8	3.2	3.0	3	2.5	3.2	3
	2002	4.3	4.6	3.1	3.1	3.5	4.4	4.4
	2003	4.7	4	4.7	4.7	3.7	4.5	4.2–5.2
	2004	5.2	4.2	5.9	6	4	5.5	4.9–5.8
	2005	4.2		4.7	4.3	4.6	5.2	
Singapore	2001	−1.9	−2	−1.9	−1.9	2.3	−2.4	−2.4
	2002	2.2	2.3	2.2	2.2	5.6	2.2	2.2
	2003	1.1	1	1.1	1.1	0.8	1.1	0.5–1
	2004	8.8	4.7	8.3	8.1	4.9	8.3	
	2005	4.4		4.4	4.5	4.2	4.3	
Thailand	2001	2.1	1.9	2.2	2.1	2.1	1.8	1.9
	2002	5.4	5.2	5.3	5.4	4	5.4	5.3
	2003	6.8	5.8	6.9	6.8	6	6.8	6.4
	2004	6.2	6	6.1	6.2	6.1	6.5	7.5
	2005	6.4		5.7	5.7	5.2	6	

(*Continued*)

Table 1.1 (*Continued*)

			IMF	World Bank	ADB	Citigroup	Consensus	ESCAP	Local Government
	Vietnam	2001	5	5	5.8	6.9		6.8	6.9
		2002	5.8	6	6.4	7.1		7.1	7
		2003	6	7	7.1	7.3	7	7.3	7.2–7.3
		2004	7	7	7.3	7.3	7.4	7.2	7.5–8
		2005	7		7.1	7.1	7.1	7.3	
World	World	2001	2.4	1				1.1	
		2002	3	2				1.7	
		2003	3.9					2.8	
		2004	5			4.3			
		2005	4.3			3.6			

Note: ESCAP, United Nations Economic and Social; CEI, Consensus Economics, Inc.

Sources: ADB, Asian Development Outlook 2004, http://www.adb.org/Documents/Books/ADO/2004/default.asp; ADB, Asia Economic Review, December 2004, http://www.aric.adb.org (February 10, 2005).

Consensus: Global Economic Trends, March 25, 2001, http://www.research.ml.com/Marketing/content/trends.pdf?mlhp; Citigroup, Economic & Market Analysis: Asia Pacific, January 21, 2005; Citigroup, Global Economic and Strategy, January 19, 2005, http://www.smithbarney.com; Citigroup, Economic & Market Analysis: Asia Pacific, June 26, 2003; ESCAP, Bulletin on Asia Pacific Perspectives, 2004/2005, www.unescap.org (February 10, 2005); ESCAP, Economic and Social Survey of Asia and the Pacific 2003; United Nations, New York; IMF, World Economic Outlook, September 2004, http://www.imf.org/external/pubs/ft/weo/2004/01/index.htm (November 5, 2004); World Bank, "East Asia and Pacific Region: Looking Beyond Short-term Shocks," Regional Overview (02/10/05).

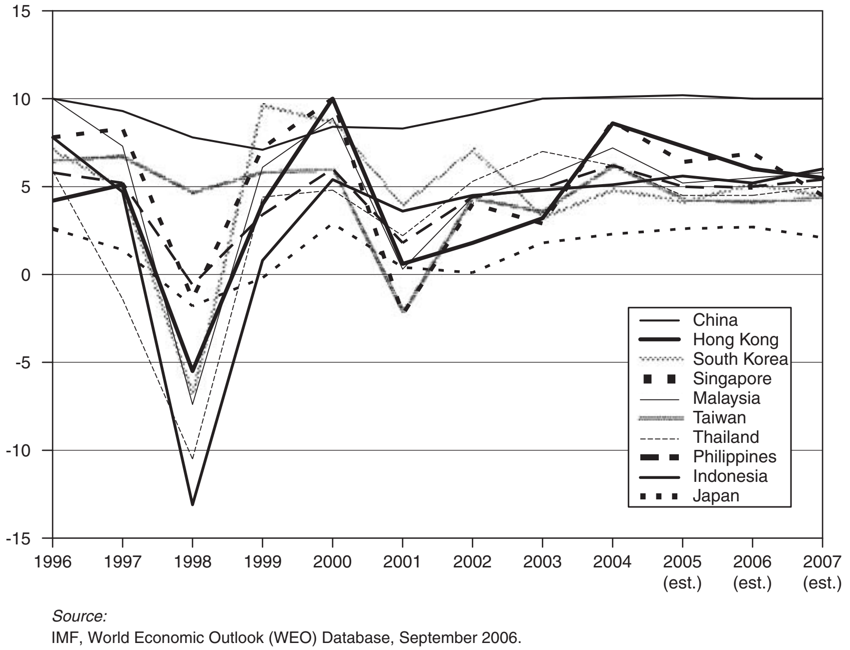


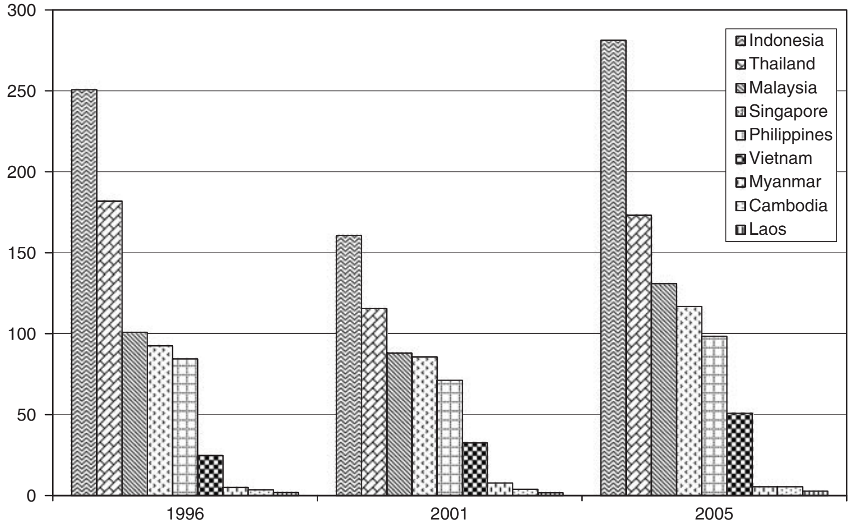
Figure 1.2 Real GDP growth.

In sum, for *four* of Asia's five largest economies (Japan, South Korea, Taiwan, and Hong Kong), there are reasons to suspect slower long-term economic growth than in the 1980s and 1990s.

Prospects in Southeast Asia are improving but are less than stellar. As we see in Figure 1.3, most of the countries in the Association of Southeast Asian Nations (ASEAN) had GDPs in 2001 that were smaller than levels reached in 1996.[29] Although the Thai and Malaysian economies are the most resilient of the ASEAN states at present, the region clearly suffers when its largest economy, Indonesia, grows slowly. Indonesia's GDP growth, which has been over 3 percent per year since 2001, is due to agricultural exports and rising prices for mineral and oil exports. The Indonesian manufacturing sector has continued to slump, and FDI has not returned to its levels of a decade ago. In early 2006, there was more positive news: GDP growth was likely to be over 5 percent, FDI rose to $1.4 billion in January alone, and Indonesian officials reached an agreement with Exxon Mobil for a 30-year oil exploration and development project near Cepu in Java.[30] There are skeptics, however, who see the new FDI in Indonesia concentrated in shopping malls and apartment buildings and not likely to generate the foreign exchange earnings that the country needs as its oil revenues decline.[31]

In addition, as shown in Table 1.2, individual incomes fell or stagnated in most of Southeast Asia in the five years after 1997. This has had a profound effect on political stability, people's attitudes toward their governments, and the optimism of businesspersons (domestic and foreign) regarding making investments.

Prior to the 1997 crisis, there was a broad consensus among academics and policy makers that the East Asian states had developed a successful growth model.



Source:
IMF, World Economic Outlook (WEO) Database, September 2006.

Figure 1.3 Total GDP in Southeast Asia.

Economists often noted the high savings and investment rates, the new capital stock, and the high profit margins that allowed Asian firms to produce quality products that could compete on a global basis and fuel export-led growth.[32]

In the mid-1990s, many specialists on Northeast Asia were confident that Japan would recover from its real estate and financial sector crash and return to lead the region.[33] Likewise, many analysts of Southeast Asia were convinced that the high growth rates of the 1970s and 1980s would continue because policies in the ASEAN states were sound.[34] Political scientists also contributed to the debate by arguing that East Asia had mastered the art of the "developmental state" by creating strong governments that distributed resources effectively and limited class conflicts by convincing all sectors of society that they would benefit from patience and high growth rates.[35]

In retrospect, there was too much optimism from international organizations such as the World Bank and the IMF, both of which portrayed East Asia as an extraordinary success model for other developing countries to follow. The World Bank extolled the mixture of policies pursued in East Asia, stressing that prudent macroeconomic policies combined with incentives for savings and investment and export-led growth would permit many countries to duplicate the Asian Model.[36]

The IMF began to make recommendations on a broad range of development policies in the 1990s and, in addition to its traditional focus on stabilization and realistic exchange rates, started to press for capital market liberalization in general. The IMF made opening capital markets its prime goal during 1996, the year before the crisis. The dramatic increase in the speed of transactions and range of financial instruments in the 1990s (with options, futures, and securitized debt being available on a global basis) meant that more capital was available to East Asian borrowers than ever before. While capital was surging into East Asia, it led to an investment

Table 1.2 Per capita GDP incomes before and after the crash

	Country	Population 1996 (Millions)	Per Capita GDP 1996 (U.S. Dollars)	Population 2001 (Millions)	Per Capita GDP 2001 (U.S. Dollars)	Population 2005 (Millions)	Per Capita GDP 2005 (U.S. Dollars)
Northeast Asia	China	1,232.5	699.4	1,285.2	1,038.0	1,315.8	1,702.8
	Hong Kong	6.5	24,582.6	6.9	24,638.1	7.0	25,444.0
	Japan	125.8	36,776.6	127.3	32,173.1	128.1	35,786.6
	South Korea	45.5	12,249.2	47.1	10,176.5	47.8	16,421.7
	Taiwan	21.6	13,441.8	22.2	13,027.5		15,119.7
Southeast Asia	Cambodia	9.9	315.5	13.5	288.0	14.1	375.0
	Indonesia	196.8	1,264.4	214.4	788.5	222.8	1,259.0
	Lao PDR	4.8	388.1	5.4	320.4	5.9	463.1
	Malaysia	21.2	4,764.1	23.5	3,664.7	25.3	5,040.0
	Myanmar	45.1	108.8	48.2	151.2	50.6	97.0
	Philippines	71.9	1,206.1	77.2	913.9	83.1	1,159.2
	Singapore	3.7	25,215.8	4.1	20,723.2	4.3	26,835.0
	Thailand	60.0	3,037.5	61.6	1,835.7	64.2	2,576.9
	Vietnam	75.4	337.0	79.2	413.1	84.2	611.9
South Asia	India	939.5	408.9	1,033.7	467.3	1,103.4	713.7
	Pakistan	134.2	594.4	146.3	490.0	157.9	769.4

Sources: Euromonitor, *The World Economic Factbook, 2000/2001*; IMF, International Financial Statistics, February 2002; IMF, The World Economic Outlook (WEO) Database, September 2003, http://www.imf.org/external/pubs/ft/weo/2003/02/data/index.htm; United Nations, http://www.un.org/esa/population/publications/wpp2002/wpp2002annextables.PDF (September 29, 2003).; UNDP, Human Development Indicators, 2003, http://hdr.undp.org/reports/global/2003/indicator/index.html (March 15, 2003); United Nations, World Population Prospects: The 2004 Revisions, 2005.

boom; once investors began to pull out, they fled with such rapidity and with such large withdrawals that they created a panic.[37]

There were some skeptics, but they were limited in number, and most did not see the overall problem of excessive investment and short-term capital overwhelming the weak banking and financial systems. Paul Krugman did note, in 1994, that economic growth in East Asia was mostly due to increased inputs (capital and labor) and did not reflect improvements in efficiency or output per worker.[38] Nevertheless, until the crisis occurred, it is reasonable to conclude that the leaders of most governments in East Asia thought they were following a sustainable path and were getting substantial praise from outside observers. The close agreement on policy directions (between the World Bank and IMF and market-oriented economists) was labeled the "Washington Consensus," and by the mid-1990s it was hard for developing countries to resist the thrust of this advice if they wanted to receive resources from Western aid donors and multilateral institutions.

In the postmortems about what caused the crisis, there were two major schools of thought: (1) criticisms about the policy choices inherent in the Washington Consensus, and (2) criticisms about mismanagement and misallocation of resources by governments and businesses in East Asia.

Jeffrey Sachs took the lead, among Western economists, in criticizing the policy prescriptions of the IMF. He argued that the IMF contributed to the crisis by making the East Asian states more open to volatile, short-term capital flows and then, after the crash, exacerbating their recovery prospects by imposing overly cautious fiscal policy.[39]

The IMF staff has rebutted these charges, stressing that a much broader set of changes was under way on a global basis, which made all countries more sensitive to changes in trade and capital flows. Hence, the IMF has urged that the capital structure and standards for banks and financial institutions be strengthened so that the impact of short-term flows would be less destabilizing.[40]

Jagdish Bhagwati challenges the view that open capital markets are a necessity. He argues that freeing trade has beneficial and widespread effects in a country, but that liberalizing capital markets can create unnecessary risks.[41] The preceding arguments illustrate the range of disagreement in the economics profession over the basic aspects of the policy prescription that the East Asian states followed in the 1990s. We will deal with each of these arguments in more detail in Chapter 2.

The second, and fundamentally different, view of what caused the 1997 crisis focuses on mismanagement and corruption *inside* the East Asian states.[42] Because growth rates had been high throughout the region for almost two decades (between 1975 and 1995), government leaders assumed that they could divert large sums for their personal use or for rewarding particular individuals or constituencies. This often led to proceeding with inefficient infrastructure projects that became the hallmark of "crony capitalism."

Except for Singapore, most of the countries in East Asia have serious problems with corruption. In some cases, this is a result of long-standing cultural practices about how to get compliance or cooperation from citizens, but there is little doubt that the scale of diversions by government leaders soared in the 1990s.[43] These diversions led to large capital transfers out of the region to safe havens and distorted choices about many large projects. This accentuated the boom mentality, as many businesspersons and government officials tried to get their funds sequestered while opportunities were available.[44]

In sum, for two decades, many people saw the countries of East Asia as economic exemplars. A whole generation of young Asians came of age without seeing a serious recession, and many thought that doubling of per capita incomes every decade would continue indefinitely. International institutions encouraged the export-oriented growth strategy and reinforced it by making resources available for opening capital markets. Debt/equity ratios increased, and many states became dependent on new inflows of short-term capital to maintain debt services.[45]

When the bubble burst in Thailand in July 1997, neither the ASEAN states nor the World Bank and the IMF were prepared for the extent of the crash. It turns out that Japan's difficulties prefigured the subsequent problems throughout the region, but at the time, many economists thought that Japan's stagnation arose from its own special conditions and was not indicative of a broader dilemma. Now there is a substantive debate about whether structural problems affect all or most of the Pacific Rim states.

In this book, we will, ultimately, make generalizations about the causes of the crisis, the reasons for the slow recovery, and future prospects. However, it is important to make distinctions among the countries involved and not to assume that any one theory will explain developments across an entire region.

The country that recovered most quickly was Malaysia. It spurned the IMF's advice, initiated capital controls, kept banks open, went to a pegged exchange rate, and chose an expansionary fiscal policy (over the contractionary policy course advocated by the IMF elsewhere). The country that had the second-fastest turnaround was South Korea, and it followed the IMF prescriptions closely. So, it is critical that we understand why Thailand and Indonesia had such difficulty in recovering from the crisis.

Thus, no single explanation for the recovery pace and process is adequate. The recovery was not just (1) a normal cyclical rebound, (2) due to a real estate bubble, (3) due to undercapitalized and poorly managed banks, or (4) due to political turmoil in the transition from authoritarian to democratic regimes. It included each of these problems in most countries but other factors as well, which we will bring out in later discussion.

Nevertheless, it is clear that the protracted recovery and turmoil caused by the crisis has sparked a major debate about appropriate policies for the future.[46] Should developing countries open their capital markets or limit them?[47] Is the export orientation, which benefited Asian states so much in the 1975–1995 period, a wise strategy for the future? Should the Japanese model of government-led industrialization be abandoned or just modified to current circumstances?

THE CENTRAL ARGUMENT: THE RISE OF THE CONTINENTAL POWERS

This book is based on the premise that the 1997 economic crisis shocked East Asia and that fundamental changes in *economic*, *political*, and *strategic* relations have resulted. The basic argument is set out below.

1. The severity of the crisis and the extent of the adjustments under way have forced most of the Asian Pacific Rim countries (except China) into a slower

economic growth trajectory. Their performance since 1997 is not just a slow recovery, but a change in their long-term growth potential.

2. East Asia's multilateral institutions performed poorly during 1997 and have become even less relevant since the crisis. Also, confidence in the World Bank's and the IMF's advice has declined. This has heightened the importance of bilateral ties within the region, increasing the influence of China, Japan, and the United States at the expense of regional organizations such as ASEAN and Asia Pacific Economic Cooperation (APEC).
3. The current U.S. focus on dealing with terrorism gives China and Japan considerable leeway to pursue their bilateral objectives in the region. China has been especially skillful at expanding its influence in Southeast Asia, most notably through its offer of a free trade area with all of the ASEAN states.
4. If the current economic growth patterns continue and the increasing salience of bilateral linkages in East Asia persists, the long-term strategic balance in the region will shift. Japan's economic slowdown during the 1990s and continued protection of its agricultural sector make it harder for Tokyo to offer trade liberalization to its neighbors (as China has done). Moreover, if China is able to contain the problems in its state-owned enterprises and banking systems while maintaining its high growth rate and modernizing its military, there is little doubt that its economic and strategic profile will be further enhanced.
5. If India can sustain its current higher economic growth rate and continues its military upgrading, then the ASEAN states, and possibly even Taiwan, might look to New Delhi as a counterbalance to China and as a supplement to a preoccupied United States.
6. *If all of these current trends continue,* then the prominence of the Asian continental powers (China and India) will rise and the *relative* importance of the Pacific Rim countries will decline.[48]

Obviously, this line of reasoning is based on a series of assumptions; if any of the principal premises is off the mark, the outcome will be different than outlined above. However, we will demonstrate below and in Chapter 4 that many of the region's governments and largest multinational businesses are already taking steps to accommodate themselves to these new economic and strategic shifts.

Thus, many key decision makers in Asia are either implicitly or explicitly responding to aspects of the above reasoning. The goal of this book is to demonstrate, with extensive quantitative support, that these trends are likely to continue.

Why Are China and India So Critical?

If this question had been asked in the early to mid 1990s, the answer would have been qualified. China's economic reforms had been under way for over 15 years and analysts were beginning to estimate the size of the Chinese economy *if* high growth rates could be maintained. There were some optimistic projections, but there was no consensus that China could sustain its rapid growth.[49] A decade later, after China has had 25 years of impressive performance, there are fewer reservations about China's potential. Also, since it is now clear that the Chinese government has systematically understated the country's GDP and growth rate, the resources available to the government, for any use, are greater than previously assumed.

With China now the fourth-largest economy in the world and the second-largest recipient of FDI, there is no question that the leadership in Beijing has the economic base to move from regional power to major-power status. Will China choose that route? No one can forecast this precisely, but there is ample evidence to suggest that it will.

Chinese government officials speak openly about being realists; many of Beijing's policy intellectuals do not like the term "peaceful rise," because it implies hesitancy to use force (which many claim will be necessary in dealing with Taiwan); and China has ambitiously built up its military power over the past decade, all of which suggests a strong preference for being a major power.[50] Thus, a broad spectrum of "China watchers" assumes that the PRC has both the will and the ability to become a major power. President Hu Jintao's government has decided to avoid controversy by dropping the term "peaceful rise" and replacing it with "peaceful development."

Few analysts even raised these issues regarding India in the early 1990s. Shortly after India exploded its first nuclear weapon in 1974, there was a spate of interest in India as an emerging power.[51] Yet, India's economic performance in the 1970s and 1980s was desultory, and the government remained so committed to controls and centralized economic management that the rate of modernization and technical innovation was low. Hence, in that period, India had the hypothetical prospect of being a major power but appeared far away from achieving it.

However, in the 16 years between 1990 and the present, several key changes occurred that transformed India's options. Not only did India turn toward more open economic policies, which accelerated its growth, but its science and engineering capabilities expanded enormously, which strengthened its military technology.[52] In addition to India's nuclear weapons, its growing expertise in software facilitated the development of more accurate conventional weapons. These steps, combined with a growing navy and active missile and space programs, put India well on the way to projecting power beyond the subcontinent. Moreover, with the economy expanding at 6–7 percent per year since 2000, both the Bharatiya Janata Party (BJP)-led and Congress-led governments have raised overall defense expenditures at more than 12 percent per year.[53]

During the 1990s, the Clinton administration's attention to the subcontinent was directed primarily at efforts to dissuade India and Pakistan from testing and developing nuclear weapons.[54] Since India already had a nuclear capability, the U.S. goal was to persuade New Delhi that proceeding further with the tests was unnecessary and destabilizing. With Pakistan, the United States hoped to discourage Islamabad from proceeding with its nuclear plans by offering conventional weapons and putting pressure on China to not supply missile technology and parts.[55] However, none of this was successful.

When India went ahead with its nuclear explosions on May 11, 1998, and was followed seventeen days later by Pakistan's nuclear tests, U.S. relations toward the subcontinent had to change.[56] President Clinton gradually gave up his emphasis on nonproliferation and had a very successful weeklong visit to India in 2000. The George W. Bush administration came into office determined to have a closer working relationship with India.

Ironically, as we will see in Chapter 5, the 9/11 attacks and President Musharraf's decision to support U.S. operations in Afghanistan made it possible for the United States to develop closer relations with *both* India and Pakistan from 2002 onward. Although the Next Steps in Strategic Partnership (NSSP) with India initially proceeded slowly, New Delhi no longer preserves its classic " nonaligned" stance: during 2005–2006, it openly discussed a broad range of military-to-military programs with the United States.[57]

More importantly, the July 18, 2005, agreement between President Bush and the Indian prime minister Manmohan Singh, to facilitate cooperation between the United States and India on civilian nuclear technology, is an explicit acknowledgment that the Bush administration accepts India as a friendly nuclear state. For the U.S.-Indian agreement to be implemented, Congress had to amend the Non-Proliferation Act. Many view this step as having undercut a generation of nonproliferation efforts. Nevertheless, the Bush decision to proceed in these agreements with New Delhi is an indication of India's rise to major-power status and the potential for strategic cooperation between the United States and India in the future.

The United States is carrying out a delicate balancing act in South Asia, as it appears intent on maintaining a close working relationship with Pakistan at the same time that it draws closer to India. In 2004 Secretary of State Powell designated Pakistan a "Major Non-NATO Ally" of the United States. Also, there is no doubt that the United States needs Pakistan's cooperation in its hunt for al Qaeda and Taliban leaders on the border areas between Afghanistan and Pakistan. Yet, there is growing evidence that Pakistan is not honoring its commitments to expel al Qaeda operatives and that it may actually be aiding the Taliban. This led President Bush to invite Presidents Musharraf and Karzai together to the White House, in September 2006, to discuss how to establish effective cooperation.[58]

Thus, in the decade from 1995 to 2005, both India and China have moved from being solely regional powers to having substantially enhanced their economic and military prominence. Both states give every indication that they will move to major-power status in the decade ahead.

The Impact of the 1997 Financial Crisis on Regional and Global Institutions

The 1997 crisis and its aftermath also weakened both regional and global multilateral institutions.

The impact on the World Bank and the IMF has been hard to measure, but there have clearly been two major developments: (1) advice from the two institutions is now less influential than it was before 1997, and (2) many governments are now hesitant to enter into new agreements with either organization.

As noted, during the early 1990s private capital was widely available, but the World Bank and the IMF were able to leverage their influence because commercial banks, insurance companies, and investment banks would often link their funds to the recipient government compliance with terms of multilateral lending.[59] At the height of the confidence in the "Washington Consensus," this seemed like a choreographed script: the multilateral institutions would negotiate their terms, and a successful negotiation would often be followed by private flows that were frequently two to ten times larger than the public funds.

The disillusionment with the World Bank and the IMF was on both sides of these transactions. The recipient governments were deeply disappointed because they felt that the multilateral institutions would help them more during the crisis. There was further dissatisfaction because many concluded that the IMF's advice to close banks and follow a contractionary policy ended up making the crisis worse.[60] On the private capital side, there was dismay that the multilateral agencies had not signaled the extent of the problems *inside* the borrowing countries and that there was *no warning* that a collapse was in the making.

As a result, the Washington Consensus carries less weight, short-term capital fled the riskiest of the Asian states, and it took almost five years for the flows of FDI to make a significant return to Southeast Asia.[61] The one main exception to this pattern of recovery is Indonesia, where inflows were $7–8 billion per year before the crisis, and in 2000–2003, there was still a net outflow (causing the government grave problems and lowering prospects for future employment and productivity growth).[62] Indonesia did not get net positive inflows of FDI until 2004—seven years after the 1997 financial crisis.

Under these circumstances, it is not surprising that East Asian governments have been hesitant to enter into new agreements with the multilateral agencies. For example, Thailand quietly told the World Bank to phase out its mission and has repaid its IMF loans earlier than was necessary. Malaysia openly boycotted the IMF during the crisis, while the Indonesians publicly celebrated the termination of their borrowing agreement with the IMF: authorities in Jakarta no longer seek broad-ranging advice from the IMF.

On its part, the IMF now has less influence with the private sector, because it has decided to press for substantial debt write-offs. Should such a program go into effect, it would have a major negative influence on private bank and insurance company profitability. Moreover, it would make many private sector firms suspect IMF intentions if, in the future, the IMF came back to encourage private investment in developing countries.[63]

Therefore, the crisis has severely tarnished the Washington Consensus, and the most important global lending institutions wield less clout than they did in the 1990s. The multilateral lenders are still important, but governments in East Asia, especially, have been looking for alternative sources of capital and advice. One tactic has been to run trade surpluses and build up government-controlled foreign exchange reserves.

The largest source of new funding, however, is private capital markets, which have expanded dramatically since the mid-1990s. World private financial accounts (equities, private debt, and bank deposits) have grown from $56 trillion in 1996 to $113 trillion in 2004.[64] Therefore, the World Bank and the IMF are relatively smaller players in an expanding range of financial options.

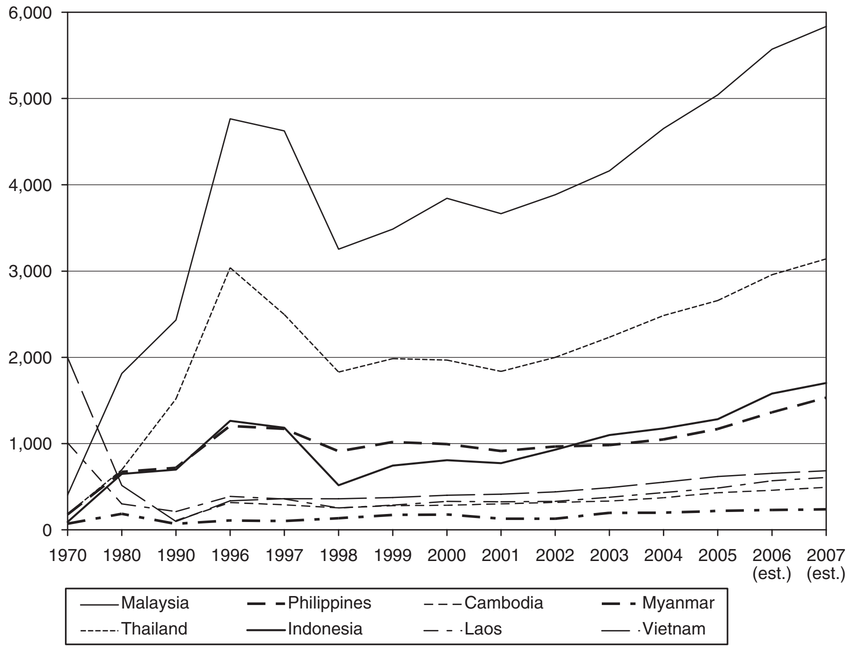
The 1997 financial crisis might have led to a growing prominence for regional institutions within Asia, but, for several reasons, it has not. The two most visible Asian regional organizations in the early 1990s were ASEAN and APEC, but neither of them proved to be significant when the crisis of 1997 enveloped the region.

ASEAN was started in 1967 as a means to reduce tension *among* the largest Southeast Asian states, and it succeeded admirably at that goal. The Thai and

Indonesians took a strong interest in having ASEAN develop a cooperative manner of interaction between the principal noncommunist states of Southeast Asia. Although ASEAN was not a military alliance, there was a tacit understanding that the original members were pro-Western and market oriented and wanted to preserve their autonomy.[65] This was achieved by the mid-1980s and led to more ambitious goals. The ASEAN Free Trade Area (AFTA) was launched to create greater economic integration; the ASEAN Regional Forum (ARF) was created to discuss security issues and to permit dialogue with major powers outside the region; and, most importantly, ASEAN was eventually expanded to include all ten states in Southeast Asia.

Although there was considerable initial enthusiasm about the expansion to include Vietnam, Laos, Cambodia, and Burma (Myanmar), it soon became apparent that the income and level of development of the newly admitted states made it hard for them to participate effectively in ASEAN economic or diplomatic interaction.[66] Figure 1.4 illustrates the enormous differences in per capita income within ASEAN. Singapore has a per capita income higher than that of many European countries; only Thailand and Malaysia are middle-income countries, whereas Indonesia and the newly admitted states are poor.

Because of size, in both geography and population, Indonesia was long the cornerstone of ASEAN. Yet, because it was particularly hard-hit in the crisis of 1997



Note:
Singapore reached a per capita income of $12,091 in 1990 and $23,077 in 2000.

Source:
IMF, The World Economic Outlook (WEO) Database, September 2006.

Figure 1.4 Southeast Asia: per capita income.

and was, simultaneously, experiencing a collapse of the 32-year-old Suharto Regime, it could no longer lead ASEAN. This meant that ASEAN experienced a double shock: (1) economic turmoil, and (2) expansion to include four low-income states with limited links to the global economy.

Although ASEAN has regained some momentum in the last year through dialogues created by the ASEAN Regional Forum (ARF) and specifically ASEAN + 3 (which includes China, Japan, and South Korea), there has been considerable disappointment with the inability to create a more cohesive grouping in Southeast Asia. Despite the press attention that ASEAN + 3 has achieved and the fact that it is nominally a multilateral dialogue, because it has Japan and China competing for influence, the process has actually emphasized *bilateral* ties to outside powers, rather than the multilateral functioning of ASEAN as a regional group.[67]

If we turn to the regional economic institutions, we have an even more limited track record. APEC holds a very successful annual meeting for heads of state that brings international attention to Asia and provides an occasion where presidents and prime ministers can engage in useful dialogue. Yet, APEC's goals (of free trade and investment flows within Asia) cannot be achieved by discussions among Asian states or those on the Pacific littoral. The World Trade Organization (WTO) is the only venue where brokerage over trading rules can encompass European, American, and Asian interests. APEC is thus increasingly becoming a formality.

What is happening within Asia is a competition for access to the Chinese and Japanese markets. China has offered a free trade agreement (FTA) to link its market with all of ASEAN and has gotten agreement from the ASEAN states by opening its market first and not expecting full reciprocity from the Southeast Asian states. Japan is proposing a series of bilateral FTAs with particular states with whom it wants to encourage closer ties. An FTA between Japan and Singapore has been agreed upon. Nevertheless, Japan's constraint is that it wants to continue to protect its agricultural market, and thus it will not offer FTAs to countries with efficient agricultural sectors. China has gotten the diplomatic initiative by completing its agreement with ASEAN and going farther to propose an FTA for *all of East Asia*.[68]

The impact of these potential FTAs will be analyzed in Chapters 3 and 4. Meanwhile, it is interesting to note that 30 years of negotiation about economic integration within ASEAN produced limited results, but the financial crisis stimulated the Southeast Asian countries with impaired credit to trade with one another.

In Table 1.3, we see that between 1981 and 1995 intra-ASEAN trade grew at about the same rate as trade with Europe and the United States. Whereas between 1995 and 2000, imports from Japan and Europe actually fell, imports from the United States remained essentially constant and those from *inside Southeast Asia* grew by almost 41 percent. This means that after 1997 many ASEAN states chose to import from one another, because they were only marginally creditworthy and had access to limited trade finance, when in the past they preferred American and European goods. Obviously, this is a form of economic integration, but it was not due to efforts of the ASEAN Free Trade Area per se.

There is one additional regional organization that bears watching: the Shanghai Six, formally known as the Shanghai Cooperative Organization (SCO). This was set up in the early 1990s by China as a means to strengthen Beijing's political ties in Central Asia, while encouraging a more cooperative relationship with Russia.

Table 1.3 ASEAN imports from main destinations (millions of U.S. dollars)

	1981	1990	1995	2000	2001	2002	2003
European Union	10,112	25,025	52,285	39,310	40,818	40,061	46,009
United States and Canada	10,963	25,193	52,845	52,628	50,125	48,454	51,906
Japan	16,623	37,767	86,115	69,796	57,988	58,368	62,855
Other Asia	17,043	48,939	120,749	151,346	138,703	158,324	198,870
ASEAN	10,509	24,846	65,919	82,930	74,120	80,892	105,324

Note: The Other Asia does not include Singapore, and therefore there is double counting between Other Asia and ASEAN, but the exact extent of the double counting is not presented here, as it requires netting out all trade with Singapore, which is counted as a developed country.
Source: UNCTAD Handbook of Statistics On-line. http://stats.unctad.org/handbook/ReportFolders/ReportFolders.aspx?CS_referer=&CS_ChosenLang=en

At its initiation, Beijing also saw the SCO as an indirect means to alert the United States that too much pressure from Washington might drive Russia and China closer together.

In that period, Russian policy was uncertain because democratization was only gradually taking hold, and it was unclear if leaders in Moscow would favor joining with China against the West or whether they would, instead, court the trade, capital, and technology that they could get only from the West.[69] Beijing sought close cooperation with Moscow because the Central Asian Republics were all former Soviet states and Russia could derail or stymie China's overtures if it so chose.

Since the attacks on the World Trade Center and the Pentagon on September 11, 2001, both China and Russia have decided to downplay competition with the United States—so an anti-U.S. coalition is not a current goal of either Moscow or Beijing. Yet, both states have this organization in reserve if relations with Washington turn in a less cordial direction. Thus, the Shanghai Six is by no means dormant. It provides a subtle way for both Moscow and Beijing to court the Central Asian Republics. For example, in July 2005, when China orchestrated an SCO statement calling for the withdrawal of U.S. forces from Central Asia, this move enhanced China's status in Central Asia. It also improved Beijing's position in much of the Muslim world, which has become increasingly skeptical of the merit of the U.S. presence since the start of the Afghan War in 2001.

The newest regional grouping in Asia is the East Asian Summit (EAS). This organization includes all the members of ASEAN + 3 and in addition India, Russia, Australia, and New Zealand. The United States was intentionally excluded by member states, which wanted the EAS to be autonomous from American influence. The EAS had its first summit in Kuala Lumpur in December 2005. Many of the ASEAN states claimed that the meeting was a success. The group did agree to hold all summits in Southeast Asia and established a secretariat there. Nevertheless, there was no agreed set of priorities for future activities, and it is too soon to know if the EAS will be an effective organization.

The Strategic Impact of the 1997 Crisis

As outlined above, the greatest strategic beneficiary of the 1997 crisis was China, with India being a close second. Both states had controls on their capital markets, and neither experienced an economic debacle. Both have the intention of becoming world powers, and both have used the intervening years to woo future potential allies.

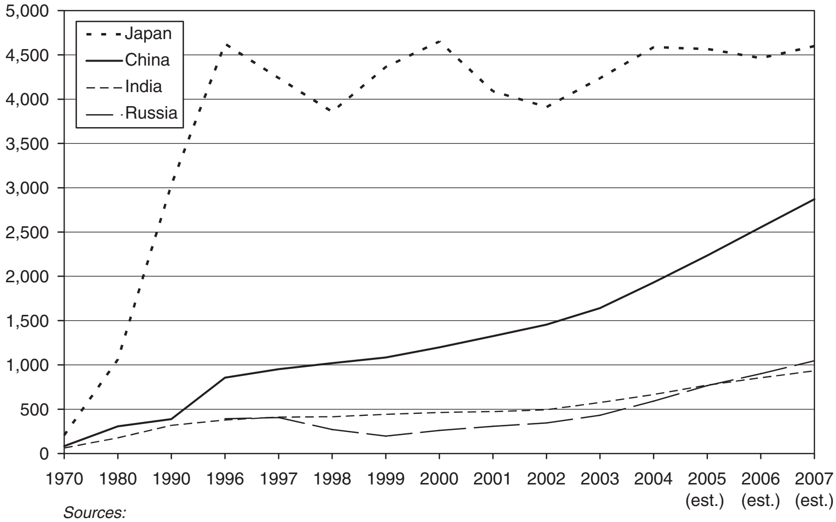
In Northeast Asia, although Japan has the largest economy, its economic doldrums during the 1990s and its ambivalence about playing a larger geopolitical role make it an uncertain player in great power politics. Under Prime Minister Koizumi, Japan played a support role for the allies in Afghanistan, sent noncombatant troops to Iraq, and used its navy to help with disaster relief for the 2004 tsunami victims. All of these actions are signs of a more vigorous international profile for Japan. What is unclear is whether this indicates a basic change in Japanese preferences about international involvement or, more narrowly, the views and efforts of a particular activist prime minister. Prime minister Shinzo Abe wants to continue these policies, but has low public approval ratings.

Moreover, Koizumi's decision to continue to visit the Yasukuni Shrine, where the remains of some World War II war criminals are interred, has deeply antagonized the South Korean and Chinese populations. During the summer of 2005, Koizumi's Yasukuni visit led to widespread riots in China and rising tensions between Beijing and Tokyo. His persistence in these symbolic visits, which were designed to appeal to the far right of the Japanese political spectrum, has limited Japanese diplomatic options and made it less feasible for Japan to play an enhanced role in East Asia's security.

In September 2006, Shinzo Abe succeeded Koizumi as prime minister and shortly thereafter made high-profile trips to Beijing and Seoul. Although there was no explicit public statement about this, presumably he would not have been invited for these visits if he had not let the Chinese and South Koreans know, in advance, that he was going to take a more conciliatory stance toward them than Koizumi had. Yet, after the North Koreans exploded their nuclear weapon in October 2006, the Japanese public faces a serious security threat, and there will be a major debate inside Japan about whether to develop nuclear weapons. This debate and subsequent decisions could reraise tensions between Japan and its neighbors.[70]

China has essential advantages: size, geography, a surging market attractive to exporters and investors, and, recently, skillful diplomacy. See Figure 1.5 for GDP comparisons of the major Asian powers. Also, China's leadership is not seriously constrained by public opinion and is quite willing to intervene internationally if it advances China's interests. Russia's reduced strategic role reflects the breakup of the Soviet Union in 1991 and the subsequent economic decline and internal turmoil. It is also worth noting that Russia experienced a serious financial crisis in 1998, similar to the East Asian collapse in 1997. However, as oil and gas prices soared in 2004–2006, Russia's prospects improved significantly. With a higher GDP growth rate, rapidly rising foreign exchange reserves, and a conviction that it could bargain for political influence from energy sales, Russia renewed its efforts at playing a great power role in East Asia.

In Southeast Asia, India has more chance of competing because it is closer to the scene and because there is foreboding about China's long-run intentions. Yet, it must be noted that China has been playing an extremely successful diplomatic hand since 1997. For example, on South China Sea issues, Beijing started in the 1970s and 1980s with a very aggressive strategy: attacking the Vietnamese in 1974 in the Paracel Islands and attacking them again in 1988 at Fiery Reef. This created a deep resentment of Beijing's tactics and facilitated cohesion within ASEAN during the



Sources:
IMF, The World Economic Outlook (WEO) Database, September 2006;
Chinese National Bureau of Statistics.

Figure 1.5 GDP Comparisons of Major Asian Powers.

period when the Southeast Asian states saw themselves as cooperating to form a grouping somewhat like the European Union.

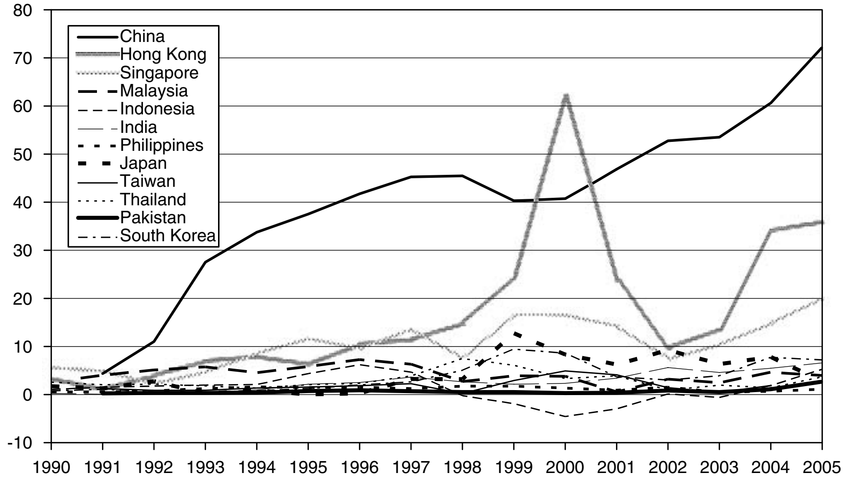
Once the 1997 crisis hit and the ASEAN states realized that they were going to get limited funds from the multilateral financial institutions, they were far more willing to bargain directly with outside powers. China offered a $1 billion aid package to Thailand and began to pursue a much more conciliatory strategy on South China Sea territorial issues.[71] Although Japan offered the most aid of any donor (in the Miyazawa Plan of 1998), Tokyo's ambivalence about being involved in great power politics has made many of the ASEAN states uncertain about whether they can count on Japan in a military crisis (as distinct from an economic one).[72]

Considerable effort has been put into developing large foreign exchange reserves and means for currency swaps during crises. The Chiang Mai Initiative, to formalize agreements for Asian central bank cooperation on currency swaps, has moved forward and will be discussed in Chapter 3.

China has another enormous advantage at present: because of its massive population and economic boom during the past 23 years, foreign investors are convinced that they have no choice but to get established in China before consumer tastes are shaped and the economy matures.

As Figure 1.6 illustrates, China has been getting over $30 billion in FDI every year since 1993. China's FDI rose to about $48 billion annually in 2002 and 2003 and still higher to $61 billion in 2004. This means that much of China's capital stock is new and efficient, that the country can benefit from first-rate technology, and that it can compete with other Asian states that industrialized earlier.

All of this has important strategic implications. Since future warfare for major powers will certainly depend on mobilizing massive resources and high levels of technology, China will be able to move into the first tier of military capabilities if its



Source:
UNCTAD Handbook of Statistics On-line.

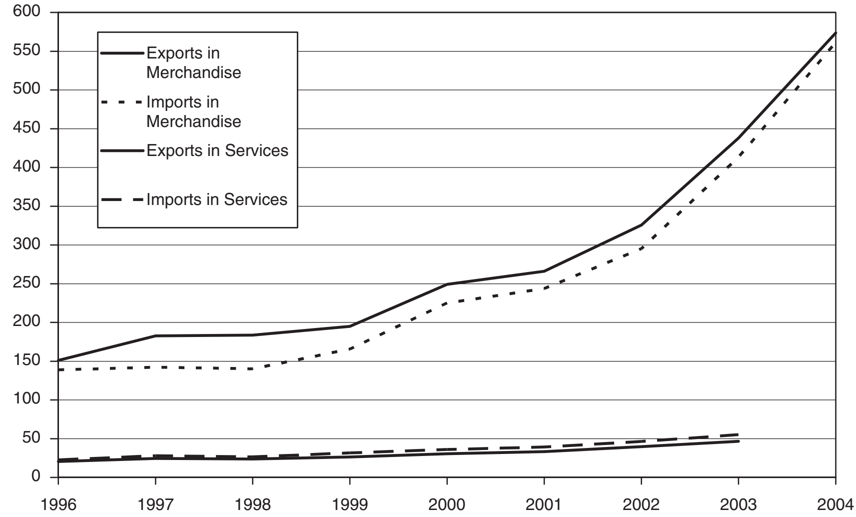
Figure 1.6 Inflows of FDI.

leadership so chooses. In Chapter 5 we will analyze the prospects for military competition in Asia and deal in detail with directions that the major powers could plausibly take. Yet, for our purposes here, starting with the economic foundations, China's momentum *versus* the tribulations of the Pacific Rim states creates the possibility of a major change in the strategic balance.

India has a number of important advantages over China: widespread domestic use of English among the educated, a truly first-rate scientific establishment, a larger number of overseas professionals working in high-tech jobs in the West, and more experience with entrepreneurship among recent graduates. There is no inherent reason why China cannot also obtain these assets over time. However, if India chose to move aggressively to capitalize on the military aspects of its citizens' skills, it might have certain short- to medium-term advantages. In the very long term (two to four decades), India has another advantage: its population is still growing, so it will not have the dilemma of supporting an aging public as soon as China will.

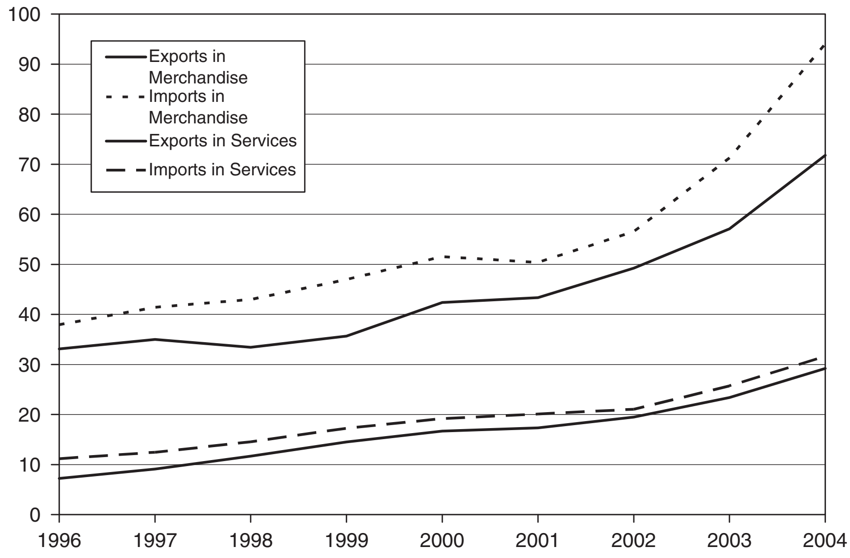
One other arena worth noting in this introduction is the role that the trade balance plays in China's and India's strategic options. As we see in Figures 1.7 and 1.8, Beijing has considerable flexibility in its strategic choices because it has been able to run a trade surplus, while doubling national income every decade. That trade surplus, combined with massive capital inflows, has allowed China to build up foreign exchange reserves of over $850 billion (excluding reserves in Hong Kong).[73] China has already begun to use those reserves to purchase high-tech military platforms from the Russians, French, and Israelis, and there is every reason to believe that they will expand this pattern over time.

India has a long history of running trade deficits and financing these deficits with remittances from Indians living abroad. Since 2000, however, India's balance of payments picture has been looking much healthier because of a sharp increase in manufactured goods exports and soaring demand for the Indian service sector. The Indian computer software business, the rise of call centers, and now the growth of



Source:
UNCTAD Handbook of Statistics On-line.

Figure 1.7 China's exports and imports.



Source:
UNCTAD Handbook of Statistics On-line.

Figure 1.8 India's exports and imports.

the "offshore" accounting and financial analysis sector are all generating buoyant export receipts. In the future, it is anticipated that further significant growth will take place in the medical diagnostic and engineering areas as well. This surge in service sector exports, combined with a pragmatic float of the Indian rupee, has allowed India to build up a foreign exchange reserve of about $130 billion by January 2006.

This cushion will permit the Indian government to sustain expenditures during economic downturns and also allow New Delhi to purchase a broader range of foreign technology and military equipment as its plans for power projection grow.

Although India has liberalized its investment regulations, its ambivalence about foreign manufacturing firms could slow the pace at which it expands its industrial base. Prime Minister Manmohan Singh has noted India's low level of FDI and has committed his government to an active effort at raising incoming investment flows with the goal of $150 billion in foreign investment by 2015. He has also urged Indian investment overseas to help assure increased supplies of oil and natural gas. Accordingly, India has been visible in its offers of assorted energy investments in Russia, Myanmar, and Iran.[74]

So far, we have focused this discussion on the impact of the 1997 crisis and its likely future impact on countries *inside* Asia. As part of the strategic discussion in Chapter 5, we will deal with Russia's role in the region, while entirely devoting Chapter 6 to U.S. policies and options.

The Structure of This Book and Its Intellectual Roots

In a book that directly discusses twenty-one countries in Asia and a broad spectrum of issues that concern them, it is not surprising to draw on a range of methods and intellectual traditions for the analysis. However, it is useful to be explicit about why the book is organized as it is.

China and India each have long and distinguished intellectual traditions established centuries before Westerners arrived in Asia. Yet, for the past 300 years, their history in the colonial era and the post–World War II period is essentially one of how these giants would modernize.

By 1950, it was clear that the leadership of both China and India had decided to choose distinctive forms of economic management that combined features of Western, market-oriented economics with centralized control. Both states limited FDI, both used a central plan, and, for four decades, neither had stellar economic performance.

Japan, on the other hand, recovered from the effects of World War II to the point where, in the late 1980s, some observers were anticipating a "Pax Nipponica."[75] By the mid-1970s, Taiwan, South Korea, Hong Kong, and Singapore had each followed in Japan's wake, and by the 1980s, the more market-oriented states in Southeast Asia followed suit.[76] This led to the focus on the "East Asian Edge" or "Pacific Rim" states as the ones that were agile and modern. In that period, China and India were seen as laggard.

China started its economic reforms in 1979, whereas India had alternating periods in the 1960s and 1980s when reforms were tried and then discarded. It was not until 1991, however, when India faced a major balance of payments and fiscal crisis, that market-oriented policies got the upper hand. So, by the end of the 1990s, though China had a decade's lead, both New Delhi and Beijing were committed to a substantial opening of their economies.

It was just in this period when the Pacific Rim states stumbled. In 1990 and 1991 Japan experienced its stock market and real estate collapse, and, as we have discussed, in 1997 South Korea and the Southeast Asian states experienced their worst economic crisis since the Depression of the 1930s.

This was exactly the moment when the stars rose for China and India. Although both states had opened their economies and were encouraging greater trade, they still retained capital controls and managed their currencies. Thus, neither China nor India experienced the collapse that occurred on the Pacific Rim. These circumstances gave both China and India the opportunity to capitalize on the weaknesses of the other Asian states that had looked so promising in the 1970s to the 1990s.

Yet, this book is not just about economic trends. China and India are both continental-sized states with proud historical traditions, and their respective leaderships want to have wide international recognition. Although their diplomatic styles vary and their ways of expressing their interests are quite different, leaders in both Beijing and New Delhi have high ambitions.

Hence, this book starts with an economic focus, which is necessary to explore the basis for the current Asian realignments, but we then turn to foreign policy and geopolitical issues. Nevertheless, it is essential to understand that neither China nor India could be entertaining great power ambitions without *first* having transformed its economy. Because of their currency controls and remaining skepticism about a truly open economy, both states, fortuitously, avoided the 1997 financial swoon.

So, the ascent by China and India has allowed them to return to the relative position they occupied in the 1950s, before the Pacific Rim states eclipsed them.

This book draws extensively on *empirical* studies of East and South Asia and theoretical work from two principal areas: development economics and realism.

The basic intent is to demonstrate that the rapid economic growth, which has transformed East Asia since the 1970s and is beginning to bring similar changes to South Asia now, has produced potentially contradictory trends:

1. Economic ties within Asia are closer and more extensive than at any time in the past, and yet,
2. There are obvious preparations for strategic rivalry throughout Asia.

Hence, this book will draw on an eclectic mix of literature to explain how economic ties could be getting *closer* at the same time that strategic rivalry is being planned.[77]

DEVELOPMENT ECONOMICS

Market-oriented development economics in the 1960s and 1970s focused on savings rates, investment rates, incremental rates of return, and maintenance of economic growth. The Cold War was the strategic setting in which competition between Western and Marxist economic ideas was played out, but the mainstream Western development economics was, essentially, divorced from strategy. For example, Everett Hagen's *Economics of Development,* one of the leading texts of the time, did not even mention strategic issues.[78]

By the 1980s and early 1990s, the political context for development choices was more explicitly expressed in the Washington Consensus discussed earlier. There was broad agreement among Western economists on the policy prescription favored for most low-income countries. If a country was willing to follow the formula, it was far more likely to get assistance from the World Bank and the IMF. With the imprimatur of the "Bank and Fund," governments could then improve their chances of getting private bank lending and increased flows of FDI.

Obviously there were some variations in policy choice among the countries that accepted the Washington Consensus. In Asia, Thailand and Indonesia had the most open capital markets, Singapore had completely free trade but some capital controls, Malaysia had assorted trade barriers and an industrial policy, and South Korea was generally more protectionist than the Southeast Asian states.[79] Nevertheless, there were some areas, such as export orientation and budgetary prudence, where the Washington Consensus was followed closely by the market-oriented Asian states.[80]

After the 1997 financial crisis, however, there was a sharp change in views among Asian policy makers. They noticed that China and India, which had (and still have) tight controls on capital flows, were able to weather the crisis better than the countries with open capital markets. It also became apparent that liberalization of goods and service markets had potentially drastic effects if domestic institutions were not sufficiently robust to stand the impact of heightened volatility and competition. Moreover, because growth had been so rapid, especially between the mid-1980s and mid-1990s, few policy makers anticipated the risks they were facing with following the Washington Consensus.

So, although there was no uniformity in the response to the 1997 crisis, it is fair to say that Asian economic policy makers have been exploring a range of post–Washington Consensus options. In Chapters 2 and 3 we will analyze the severity of the 1997 crisis and the implications of the slow recovery, as well as note significant changes in economic policies. Our discussion will link the new directions being explored in Asia with related adjustments in the theoretical literature.

On merchandise trade, many assumed fixed ratios of capital, technology, land, and labor among trading partners, while the joint gains were achieved through specialization.[81] What has been happening in East Asia, especially in the past decade, is a much more dynamic process where design of products may take place in several locations, parts fabrication also comes from multiple suppliers, while final assembly can be in still another location for sale within or outside the region.[82]

East Asia now has many countries for product design and many locations for parts fabrication, but only one with the lowest costs for assembly: China. Although wages in Indonesia and Vietnam are lower, China now has an impressive infrastructure (communication links, ports, rail lines, and highways), which makes the speed and total cost of assembly the lowest in East Asia.[83]

Thus, recent trends have created a pattern where the middle- and higher-income countries on China's periphery (South Korea, Japan, Taiwan, Malaysia, Singapore, Thailand, and Indonesia) are linked like spokes of a wheel to China. Rapid shifts back and forth in leadership among those states where design and fabrication of parts takes place are also a new development. For example, Samsung Electric and LG, both Korean companies, are now the second and fourth leading producers of cellular phones, while Taiwan Semiconductor has become a major innovator in specialty computer chips.[84] These changes have reduced the role of the United States as the orchestrator of the product cycle, although the American market remains the principal export destination for assembled items.

Strategic Rivalry

The waning confidence in the Washington Consensus as a set of guidelines for economic policy and the reduced role of American firms in shaping the agenda for product development in East Asia provide the setting in which long-term strategic decisions are now being made.

Although the United States is the world's only superpower and is likely to have a military lead over any potential rival for at least another decade, the Iraq War has become a quagmire, and even a state that is primus inter pares cannot succeed at dominating in every arena.

One possibility is that the United States will continue to provide security guarantees in an arc from South Korea to Thailand, while accepting a gradually reduced place in the region's economic activity. At some point, however, the American public and then the Congress will ask the question, Why should U.S. citizens pay to defend Asia, when American economic interests are playing a diminishing role in the region?

There is also a very real possibility that leaders in China, Japan, and India will, on their own, decide that their respective countries need to play a larger role in Asia's security. The East Asian Summit process may be an early indication of this tendency. If this drive for autonomy grows, the American dominance will be challenged from within Asia.

The three principal schools of international relations theory (realism, liberal internationalism, and constructivism) each provide a coherent way to approach the uncertainty ahead in Asian security relations.[85] Liberal internationalism highlights the role that trade and foreign investment could play in creating constituencies throughout the region that focus on limiting rivalry—so that economic gains can be sought.[86] Constructivism, with its emphasis on changing the values of the elite in Asia, also provides a perspective that warrants attention as we proceed.[87]

Nevertheless, it will be argued here that realism and its related subfield, geopolitics, are the most insightful theoretical perspectives for analyzing the coming realignments in Asia.[88] Why is a realist perspective persuasive?[89]

First, the governing elite in China openly acknowledge that they are realists.[90] The leaders in Beijing are not embarrassed about it and state that because they are realists, China will not try to project its power before it can do so with certainty.[91] Views among the elite in Tokyo and New Delhi are more diverse than in Beijing. These differences will be discussed in Chapter 5.

Yet, it is worth noting that Prime Minister Koizumi began to lay the basis for an expanded Japanese security role in Asia. Koizumi encouraged closer defense cooperation with the United States, and in 2005 he openly acknowledged that preserving peace in the Taiwan Strait was an important goal for Japan.[92]

In India's case, although Prime Minister Singh comes from the political left (which previously espoused various forms of " nonalignment" and cooperation with the Soviet Union), he has been bold in pursuing "strategic cooperation" with the United States. This has culminated in his visit to Washington in July 2005 and President Bush's visit to India in February 2006. It is too soon to know if the Nuclear Cooperation Agreement will be implemented, but there is no question that the political center in New Delhi has shifted to the right and that India is now openly considering various types of outside ties to strengthen its security position.[93]

Second, despite rapidly growing trade and investment ties within Asia, which liberal internationalists expect will reduce tensions, there are clearly visible signs of strategic rivalry between China and Japan.[94] Both countries are proceeding with missile development and satellite programs, both are purchasing and building larger and more sophisticated naval vessels, and both are upgrading the quality of their air forces. For its part, India already has a high-performance air force and a massive army, and its two aircraft carriers indicate the intent to project naval power. India also has a host of short- and medium-range missiles to go with its nuclear force.[95] Hence, a realist view of Asian states seeking security through expanding their military capabilities appears to be a compelling explanation.

Third, there is no organization *within* Asia now, or on the near-term horizon, that could truly provide regional security as NATO has done in Europe. We will explore this issue in depth in Chapter 4, but under current circumstances, no country is willing to directly challenge the United States, and those that depend on it are not willing to transfer their loyalties until they see a viable alternative.[96]

Fourth, the historical legacies of conflict in Asia make the task of leaders who want cooperation extremely difficult. There is certainly no shortage of political figures who are willing to directly manipulate antagonistic feelings toward neighbors. Chinese and Korean resentment toward Japan is well documented, Vietnamese fears of China have a long history, Singapore has worries about Malaysia and Indonesia, and many Indians are still resentful of their loss to China in the 1962 Border War.[97] These memories mean that it is far easier to construct national or subnational identities than to get cooperation for Asia-wide organizations.

For these reasons, it will be argued that a realist perspective is the best guide, at the moment, to strategic behavior in Asia. It is also worth noting that both Indian and Chinese strategists are influenced by geopolitics.[98] It is useful to introduce geopolitics here because we use the term "Continental Powers," and part of the significance of China and India is that they control such massive land areas. The intent, however, is not to focus exclusively on land, because, as we have discussed, both Beijing and New Delhi have growing air and naval forces to help them assert control on key continuous areas. Geopolitics is helpful precisely because it puts control of key transit points and sea-lanes at the hub of its analysis.

In 1944 Nicholas Spykman summed up the central elements in geopolitics by stressing that major powers are responsible for securing themselves and for preventing hostile states from controlling, often distant, areas that have needed resources or a vital location:

> The United States must recognize once again, and permanently, that the power constellation in Europe and Asia is of everlasting concern to her, both in time of war and in time of peace . . .
>
> We shall continue to depend primarily on our own national strength, for we know that the failure of a great state to consider power means its eventual destruction and conquest.[99]

Although policy makers in Beijing and New Delhi would not set out their goals as bluntly as Spykman did, there is little doubt that both China and India intend to dominate their respective peripheries. This is a central reason why India finds

Pakistan to be such a thorn in its side. Also, despite current public displays of amity between Beijing and New Delhi and agreement on resolving border disputes, dominance in the Indian Ocean and contests for influence in Pakistan, Bangladesh, Myanmar, and Central Asia are all likely to be a basis for long-term tension between the two giants.[100] Thus, a clear sense of the geopolitical aspects of realignments in Asia is essential to this book.

In Sum

This book has three parts: an assessment of economic changes since 1997 and their implications, analysis of why the regional institutions in East Asia are being eclipsed, and an explanation of strategic realignments that are under way. It attempts to explain why the 1997 financial crisis was a transforming event and why Asia is not following the European model of economic cooperation that leads to political integration. In fact, it appears that East and South Asia are developing their own distinctive form of linkages based on ties between the continental powers and the smaller, more vulnerable peripheral and island states.

CHAPTER 2

WHY WAS THE 1997 CRISIS SO SEVERE?

INTRODUCTION

START OF THE CRISIS

There is broad agreement among economists on what triggered the financial crisis in Thailand on July 2, 1997. As Thai exports sagged, imports surged, and official reserves dwindled, the government of Thailand tried to maintain the exchange rate between the baht and the U.S. dollar at an unrealistic level. This might have been a relatively routine situation, warranting a currency devaluation and modest changes in the Thai economic policy.

However, it soon became clear that there were other circumstances that quickly complicated a response: the Thai financial sector was highly leveraged and poorly regulated; the Thai government had encouraged the creation of thinly capitalized "finance companies" to provide competition to the commercial banks, but many of these firms took excessive risks; local entrepreneurs had counted on a fixed exchange rate and had borrowed large quantities of foreign currency on a short-term basis to fund long-term projects; an extraordinary "bubble" had developed in the Thai real estate market because of overinvestment in residential and commercial properties; and it was gradually revealed that the Central Bank of Thailand had falsified its data on official foreign exchange reserves. Because Thailand had liberalized its currency and capital markets and investors could sell at least part of their Thai assets, they did. The short-selling of the Thai currency and the avalanche of equity sales led to the plunge in the baht and the start of the financial crisis of 1997.[1]

Three principal theoretical models are widely used in explaining the start of financial crises. These models focus on specific circumstances, but, as we will see, any one country can face multiple difficulties and have a range of causes for its distress.[2] The first and most common cause is an *unsustainable macroeconomic policy*, where overly expansionary monetary or fiscal policy or a misaligned exchange rate leads to a loss of foreign exchange reserves and a serious loss of confidence in the country's direction.[3] A second and more complex situation to analyze is when a country's economic condition is subject to sufficiently different assessments, where foreign and domestic investors and even government officials are uncertain what would be a stable exchange rate level. This condition of *multiple equilibria* creates market instability.[4] A third cause, which has gotten a great deal of attention in the last decade, is *moral hazard,* where governments or international financial institutions use resources (foreign exchange reserves, loans, or guarantees) to continue an unsustainable policy.[5] In this latter case, it is just a matter of time, until there is a major correction.

As we explore the Thai situation and the circumstances of the other countries most adversely affected in 1997 (Indonesia, South Korea, and Malaysia), we will see that each country had multiple problems and that each of the theoretical models above is useful in our discussion.

Spread of the Crisis

As the Thai currency and stock market collapsed (both losing over 40% of their value in 2 weeks), the initial reaction in East Asia was surprise but confidence that the crisis would not spread. Many observers looked at the basic macroeconomic data for East Asia and concluded that Thailand was the exception. The World Bank's volume *The East Asian Miracle* had stressed how "orthodox" macroeconomic policy was in the region.[6]

If we look at Table 2.1, we note that Indonesia, Malaysia, the Philippines, and Singapore all ran budget surpluses in 1996 and 1997. In addition, these countries had conservative monetary policies and high savings rates. Thus, if one analyzed the Latin American crises of 1982 and the Mexican crisis of 1994 (where there were large fiscal deficits and irresponsible monetary policies), the Asian situation seemed quite different.[7] In fact, if one focused predominantly on budget deficits, it would appear that Southeast Asia was in good shape and Northeast Asia and South Asia had bigger problems. See Figure 2.1 for a comparison of Northeast Asian and South Asian fiscal data. It is significant that China, Japan, India, and Pakistan all ran major budget deficits in 1996 and 1997, yet did not have financial crises.

Yet, as quickly became obvious, the 1997 financial crisis was *not just* about deficits and government spending; it was mostly about volatility and vulnerability in the private sector and the interaction between private financial flows and public responses. Although Japan was (and still is) running enormous fiscal deficits, it had massive foreign exchange reserves and extremely high levels of personal savings; thus, its currency and financial system were less vulnerable than those in Southeast Asia.[8] China, India, and Pakistan looked lax in their budget deficits, but each had currency controls and highly regulated capital markets; hence, they too were insulated from the panic selling that started in Thailand and then hit Indonesia, Malaysia, and finally South Korea.[9]

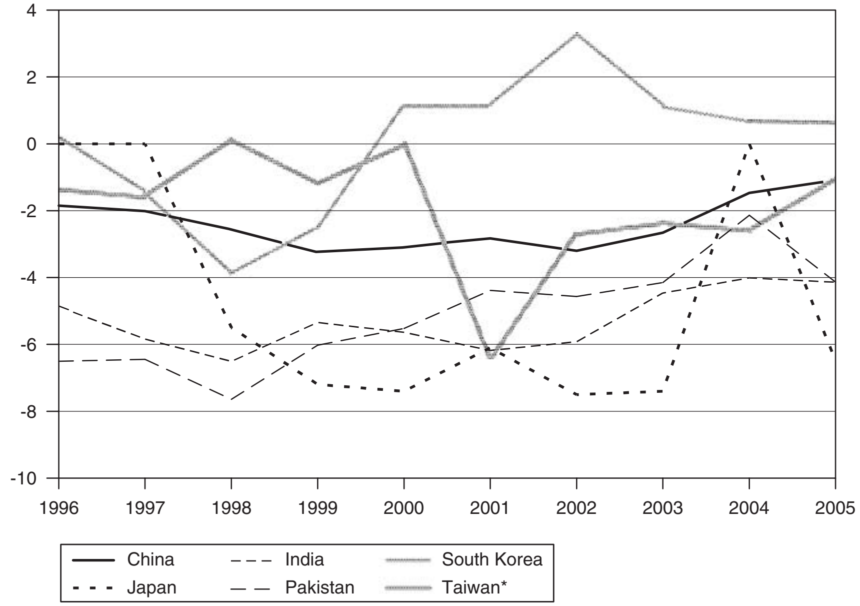
Some observers have argued that 1997 crisis was unnecessary and precipitated by currency speculators. Dr. Mahathir Mohammed, the former prime minister of Malaysia, promoted this view in a very strident fashion. In August 1997, at Malaysia's Independence Day commemoration, Mahathir said, "If we do not strive to protect our independence, directly or indirectly, colonists will return to colonize us." At the 1997 annual meeting of the IMF in Hong Kong, Mahathir went farther, saying, "Currency trading is unnecessary, unproductive and immoral . . . We know that economies of developing countries can be suddenly manipulated and forced to bow to the great fund managers who decide

Table 2.1 Central government budget balance (percent of GDP)

	Country	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Northeast Asia	China	−1.9	−2.0	−2.6	−3.2	−3.1	−2.83	−3.2	−2.66	−1.47	−1.1
	Hong Kong	2.1	6.4	−1.8	0.8	−0.6	−4.9	−4.8	−3.3	1.4	−2.3
	Japan	−5.0*	−3.8*	−5.5	−7.2	−7.4	−6.1	−7.5	−7.4	–	−6.5
	South Korea	0.2	−1.4	−3.9	−2.5	1.1	1.2	3.3	1.1	0.7	0.6
	Taiwan*	−1.4	−1.6	0.1	−1.2	−4.6	−6.4	−2.7	−2.4	−2.6	−1.0
Southeast Asia	Indonesia	1.0	0.5	−1.7	−2.5	−1.1	−2.4	−1.5	−1.7	−1.1	−0.5
	Malaysia	0.7	2.4	−1.8	−3.2	−5.7	−5.5	−5.6	−5.3	−4.3	−3.8
	Philippines	0.3	0.1	−1.9	−3.8	−4.0	−4.0	−5.3	−4.7	−3.9	−2.7
	Singapore	10.5	11.7	3.4	7.2	10.0	5.1	4.8	3.1	4.1	8.0
	Thailand	0.9	−1.5	−2.8	−3.3	−2.2	−2.4	−1.4	0.4	0.1	−0.6
	Myanmar	−2.2	−0.1	0.8	−0.3	0.7	−5.8	−3.6	−4.9	−6.0	–
	Vietnam	−0.7	−0.8	−0.1	−1.6	−2.8	−3.2	−2.8	−2.6	−2.2	−1.9
South Asia	India	−4.9	−5.8	−6.5	−5.3	−5.6	−6.2	−5.9	−4.5	−4.0	−4.1
	Pakistan	−6.5	−6.4	−7.6	−6.0	−5.5	−4.4	−4.6	−4.1	−2.1	−4.1

*General government balance.

Sources: ADB, *Asian Development Outlook 2004*, *2003*, *2002*; IMF, *World Economic Outlook: Fiscal Policy and Macroeconomic Stability*, May 2001; IMF, The World Economic Outlook (WEO) Database, September 2003, http://www.imf.org/external/pubs/ft/weo/2003/02/data/index.htm.



Sources:
ADB, Asian Development Outlook 2003, 2002;
IMF, World Economic Outlook: Fiscal Policy and Macroeconomic Stability, May 2001;
IMF, The World Economic Outlook (WEO) Database, September 2003.

Figure 2.1 Central government budget balance.

who should prosper and who should not . . . For them, wealth must come from the impoverishing of others."[10]

We will attempt to demonstrate below that the crisis of 1997 was not inevitable; on the other hand, it was definitely not attributable to speculators alone. Given the multiple weaknesses of the financial systems and economies in the countries affected, a crisis was highly likely. Recognizing that the "East Asian Miracle" was built on shaky foundations came as a shock to observers in the region and outside.

Central Questions

This chapter will concentrate on three principal questions:

1. Why was the crash so severe?
2. Why was the recovery so prolonged,[11] and why was there a double-dip recession rather than a "normal recovery"?
3. Why is there no satisfactory "single explanation" for the difficulties that East Asia faced in recovering from the crash?

It is worth exploring each of these questions, because many commentators in 1997 and 1998 anticipated a quick rebound from the panic. Although finance ministers in the region repeatedly claimed that the region was experiencing a "normal recovery" and many analysts stressed one principal explanation for the crash, there were, as we will see, a myriad of reasons for East Asia's protracted difficulties.[12]

Table 2.2 Impact of the 1997 crash

Catastrophic Results	Limited Effects	Prior Recession Prolonged	Caught in Regional Downturn	Avoided the Crisis
Thailand	Malaysia	Japan	Singapore	China
Indonesia	Philippines			Vietnam
South Korea	Taiwan			Cambodia
				Laos
				Myanmar
				India

Why Was the Crash So Severe?

Table 2.2 provides a ranking of how severely countries in the region were affected by the crash. Most of our discussion in this chapter will concentrate on Thailand, Indonesia, and South Korea, the hardest-hit states. Developments in these three countries will be contrasted with the more limited impact in Malaysia, the Philippines, and Taiwan.

Japan's crash in 1990–1991 and its prolonged stagnation in the 1990s had an adverse effect on South Korea and Southeast Asia. However, the 1997 events prolonged Japan's doldrums but was not their principal cause. Singapore had a sound financial system and was not directly involved in the 1997 typhoon, but it soon found that its fortunes were tied to its trade and financial dealings with its distressed neighbors.

China, Vietnam, Cambodia, Laos, Myanmar, and India were all able to sidestep the crisis because their capital markets were closed or tightly regulated, and here we will only mention them in comparison with the crisis countries. In Chapter 3, there will be an extensive discussion of current economic issues in China and India and their likely future impact on the region.

We now turn to six distinct reasons why the crash of 1997 was so severe: (1) the long surge of growth in 1975–1995 created overconfidence, (2) high levels of external borrowing, (3) weak financial systems, (4) poorly planned capital market liberalization, (5) asset price distortions, and (6) hesitancy about aiding the crisis countries during the panic.

The Long Surge of Growth in East Asia: 1975–1995. It seems ironic to argue that a long period of growth contributed to a crash, and, clearly, it was not the growth per se but the expectations generated by the boom that led to risky behavior.

Not surprisingly, a generation of rapid economic growth leads many government officials, businesspersons, and even researchers to assume that the pattern would continue. If we look at Table 2.3 for comparisons of total domestic economic activity, we can see why so many participants and observers thought that growth in East Asia was miraculous. Although the figures for Japan are overstated, because these statistics are in U.S. dollars and there was a dramatic appreciation of the yen between 1970 and 1990, it is, nonetheless, stunning to see the expansion of East Asian economic activity.

Many of the market-oriented countries in East Asia experienced a tenfold increase in GDP between 1970 and 1990, and, for most, there was an additional doubling

Table 2.3 Total GDP comparisons (billions of U.S. dollars)

		1970	**1980**	**1990**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005 (est.)**	**2006 (est.)**	**2007 (est.)**
Northeast Asia	China	82.56	307.60	387.77	856.01	952.65	1,019.48	1,083.28	1,198.48	1,324.81	1,453.84	1,640.97	1,931.64	2,234.13	2,554.20	2,871.02
	Hong Kong	28.58	28.59	76.89	158.97	176.31	166.91	163.29	168.75	166.54	163.71	158.47	165.84	177.70	188.67	201.37
	Japan	203.74	1,059.50	3,031.46	4,623.22	4,239.02	3,857.62	4,363.11	4,650.95	4,090.19	3,911.58	4,237.07	4,587.15	4,567.44	4,463.59	4,599.36
	South Korea	8.87	64.00	263.84	557.64	517.04	345.00	445.17	511.92	481.97	546.71	608.17	679.98	787.57	877.19	929.74
	Taiwan	6.21	42.29	164.79	289.34	300.82	276.32	298.83	321.37	291.89	294.88	299.61	322.30	346.18	355.47	374.64
Southeast Asia	Indonesia	11.00	95.92	125.72	250.75	238.41	105.47	154.71	165.52	160.66	195.59	234.83	254.47	281.26	351.03	382.94
	Malaysia	4.21	24.94	44.03	100.85	100.17	72.18	79.15	90.32	88.00	95.27	103.99	118.46	130.84	147.02	156.61
	Philippines	6.58	32.45	44.16	84.37	83.74	66.60	76.16	75.91	71.22	76.81	79.63	86.70	98.37	116.92	134.27
	Singapore	1.80	11.73	36.84	92.55	95.87	82.40	82.61	92.72	5.61	88.47	92.73	107.50	116.78	133.53	144.50
	Thailand	6.44	32.35	85.64	181.95	150.89	111.86	122.63	122.73	115.54	126.88	142.92	161.69	173.13	194.57	208.62
South Asia	India	62.88	177.10	316.66	377.66	411.40	414.12	442.38	462.64	474.10	493.54	575.27	665.58	771.95	854.48	933.05
	Pakistan	11.22	28.63	48.04	77.35	76.26	75.97	71.25	74.08	71.46	71.85	82.59	98.09	110.97	129.00	145.09

Sources: IMF, The World Economic Outlook (WEO) Database, September 2006; Chinese National Bureau of Statistics, www.stats.gov.cn/english/newsandcomingevents/t20060110_402300302.htm of income between 1990 and 1996.[13] This meant that an entire generation of investors and policy makers had seen only minor setbacks. The oil and gas price declines in 1982–1984 had adversely affected Indonesia and Malaysia, but both states made sensible macroeconomic policy adjustments and were back on a high growth path by 1986.[14]

Of course, focusing on total GDP says nothing about the distribution of income within these countries. Although World Bank statistics show poverty declining in all the fast-growing Asian states during the 1990s and there were substantial improvements in rural health care and education levels, there is little doubt that the principal beneficiaries of the boom were urban and members of the business and government elite.[15]

However, for our purposes here, it is important to recognize how a long boom affects business and government decision-making. Businesses will launch increasingly risky ventures and government officials often think that rising revenues will permit the continuous expansion of programs, subsidies, and guarantees. This process of "changing expectations" has long been recognized, but, when the boom is a long one, there are few participants who have been hurt by a prior downturn.[16] An example of risky behavior is that, in the 1980s and 1990s, many businesspeople in Asia borrowed in U.S. dollars and did not bother to hedge their currency exposure. Similarly, because interest rates were low and credit was often easily available, many investors took on project risks that they would have avoided if credit were tighter.

An extended boom also affects analysts. If we look at Figures 2.2 and 2.3 covering Northeast and Southeast Asia for the period from 1970 to 1996, we see not only

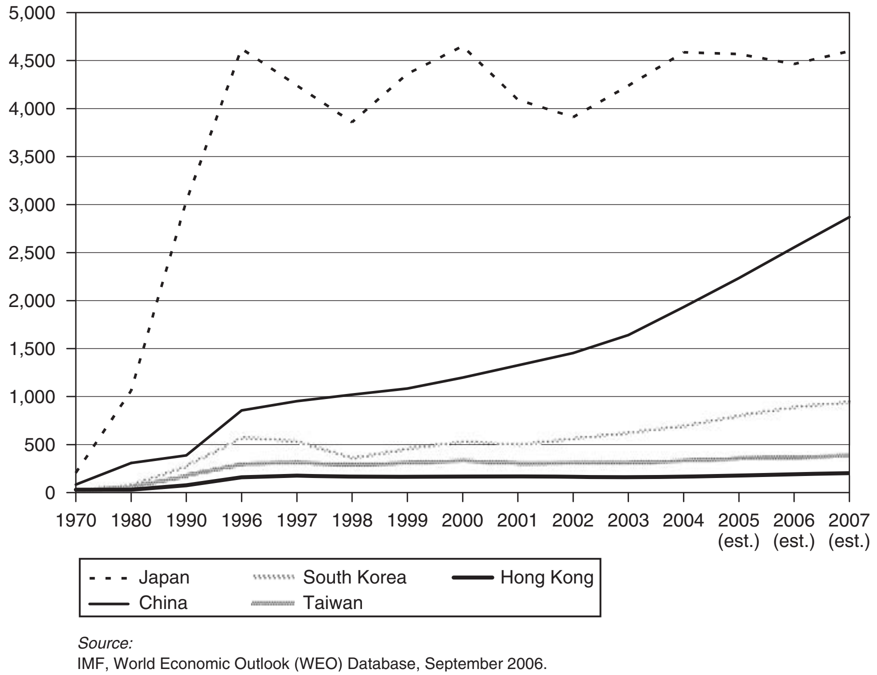


Figure 2.2 Total GDP: Northeast Asia.

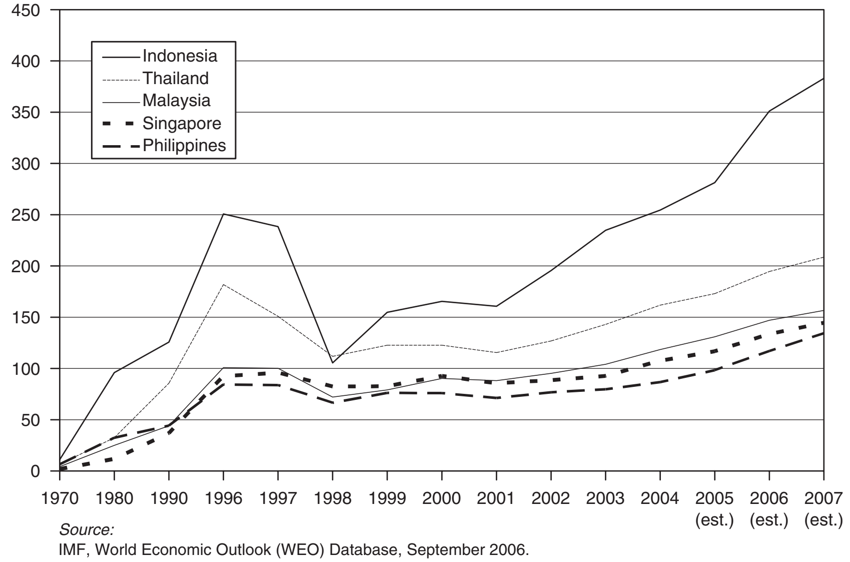


Figure 2.3 Total GDP: Southeast Asia.

an extraordinary boom but also the remarkable consistency of economic growth. This meant that those who were skeptical of the region's ability to sustain this path had to argue that some new factors would derail the "Asian Miracle."

Many seasoned analysts failed to see the warning signs. As discussed in Chapter 1, the principal monitor and watchdog of macroeconomic performance, the IMF, completely failed to anticipate the 1997 crash. Not only did the IMF give no warning, it predicted *rapid growth* throughout 1997 for all the countries that *did crash.* Moreover, the IMF gave a euphoric assessment of the positive features of capital market liberalization, without noting the dangers that countries faced in the process.[17]

The IMF and the World Bank were not alone, however, in their enthusiasm for economic policies being adopted in East Asia.[18] For example, some very experienced economists thought that the rapid growth in the Indonesian banking and insurance industry was a sign of vitality and that other countries might find useful lessons from the way in which Jakarta had gradually opened its capital markets in the period after 1989.[19]

There had been a major debate among economists in the early and mid 1990s about whether East Asia could sustain its growth rate. Alwyn Young published two important articles that took a "contrarian" view of the region's performance. Young argued that growth in East Asia had not been due to improvements in efficiency (total factor productivity) but rather due to massive increases in investment and inputs (labor, capital, and intermediate goods).[20] Jong-Il Kim and Lawrence Lau came up with similar findings using different statistical techniques.[21] Paul Krugman then took conclusions from these technical articles to write a piece for nonspecialists in *Foreign Affairs,* arguing that "Asia's Miracle" was overstated. Krugman compared the high savings and investment rates in East Asia to forced industrialization in the Soviet Union in the 1930s and predicted that growth rates would slow down.[22]

Although specialists noticed this debate about the sustainability of East Asia's growth, neither the participants nor critics of this view took the position that a crash was imminent. Many took the position that Asia's growth might slow but that it was still faster than the growth in many other parts of the world and that the "export-oriented" growth strategies that the region had followed were an appropriate model for other developing countries.[23]

External Indebtedness. Foreign debt, especially private, short-term borrowing, played a key role in the 1997 crisis. Sorting out what to do about defaulted debt ended up delaying the recovery process substantially throughout the region. Initially it was hard to know what to do because most of the affected countries had inadequate data on private debt. Each of the principal crisis countries had a distinct mix of problems.

Thailand allowed its foreign debt to soar from $38 billion in 1991 to $91 billion in 1996. Servicing this debt would have been a major drag on the economy under any circumstances, but was even riskier because of the surge in short-term debt, which went from $15 billion to $38 billion in the first half of the 1990s. This meant that Thai banks that borrowed money might have to repay their loans on short notice if foreign lenders lost confidence in them. In addition, Thai banks lent much of these funds in U.S. dollars. This was done to meet Thai government regulations that required banks to keep their foreign exposure to less than 20 percent of their capital, because domestic interest rates were higher than international lending rates and there was an incentive to borrow abroad.[24]

Thus, in Thailand, there were two tiers of risky behavior: (1) banks were funding long-term projects with short-term money, and (2) the borrowing was in foreign currency, but much of the anticipated revenue from the boom in real estate lending was in local currency. This meant that, if the baht declined, the quantity of local currency necessary to cover the loans would go up. Since the baht fell by almost 50 percent in the six months after July 2001, local borrowers had to pay twice as much in local currency to service their dollar-denominated loans. Since few Thai firms could double their debt service payments, these became nonperforming loans (NPLs), and the banks that had lent them money were caught in a squeeze. Because the Thai banks had, unwisely, borrowed the money on a short-term basis, their creditors called the original loans, and soon both the Thai banks and local borrowers were in default.

Indonesia faced a different situation in 1997. Because it is a nation of thousands of islands, it has been virtually impossible to control smuggling on capital flows, and the country had a long history of open capital markets. Also, Indonesia began growing rapidly in the 1970s and, after the Sukarno Debt was settled, had a good credit history.

Thus, the Indonesian strategy, under President Suharto, was to use the large inflows of foreign direct investment (FDI) as a source of currency reserves and as a means to service relatively high levels of debt.[25] In a low-income country with substantial social and developmental needs where foreigners were bringing in $5–8 billion each year in FDI, this seemed like an acceptable risk.[26]

In the 1990s, however, Indonesian corporations became sufficiently credit-worthy to borrow themselves. Moreover, the private banking sector began to grow, so the country's external debt became a mixture of private and public borrowing.[27] This became a dangerous mixture when (1) the government's plan to stimulate the private banking sector led to a surge of lending by new, inexperienced banks, and (2) the public authorities lost control of total borrowing. Thus, between 1990 and 1997, Indonesia went from having a conservatively managed, government-controlled financial system to a situation where credit extended by foreign and domestic banks was spiraling upward. When the crash came in 1997, the Indonesian government could not even estimate the private debt borrowing outstanding, much less take any coherent action.

South Korea got itself into enormous difficulties, but through an entirely different route. Unlike Thailand and Indonesia, where the governments allowed private borrowing to soar and where investment in equities were significant, Korea had a long-standing system where all capital flows were monitored by the Ministry of Finance and Economy and, usually, guaranteed by the government.[28] The Korean government allowed foreign borrowing to skyrocket from $40 billion in 1993 to $125 billion in 1997.[29] This was clearly an unsustainable course. As we will see below, the Korean government chose this route because the major industrial conglomerates, *chaebol,* were faltering and NPLs rose from 17 percent of corporate loans in 1995 to 32 percent in 1998.[30] Thus, foreign borrowing was sought to prop up a failing industrial and banking system.

Weak Financial Systems. Many outside observers misunderstood the depth and complexity of the problems that the crisis countries faced in 1997.[31] If the problems were just ones of external debt, they could have been solved by quick rescheduling, but the issues were far more daunting. As economic historians have demonstrated, long booms can turn into periods where normal caution is discarded and excessively risky behavior ensues.[32]

Because the economic boom in East Asia lasted for two decades, from the mid-1970s to the mid-1990s, many of the policy decisions taken in the early 1990s were made in a context where 15 years of expansion was considered the norm. Thus, assumptions were overly optimistic, commercial bank reserve requirements were too low or not enforced, and weak institutions, staffed by inexperienced administrators, were widespread. In addition, corruption involving regulators and bank managers and borrowers was widespread in all the crisis countries.

In this regard, the Thai and Indonesian cases were very different from the Korean circumstances. In Bangkok and Jakarta, between the late 1980s and early 1990s, the central governments made the decision to change the scale and character of their respective financial systems by increasing the number and range of institutions. Both the Thais and Indonesians decided to move beyond a financial system controlled by commercial banks.[33]

The Thais decided to move rapidly in their financial sector diversification by setting low standards for their new institutions. They encouraged the development of (1) equity finance through limited regulation of the Stock Exchange of Thailand (SET), and (2) investment banking by minimal standards for "merchant banks." In addition, banking regulators increased liquidity in the system by allowing a surge of foreign capital through the Bangkok International Banking Facilities (BIBF).[34] Compounding the impact of these structural changes was widespread malfeasance in bank management. For example, when the Bangkok Bank of Commerce collapsed, it was discovered that "two senior managers had lent about one-third of the bank's portfolio to themselves."[35]

The Indonesian financial system was built on even shakier foundations. It started from a nationalized, government-run system and initially expanded as several Chinese-Indonesian business groups set up their own banks.[36] The fundamental weakness of the system was that the government banks made loans to poorly run state-owned corporations, while the Chinese banks loaned money to friends and other parts of their respective conglomerates.[37] In 1992 Indonesian authorities added to this weak structure by passing a revised banking law that permitted the creation of a large number of new banks.[38]

By the mid-1990s, Indonesia had 200 private banks, many of them run by people with little or no banking experience.[39] The 1992 Indonesian banking law provided new bank regulations, but that legislation was not accompanied by adequate supervision of the new institutions, and bank executives often ignored the new regulations. Most notable was a pattern of lending excessively to firms within the same conglomerates that owned particular banks. Many of these banks borrowed funds from overseas and were insolvent when the rupiah started to drop precipitously in 1997. Comparable developments occurred in the Indonesian insurance and mortgage lending areas, so the entire Indonesian financial sector was already teetering on the edge as the crash of 1997 approached.

The South Korean financial sector was poorly supervised, but not for lack of government attention. In fact, in the 1990s Korean banks got into the troubles they faced *because* they followed government directives to continue lending to the country's conglomerates, *chaebols.* During the 1970s and 1980s the *chaebols* were Korea's chosen method for rapid industrialization.[40] The government gave them import protection, cheap credit, and various other subsidies so they could reach the scale and quality of production necessary to be successful in an export-oriented growth strategy. By the mid-1990s, the thirty-five top *chaebols* had grown so quickly and were so dominant in Korea that they produced 40 percent of the country's GDP. Some observers even thought that this strategy would continue and help South Korea challenge Japan for regional economic leadership.[41]

By the mid-1990s, however, several key problems developed: the cost of South Korean labor increased, other countries began to challenge its low-tech exports, and the price of buying increasingly sophisticated imported technology rose.[42] This meant that the profit rates for the *chaebols* declined. South Korea had long held a protectionist view toward ownership of the *chaebols.* New capital was not sought from the equity markets or from the long-term bond markets where foreign fund managers and bondholders would have gained influence over management decisions. Instead, the chosen option for expansion was increased commercial bank lending.

Thus, the South Korean industry developed increasingly high debt-to-equity ratios (averaging three times the levels of debt in American firms). The Korean Ministry of Finance and Economy did not want to crimp the *chaebol* expansion, so the only politically acceptable alternative was to direct banks to repeat the cycle of renewed lending. Since a growing number of firms could not service these loans, the banking system's returns on assets and on equities plummeted.[43]

South Korea's monetary authorities realized that the only way to keep this process going was to seek foreign capital. Since there continued to be deep resistance to foreign equity and bond finance, capital was sought through bank borrowings from international commercial banks. This produced a $65 billion increase in foreign borrowing between 1993 and 1997. Obviously, this strategy could not be continued indefinitely. One very sad element of the episode was that the government guaranteed the foreign borrowing to encourage foreign banks to continue to lend. This meant that when the crash came, the South Korean public had to pay for the flawed decisions that maintained the triangular ties between the government, the banks, and the *chaebols.*

Capital Market Liberalization. In 1996 the IMF stated that its top priority in developing countries was to free capital markets, and it held several high-profile conferences to promote this goal. This effort was preceded by several years of quiet pressure on member governments to go beyond freeing up their currency markets and to allow foreign participation in equity and bond markets as well.[44]

The World Bank also supported capital market liberalization.[45] Although there was ample concern expressed about how countries would respond if capital flowed out on short notice, a substantial number of academics and government officials were convinced that freeing up capital markets was an important next step in economic development.[46] Why?

Capital market liberalization had become a key feature of the "Washington Consensus" and was seen as having a number of positive effects. Broadening and deepening local equity and bond markets permitted corporations to reduce their reliance on commercial bank borrowing. It also encouraged entrepreneurship because corporate managements would have an incentive to make companies public through initial public offerings (IPOs). At the most basic theoretical level, capital market liberalization should have provided an environment to facilitate the movement of funds to more efficient uses.[47] This was considered critical in East Asia, where savings and investment rates were high but much of the capital was used inefficiently.[48]

Hence, the Washington Consensus drew on elements of the neoclassical growth theory (balanced budgets, prudent monetary policy, and limiting external debt) and combined it with the more recent theoretical work urging the use of capital mobility to disseminate technical innovation and more efficient production techniques (embodied in new equipment).[49] The Washington Consensus, supported by the U.S. Treasury, also challenged the statist, government-led pattern of economic management that was widespread in East Asia.

Unfortunately, the advocates of capital market liberalization in East Asia, official and private, did not fully appreciate how thinly traded and how vulnerable the new equity and bond markets were. As we can see in Figures 2.4 and 2.5, Asian equity values plummeted between July 1997 and March 1999.[50] In Southeast Asia, the markets moved almost in unison despite very different circumstances. In Northeast Asia, Hong Kong's Hang Seng Index was extremely volatile but was able to avoid the steep declines experienced by the Taiwanese, South Korean, and Japanese markets. Capital flight from Hong Kong was more limited because many foreign investors saw Hong Kong firms as a route to China (which continued to grow steadily) and because the Special Autonomous Region's government used its reserves to purchase

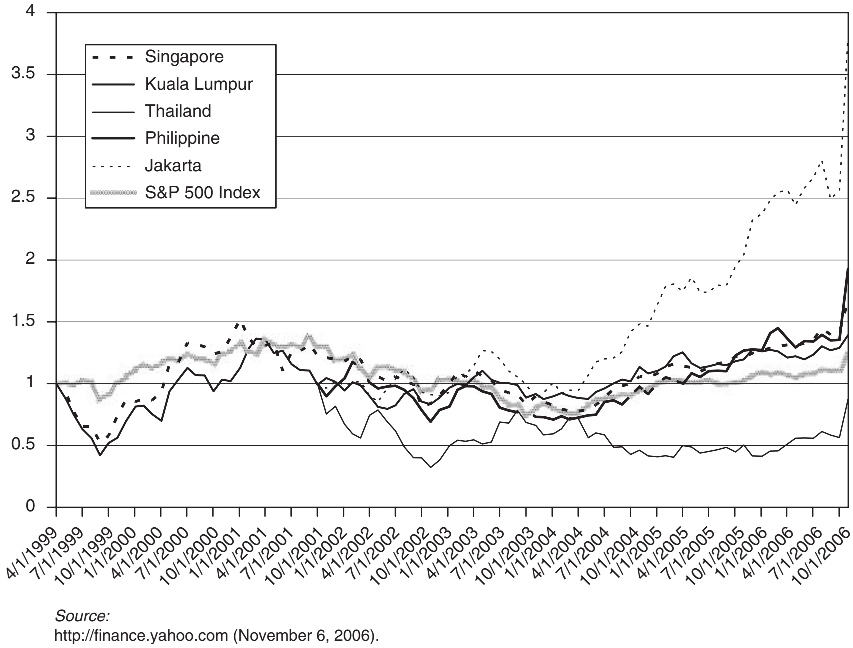


Figure 2.4 Stock market indices: Southeast Asia versus S&P 500.

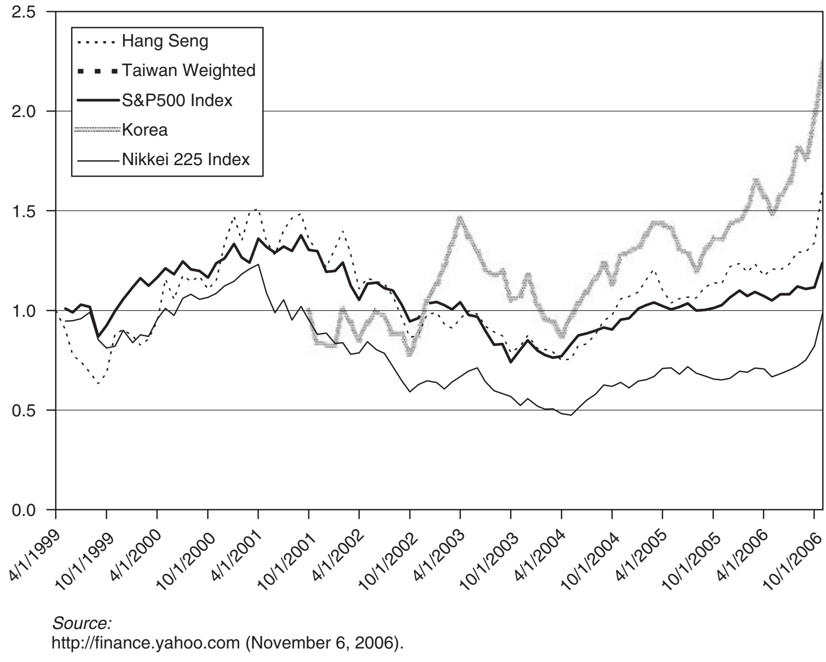


Figure 2.5 Stock market indices: Northeast Asia versus S&P 500.

local shares. Yet, all other markets in East Asia lost significant value as institutional investors fled. In the broader region, only the Chinese and Indian markets avoided the crash, and this was clearly due to their prior decisions to control their capital markets and avoid full capital market liberalization.[51]

Thus, the East Asian experience with liberalizing capital markets was not a propitious one. Few complained while capital was flowing in and the markets were soaring in the early 1990s, but, in retrospect, the IMF's pressure to proceed with equity and bond market openings heightened the vulnerability of most East Asian economies. This produced a very bitter reaction in the states experiencing the worst crashes and limited the influence of international institutions in the recovery period.[52]

In addition to improving the efficiency of capital allocation, liberalizing capital markets could, theoretically, have two other advantages: (1) diversifying risk by increasing the range of financial instruments available, and (2) promoting the development of a broader and more robust set of financial institutions.[53]

The mixed results of capital market liberalization in developing countries, where it has been tried, strengthened the arguments against it.[54] After the 1997 crash, the IMF initiated two major comparative statistical studies to evaluate the past results where developing countries had opened their financial markets.[55] Both studies found *no positive causal relationship* between opening capital markets and growth for low-income countries. There was some evidence that middle-income countries benefited from capital market opening, but they, usually, had more diversified and stronger financial institutions than the low-income countries.[56] More troubling, however, was the fact that both IMF studies found what many outside observers and government officials had long claimed—that opening capital markets made low-income countries more vulnerable to external shocks.

The IMF's leadership now recognizes that it needs to focus on crisis prevention, not just on efficiency of resource allocation.[57] Yet, in the countries most affected by the crisis—Thailand, Indonesia, and South Korea—there is widespread resentment over the economic policy advice provided in the 1990s by international institutions and deep ambivalence over how far to open capital markets in the future. For example, in her 2004 Independence Day address, President Megawati Sukarnoputri suggested that the IMF ought to reimburse Indonesia for the resources it lost by taking the IMF's advice.

Some argue that the IMF contributed to the moral hazard problem, because it was putting pressure on Asian governments to liberalize their capital markets, and many decision makers presumably thought that the IMF would be available with adequate credit if problems developed. When large capital withdrawals did trigger a crisis in 1997, the IMF imposed stringent monetary and fiscal policies as a condition for its loans. To many observers, the combination of large-scale capital flight (made possible by open capital markets) plus tight macroeconomic policies imposed a very high adjustment burden.

Asset Price Distortion. Linked to the issue of capital market liberalization, but not identical to it, is the problem of asset price distortion. Unless an economy is completely open to capital flows (like Hong Kong or the United States), foreign capital can move into only the sectors permitted by the local government.[58] This can drive up prices in those sectors during periods of inflows and lead to price drops when capital is flowing out. This process is accentuated when equity and bond markets are liberalized and governments choose to allow only a certain portion of domestic companies to be sold to foreigners. An elaborate brokerage then develops between shares held by local nationals and foreigners, and the possibility of gaining "supernormal" profits exists for those who control the local shares.

Most countries also have a range of other subsidies and regulations that encourage investment in favored sectors. In addition, if regulators do not require industrial firms and banks to accurately reflect the value of their assets, investors get inaccurate information.[59] In Japan, this process of allowing incomplete information to stand went on for decades during the economic boom of the 1950s to 1980s; it was only when the stock market and real estate bubble burst in 1990 that outsiders saw how overvalued certain prices were.[60]

This problem of asset price distortion was prevalent throughout East Asia, and it added to the severity of the crash in 1997.[61] It was particularly noticeable in Thailand, where the real estate sector received a disproportionate amount of investment—it complicated problems in Indonesia, because banks were not forced to recognize losses on their loans—and in South Korea, where the entire industrial sector was staggering from debt and poor investments because the government had not forced banks and firms to adequately inform the public.[62]

For East Asia, the combination of capital market liberalization, faulty banking procedures, and asset price distortion proved disastrous. Foreign investors and bankers poured funds into corporations that were not what they claimed to be. Understandably, investors and lenders who had been misled withdrew their money as soon as they could. This contributed to the region's downward spiral because so many local ventures were excessively leveraged with debt, without adequate cash reserves, that they could not function when foreign funds were withdrawn. This downward slide then affected otherwise sound firms and spread the panic throughout the economies of the countries in crisis.

Hesitancy about Aid during the Crisis. Many observers, especially in Indonesia and South Korea, are bitter that the IMF and World Bank did not move more quickly to aid Thailand in July 1997.[63] In retrospect, if the leadership of the international financial institutions had known that a regionwide crisis was about to start, they might have put their qualms aside and come to Thailand's rescue sooner and with a larger bailout package.[64]

Nevertheless, there were a number of constraints. First, the Thai government had not been candid about its financial situation in the spring of 1997: foreign exchange reserves were overstated, foreign borrowing was understated, and the extent of overbuilding in the real estate sector was not adequately presented.[65] This made technocrats in the IMF skeptical of what they were being told and slowed negotiations.

The IMF now acknowledges that its initial policy recommendations in Thailand in July 1997 failed to halt the panic, and even the IMF's first Stand-By Agreement, on August 20, 1997 (with $17 billion of funds pledged from the IMF, Asian Development Bank, World Bank, Japan, and China), was inadequate to deal with the disarray in the Thai financial system.[66] Even worse problems developed in Indonesia, where three successive IMF programs failed. The October 1997 effort wilted because top Indonesian government officials resisted the stabilization plan. The November 1997 program, which was broader and included closing some of the weakest commercial banks, also failed because the public did not understand its rationale and some insolvent banks were allowed to continue to operate (under Indonesian Central Bank direction). The January 1998 program proved ineffective as well because, instead of being too timid, it was viewed as too ambitious, as it tried to solve broad structural problems in the economy, rather than focusing on financial restructuring.[67]

Second, in the late 1980s and early 1990s, many economists had become convinced that international institutions should not bail out countries that mismanaged their economies, because this would simply encourage more irresponsible behavior.[68] This moral hazard argument was widespread among conservative legislators, who were skeptical of international financial institutions generally and who saw the 1994 bailout of Mexico as a subsidy for Mexico's creditor banks, engineered by the U.S. Treasury.[69]

Third, during the summer of 1997, the U.S. Treasury was in negotiations with the U.S. Congress over extending the funding for the World Bank, and there was little enthusiasm about bailing out the Thais when this might endanger future funding for dozens of other developing countries. Thus, the Clinton administration made a calculated decision to leave the negotiations with the Thai government to the IMF. After Malaysia and Indonesia experienced crises in the fall of 1997, the United States took a more interventionist position with South Korea and actually led the planning for the Korean bailout at the end of 1997.[70]

The board of the IMF is often divided about the role it should play in coordinating the creditors during and after financial crises.[71] In the cases where the borrowing country will eventually repay all its obligations, the IMF can comfortably serve as an interim source of liquidity. However, in situations of both delay and major write-downs, the IMF has its own ethical dilemma: if it pressures banks and financial institutions to continue lending, it could be forcing those institutions to take losses and might be weakening the balance sheets of the lenders and their home state's banking systems.

During the Asian crisis, this was less of an issue for South Korea (because the government had, just before the crisis, guaranteed almost all commercial bank borrowing), but it was a critical element in the delays of funding for Thailand and Indonesia, where data were incomplete and much of the financial distress was in nonguaranteed private obligations.[72]

Some argued that private debt could have been resolved later, but because so many of the domestic bank liquidity problems were due to private borrowing from abroad, the private and public debt issue was intertwined. In Indonesia, the debate about whether to fully guarantee deposits in failing banks was a *fourth* cause of instability. In November 1997, the Indonesian government did not adequately explain why some failing banks were being closed, while others were being allowed to continue. Also, when President Suharto's son reopened his bank, against government regulations, there was additional public resentment and disarray. The subsequent decision in the spring of 1998 to guarantee all deposits raised the cost of the bailout to the Indonesian public, because fraudulently obtained deposits were guaranteed along with validones.

Therefore, in answering the question Why was the crash so severe? we find a host of reasons. In Table 2.4 we see the principal factors that accentuated the crisis: reliance on short-term capital, high external debt, weak financial system, overvalued exchange rate, asset price distortion, and misallocated investment. The presence of one or two of these

Table 2.4 Factors accentuating the crisis*

	Reliance on Short-term Capital Flows	High External Debt	Weak Financial System	Over-valued Exchange Rate	Asset Price Distortion	Corruption/ Misallocated Investment
Thailand	X	X	X	X	X	X
Indonesia	X	X	X	X	X	X
South Korea	X**	X	X	X	X	X
Malaysia	X				X	X
Singapore						
Philippines		X				X
Taiwan					X	X
Japan					X	
China			X		X	X
India						X

*Countries are listed by severity of crisis impact.
**In South Korea, the short-term flows were bank loans, not equity or other structured finance.

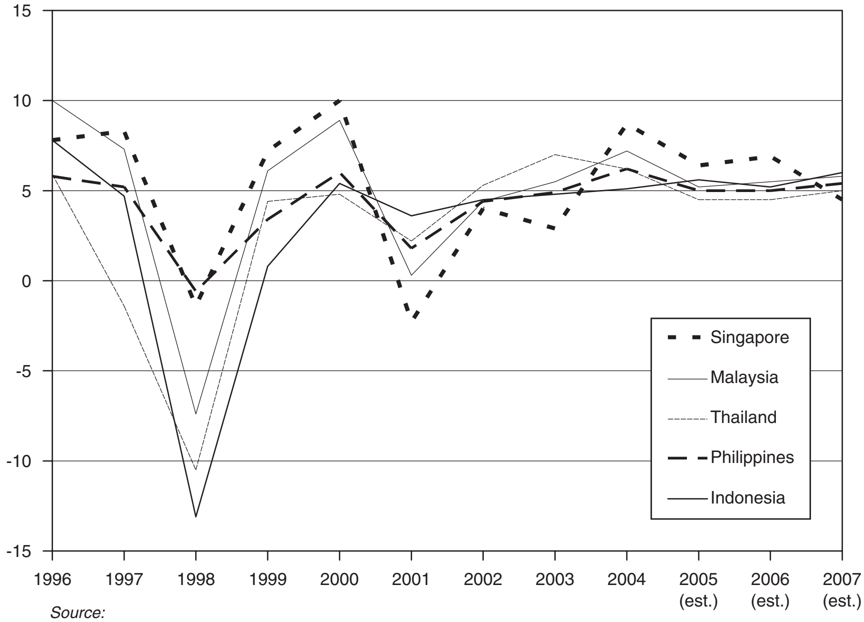
factors was not enough to ensure a crisis, but it is striking to note that Thailand, Indonesia, and South Korea each had weaknesses with *every one* of the problem areas. Also, all three countries suffered under a powerful elite that benefited from continuing risky financial practices and resisted change once the crisis hit. Indonesia faced the added problem that the Suharto regime was disintegrating, and it was unclear what would replace it. So, in the spring of 1998, as Indonesia's situation deteriorated and anti-Chinese riots broke out, the outward flight of capital accelerated.

Moreover, although Malaysia was able to avoid a collapse of its economy, it had the next most serious economic contraction and had problems in three of the six substantive areas mentioned above. China also had problems in three of the areas, but it had tight currency controls and massive foreign exchange reserves so it could fend off any speculative attack on the yuan. Even Singapore, which had none of the structural weaknesses, was dragged into the problems because its trade and financial activities were concentrated in Southeast Asia, where the downward spiral took place.

Why Was the Recovery So Prolonged, and Why Was There a Double-Dip Recession Rather Than a "Normal Recovery"?

Like the issue of crisis severity, the halting recovery had many causes. Although it is difficult to quantify, there is little doubt that having a generation of rapid growth in East Asia meant that a sizable percentage of the business and government leadership had never experienced a major downturn. As noted above, this led to much overconfidence and many public and private investments that more cautious managers, who had been through previous crises, would not have considered.

This overconfidence during the upturn also led to inaction and counterproductive choices during the recovery because so few of the key figures involved had ever experienced a serious downturn or considered the steps necessary for recuperation.[73] There were, in addition, a number of daunting macroeconomic obstacles for the crisis countries to overcome.



Source:
IMF, The World Economic Outlook (WEO) Database, September 2006.

Figure 2.6 Real GDP growth rates.

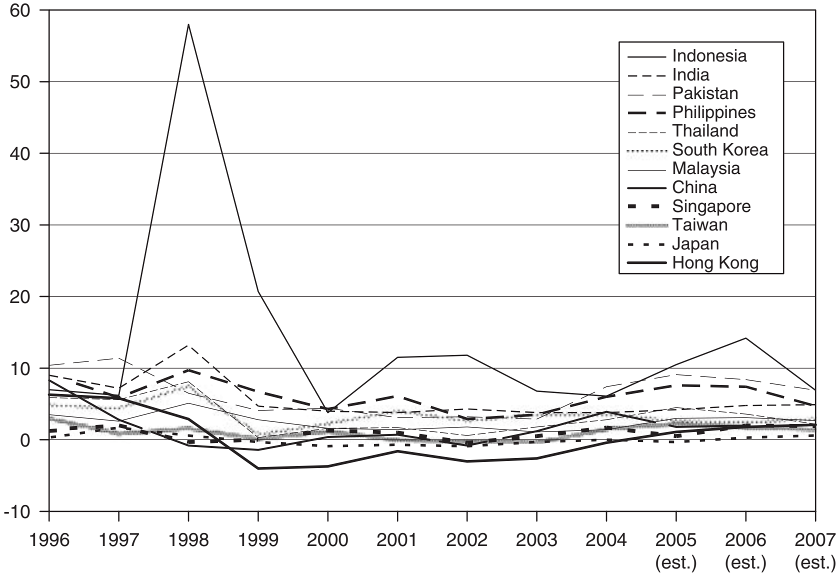
Depth of the Shock

Figure 2.6, which covers real GDP growth rates between 1996 and 2005, shows the extent of the shock to the Southeast Asian economies. Indonesia experienced the worst setback, but every country in Southeast Asia had negative growth in 1998. The scale of the decline in national income is stunning: in one year, between 1997 and 1998, Indonesia went from 6 percent growth to –12 percent, Thailand went from 3 percent growth to –10 percent, and Singapore went from 9.5 percent growth to –1 percent. These are enormous jolts to an economy, to citizens, and to any political system.[74] Under these circumstances, new investment comes to a halt, importers find that their regular customers quit buying, and many firms that were previously viable become endangered.

Because Indonesia has the largest population and the largest economy in Southeast Asia, its downward spiral in 1998 had a pervasive effect in the region. Figure 2.7 shows the initial upward surge in inflation rates that came in 1998 as currencies depreciated and as panic buying drove up prices. Then, by 1999, as the extent of the regional depression was felt, prices declined and inflation rates stabilized.

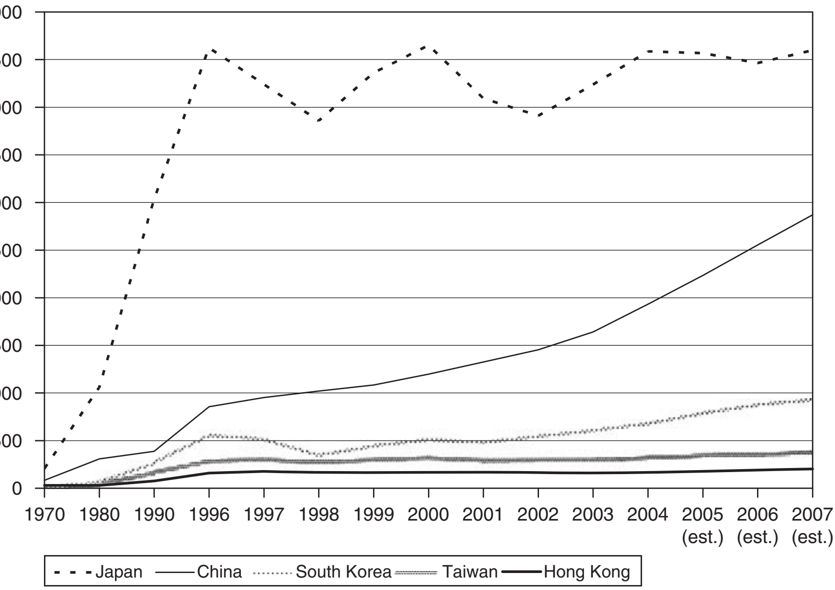
Figure 2.8 provides a graphic illustration of how rapidly Southeast Asia's economies expanded between 1970 and 1996 and then how much they contracted between 1996 and 1998. We see the gradual recovery between 1998 and 2000, but then a double-dip recession in 2001.[75] Only in 2004 did Indonesia approach its 1996 level of GDP, and Thailand still had not recovered completely, nine years after the crisis.

Figure 2.9 shows the impact on exchange rates in the region. Except for the Chinese yuan, which rose briefly against the U.S. dollar, all the other currencies in



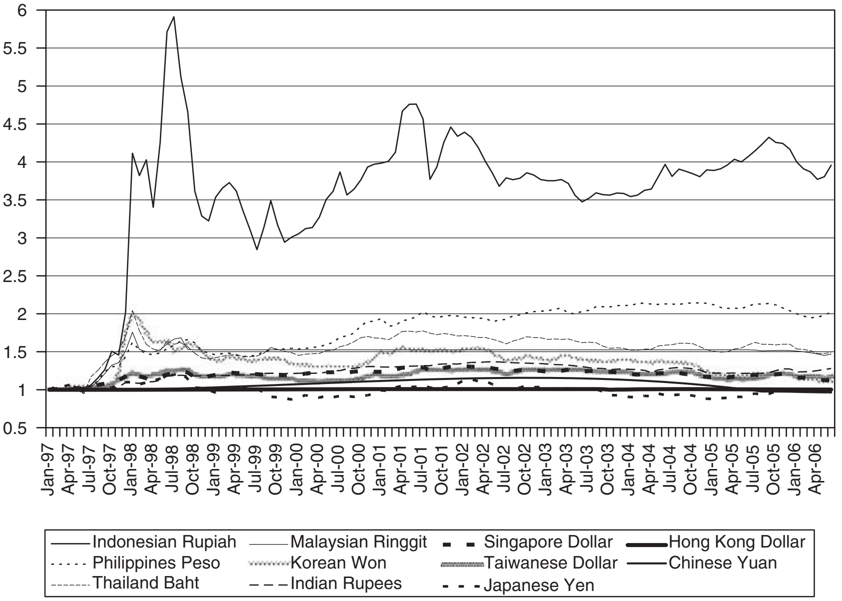
Source:
IMF, The World Economic Outlook (WEO) Database, September 2006.

Figure 2.7 Inflation (annual percent change).



Source:
IMF, The World Economic Outlook (WEO) Database, September 2006.

Figure 2.8 Total GDP (billions of U.S. dollars).



Note:
In this period the Chinese yuan was essentially fixed, and therefore it overlaps with the Hong Kong bold line.

Source:
University of British Columbia;
Pacific Exchange Rate Service (monthly averages).

Figure 2.9 Exchange rates in U.S. dollars.

East Asia depreciated considerably after the crisis.[76] Most of the currencies in the region lost between 30 percent and 50 percent of their value, and the Indonesian rupiah had lost about 60 percent of its worth once it stabilized.

Currency declines immeasurably complicated the recovery process. As discussed above, most of the governments and businesses in Southeast Asia had grown accustomed to stable exchange rates and many had borrowed in U.S. dollars without hedging their exchange risk. So, both businesses and governments were caught in a squeeze: as their local currencies declined, they owed more to foreign creditors. In addition, because of the depression, their revenues had contracted. This produced the wave of bankruptcies, which further slowed the recovery.

A *fifth* issue that complicated the recovery process in both Indonesia and Korea was the IMF's decision to require "structural conditionality" as the quid pro quo for its Stand-By funding.[77] In Indonesia, the IMF attempted to end many of the inefficient and corrupt practices that the Suharto administration had used to reward its political supporters. The Fund tried to terminate monopolies that benefited a few powerful individuals, and it tried to limit subsidies and indirect financing for many favored groups. Although desirable as broad policy objectives, this effort diverted attention from the specific need to reform the Indonesian banking sector. Moreover, it fortified the resistance to the overall IMF program among those around President Suharto, thus making it impossible to get real change until the president resigned, in May 1998. A less dramatic but similar situation developed in Korea, where corporations accustomed to inexpensive credit and import protection strenuously resisted IMF efforts to open the economy to greater competition. However, South Korea had fortuitous timing for its presidential elections. So, the incoming president Kim Dae Jung, got a mandate for change in December 1997 that his predecessor, Kim Young Sam, lacked.

Thus, it is not surprising that the imploding economies, collapsing currencies, and slew of bankruptcies created a widespread loss of confidence in the region. The panic may have been excessive, but it was real. Even Nobel laureates can be forgiven for focusing just on the numbers and concluding, *incorrectly,* that the situation was not dire.[78]

Speculative Nature of the 1998–1999 Recovery

In Figure 2.10, which compares GDP growth rates in Northeast and South Asia, we see that both Hong Kong and South Korea had dramatic economic recoveries in 1998, while the other states had much more muted declines and upswings. Moreover, both Hong Kong and South Korea had sharp second declines in the double-dip recession of 2001. Why? Each faced circumstances that investors misinterpreted.

Unlike most of the countries in Southeast Asia, South Korea had not substantially opened its markets to foreigners before 1997, but it did yield to pressure from the IMF to begin the process after its December 1997 bailout. This led to a surge of new foreign investment in 1988, before the Korean banking collapse had been resolved and before the industrial restructuring of the *chaebols* had proceeded very far.[79] By 1999, it became clear that the Korean banking problems would take years to resolve and that the leaders of the *chaebols* would resist downsizing and divestiture of their many subsidiaries. Investors then realized that there would be no

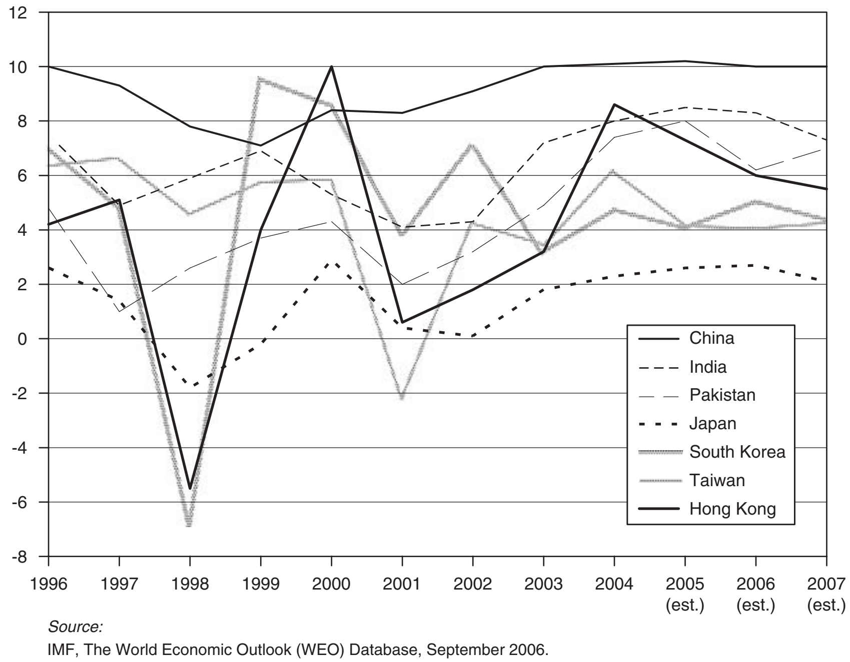


Figure 2.10 Real GDP growth: Northeast and South Asia.

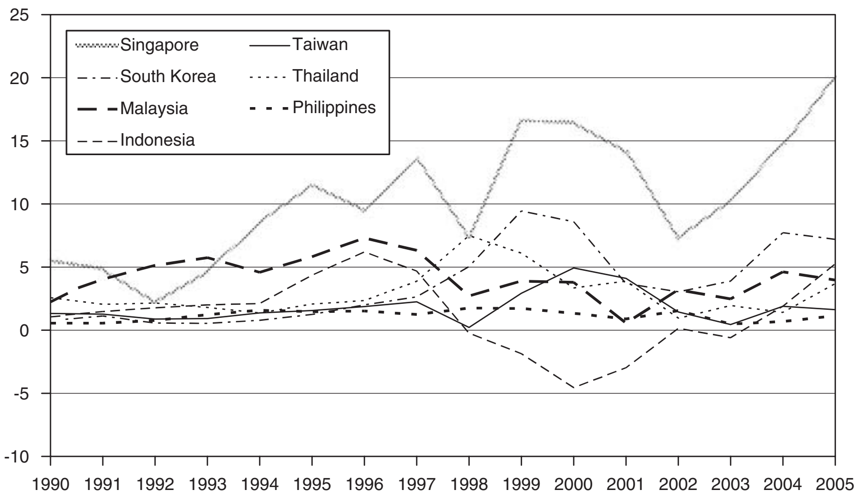
sustained recovery until more fundamental changes were made, contributing to the downturn in 2000.

Hong Kong faced a completely different set of circumstances. The year 1997 was one in which sovereignty and political leadership were transferred from the United Kingdom to China. Thus, there was a great deal of apprehension, inside Hong Kong and abroad, about the new directions that the "Special Autonomous Region" would take. In addition, Hong Kong had experienced a speculative real estate boom in the 1990s and the new governor, Chung Tee-Hwa, made clear that he was going to end assorted tax breaks and subsidies for real estate investors. Not surprisingly, these uncertainties, combined with the crash of 1997, contributed to Hong Kong's economic slide in 1998.

Hong Kong's recovery in 1999 and 2000 was due to steady growth in China and the recognition that the pessimism of 1997 may have been overdone. However, as an entrepot and financing center, Hong Kong's fortunes turned down again in 2001 as the recession in the United States and the double-dip recession in Southeast Asia took hold.

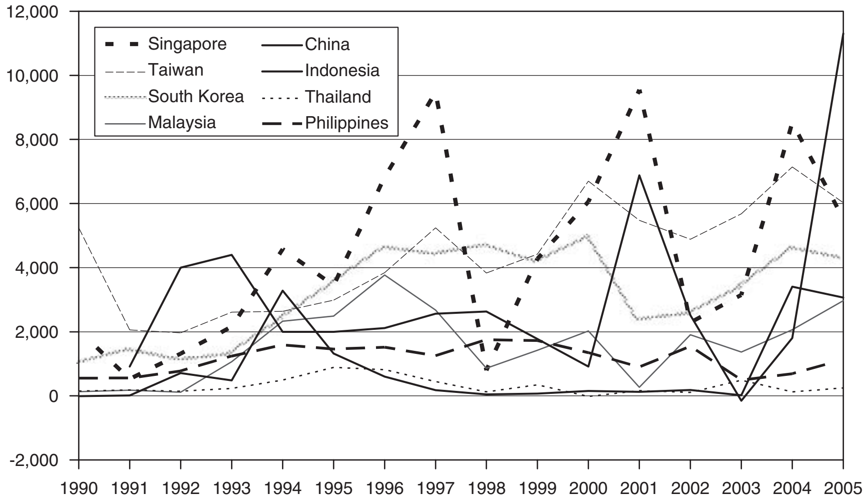
Figures 2.11 and 2.12 on East Asian inflows and outflows of FDI display another key element of the post-1997 adjustment difficulties. Indonesia went from receiving about $6 billion per year to a net annual outflow of over $4 billion in a four-year period. That is a wrenching change for an economy that relied on foreign capital to provide it with new technology and a growing, modern manufacturing capability. Few countries could absorb that kind of loss without a broad-reaching effect.

The volatility of FDI flows in and out of Malaysia, and Thailand was not as extreme as in Indonesia but a major macroeconomic dilemma nonetheless. Thailand never established capital controls and made the calculated decision that it would accept foreign control of its banking system and much of its industry as the price to be paid for exiting the 1997 crisis. Midway into the crisis, Malaysia did establish limited



Source:
UNCTAD Handbook of Statistics On-line.

Figure 2.11 Inflows of FDI.



Source:
UNCTAD Handbook of Statistics On-line.

Figure 2.12 Outflows of FDI.

capital controls and used various government investment funds to prop up its equity markets and is generally credited with getting through the postcrisis period with less trauma than found in Thailand and Indonesia.[80]

U.S. Recession in 2001

It is now clear that the U.S. economy began to slow down in the fall of 2000, but that the pace of decline accelerated in the spring of 2001. At the time, it appeared to be a normal easing of growth after the rapid spurt of the late 1990s. Two factors then complicated the American recovery: (1) the sharp drop in demand for high technology equipment, which led to the collapse of technology stocks and then the broader stock indices as well, and (2) the 9/11 al Qaeda attacks.

The Bush administration came into office advocating a tax cut and had it passed before 9/11, but the reductions were to phase in over several years so the stimulative effect did not immediately compensate for the worsening recession and the uncertainty created by terrorism. Although the Federal Reserve Board began aggressively cutting interest rates, the U.S. economy stalled through the remainder of 2001 and much of 2002.

These developments contributed to the double-dip recession in Southeast Asia and South Korea in 2001–2002. However, U.S. efforts at avoiding a major recession and continued American openness to Asian imports played a key role in fueling a recovery in Asia as well. In Asia, China was the principal exception to the double-dip recession as foreign investment poured in and surging government and private investment maintained its buoyant growth.[81]

Therefore, the scale and unanticipated nature of the crash, the speculative rebound in 1998–1999, and the U.S. recession of 2001 all prolonged the recovery from the 1997 crisis.

Why Is There No Satisfactory "Single Explanation" for the Difficulties That East Asia Faced in Recovering from the 1997 Events?

At one level, the answer is simple: there is enough variation among the countries involved that no single explanation will suffice. However, what we have found is three widely shared problems and then four additional factors that were present in some cases but not in others.

The three widely shared patterns are as follows:

Mismanagement inside the Asian countries. This was so pervasive that, in retrospect, a major crash and restructuring appears to have been inevitable. The combination of bad corporate practices, corrupt links to national governments, and assorted pubic subsidies for nonviable projects meant that the productive sectors of many Asian states had to carry an enormous burden of inefficiency.[82] Moreover, because growth had been so rapid for two decades, many corporate and public leaders thought that they would not have to pay a price for this behavior.

Bad policy advice from the IMF. Although the IMF was not responsible for *causing* the crisis, its advice did *exacerbate* the downward spiral in 1997.[83]

In Thailand, the IMF's pressure to adopt tight fiscal and monetary policy right after the collapse of the baht drove many heavily indebted companies into bankruptcy and made it even harder for viable businesses to recover. Thailand needed the IMF's approval to get its bailout package, so policy makers in Bangkok had no choice in July and August 1997 but to accept these counterproductive guidelines.[84]

In Indonesia, profligate macroeconomic policies did not cause the crisis; capital flight from a highly leveraged financial system precipitated it. The IMF's requirement that Indonesia close insolvent banks, with only a partial deposit insurance plan in place, created an investor and depositor panic that crushed the entire economy.[85]

By December 1997, when South Korea came under pressure, leaders in Washington recognized that a key ally was in trouble. The United States, therefore, took the lead in organizing the Korean bailout.[86] By then, the IMF recognized that it had been too stringent in Southeast Asia, so it agreed to a more lenient set of terms in South Korea, and a total of $58 billion was made available in the package.

Vulnerable financial systems with limited abilities to adjust. Although there have been significant improvements in Asian banking systems since 1997, the crash occurred as many countries in the region were trying to reduce reliance on bank lending and increase the use of equity and bond financing.[87]

This was especially notable in Thailand's case in the 1990s, as the government was attempting to increase the number of banks and to provide for a more robust stock and bond market. These moves proved ephemeral when the newer banks and stock market both collapsed.[88] As discussed, Indonesia was undergoing a somewhat similar process when the 1997 crisis struck, and the subsequent bank consolidation in 1998–2002 reduced rather than increased the number of financial institutions. Thus, one of the indirect effects of the entire episode was further delay in developing a broader range of Asian financial institutions.

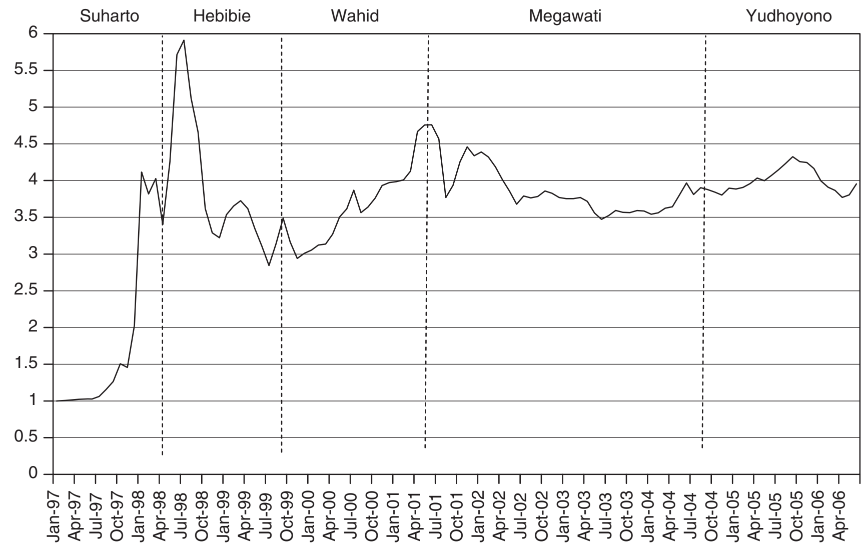
We now turn to factors that complicated the recovery process but varied substantially between the affected countries.

The political setting is critical. This seems a truism but is worth demonstrating, nonetheless. In all three of the worst-hit countries there was a change of government after the crisis. Thailand has a parliamentary system and the Chavalit government was quickly replaced by one led by a well-known reformer, Chuan Leekpai. In the South Korean case, a regular presidential election was scheduled for December 1997. When President Kim Young Sam's party was repudiated, his successor, Kim Dae Jung, could, more easily, reverse policy directions.

The Indonesian transition was much more protracted as President Suharto had been in power for 32 years and showed no willingness to resign. Yet, Suharto was in failing health, the economy was rapidly deteriorating, and his long-time opponents took this as an opportunity to start massive protests, which ultimately brought him down in May 1998. Hence, Indonesia faced two simultaneous crises: overthrowing an authoritarian regime and dealing with massive capital flight.[89] This would have been a Herculean challenge for any government.

Clearly Thailand and South Korea benefited from fortuitous timing in changing regimes, while Indonesia suffered even more because it had no shadow government in place and had not practiced open democracy since the 1950s. Figure 2.13 shows the disastrous decline in the Indonesian rupiah during the end of the Suharto era and the first few months of his successor's term. Interestingly, when Vice President Habibie did actually assume office, he instituted economic policies that led to price stabilization, which in turn led to an almost 50 percent rise in the rupiah.

There was no single growth strategy in East Asia in the 1990s. In the vast literature on East Asian economic development, there are many examples of attempts to show



Source:
Pacific Exchange Rate Service (monthly averages),
http://pacific.commerce.ubc.ca/xr/data.html (June 30, 2006).

Figure 2.13 Indonesian rupiah exchange rate in U.S. dollars (monthly averages).

that there was one basic economic strategy in the region.[90] This effort is misleading. There were many similarities among the East Asian countries' strategies, but what is striking about looking closely at Thailand, Indonesia, and South Korea is how truly different their approaches were. Thailand followed almost a laissez-faire policy, Indonesia had open capital markets but wide-ranging government intervention in many manufactured goods sectors, while South Korea was highly protectionist and followed the state-led pattern pioneered in the region by Japan. This demonstrates that *it is unlikely there could have been any one factor* that led to the 1997 collapse, nor was there any one *subsequent policy* that necessarily prolonged the recovery.

Preventive action and timing matters. China and Taiwan avoided the crash of 1997 mostly because of capital market controls; however, both had, prudently, devalued their currencies in 1994 and were not seen as attempting to prop up overvalued exchange rates.[91]

One would hardly give Japanese economic policy makers high marks for the handling of their real estate and stock market swoon; nevertheless, they had an enormous advantage: their problems came seven years before the regionwide distress. This meant that the Japanese had ample time to think out how to react. The Japanese government then tried a series of unsuccessful plans to initiate remedial action. If Japan's bubble had burst in 1997, it is highly likely that there would have been an even greater panic. Moreover, Japan offered a very large aid package to the ASEAN states in the 1998 Miyazawa Plan; this would have been inconceivable had the Japanese and Southeast Asian problems happened concurrently.

In sum, the crash of 1997 was a truly extraordinary event. Its start was unanticipated, its severity was unanticipated, and its prolonged consequences were unanticipated. Numerous analysts predicted a "normal recovery," which never came, and the region is still dealing with the long-term effects of the crash. In turning to the current situation in Chapter 3, we will compare the different trajectories that the recovering states took and also look closely at developments in China and India.

Chapter 3

Is the Current Recovery Sustainable?

Introduction

In 2004–2007, there has been a simultaneous business expansion in Europe, the United States, Japan, and China. The world's four leading economic areas, which account for about 70 percent of global GDP, have not had a similar, simultaneous business expansion since 1972. The International Monetary Fund forecast that average GDP growth in these four states in the two-year period of 2004–2006 would be as follows: Europe (3.4%), United States (2.9%), Japan (2.7%), and China (9.7%).[1]

Neither this book nor this chapter is an exercise in forecasting. Instead, we will take mainstream forecasts and then assess their implications if actual trends continue as expected. We will also explore which factors might produce significantly different results than the mainstream forecasts. So, the title of this chapter is meant to connote an explanation of the conditions necessary to maintain growth, not a specific set of point forecasts. Obviously, we cannot assess every country in Asia in depth, so the goal is to focus on the largest economies that have a chance to affect the region's performance.

We face a particularly difficult situation now because the global *cyclical* expansion that is helping the recovery in Asia may be masking various deeper *structural* problems, which would be more obvious in a less buoyant period.

Thus, our discussion will first set out the basic patterns that distinguish the rapidly growing Asian states from those growing at a more moderate rate. Then we will turn to examining the major economies that could affect all of Asia. The remaining portion of the chapter will deal with midsize Asian economies and various region-wide issues such as oil prices and productivity growth.

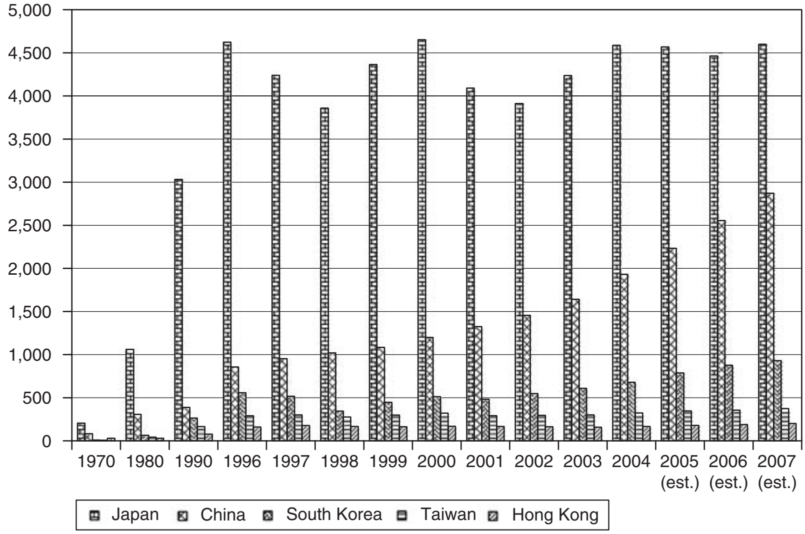
The Current Macro Picture

One of the central themes of this book is that there are strong reasons to anticipate that India and China will grow faster than the Pacific Rim states. In Table 3.1, we see

Table 3.1 Growth estimates 2006 (annual GDP percentage of growth rates)

Rapid		Moderate	
China	10.4	Malaysia	5.5
India	7.8	Indonesia	5.2
Vietnam	7.8	Philippines	4.6
Singapore	7.2	South Korea	5.2
		Thailand	4.5
		Taiwan	4.1
		Japan	2.7

Source: Consensus Forecasts, *Citibank Asia Pacific*, October 10, 2006, p. 6.



Sources:
IMF, The World Economic Outlook (WEO) Database, September 2006;
Chinese National Bureau of Statistics.

Figure 3.1 Total GDP: Northeast Asia.

that prominent forecasters anticipated significantly faster growth in 2006 from China and India than from the rest of the Asian economies. Of the Pacific Rim states, only Vietnam and Singapore were likely to grow faster than 6 percent, but they are such small economies that they have limited effects on the region. It is heartening to see that the Pacific Rim states are finally returning to faster growth trajectories than they experienced in the 1997–2004 period. Yet, most importantly, if these forecasts are an indication of future trends, the gap in expectations and dynamism between the continental economies, China and India, versus the Pacific Rim will be reinforced.

Because the Northeast Asian economies are so much larger than the Southeast Asian ones, their growth is critical to the overall region's performance. If we look at Figure 3.1, we see another issue of concern. Although China's GDP has moved up steadily since 1990, South Korea, Taiwan, and Hong Kong have all experienced recessions and notably slower growth in that period. Moreover, we know that all three economies are increasingly linked to China, through trade and investment, for their own growth.

Table 3.2 Average real GDP growth by decade (annual percent changes)

	Country	1980s	1990s	2000s
Northeast Asia	China	9.3	10.4	9.67
	Hong Kong	6.89	4.57	4.71
	Japan	3.96	1.25	1.71
	South Korea	8.74	6.19	4.56
	Taiwan	8.01	6.51	3.4
Southeast Asia	Cambodia	8.88	7.14	8.2
	Indonesia	5.48	4.16	4.97
	Laos	5.68	6.3	6.43
	Malaysia	6.06	7.22	4.84
	Myanmar	1.42	7.14	10.91
	Philippines	1.8	3.07	4.67
	Singapore	7.48	7.62	4.44
	Thailand	7.94	4.59	4.96
	Vietnam	5.89	7.58	7.54
South Asia	India	5.81	5.62	6.81
	Pakistan	6.19	3.97	5.53

Source: IMF, The World Economic Outlook (WEO) Database, September 2006.

This means that among the Pacific Rim economies, only Japan is seen as a truly separate source of growth for future trade, investment, and technology.[2] Even Japan is now moving capital and manufacturing jobs to China, with Japanese FDI of over $4 billion per year.[3] If these trends continue, China will become, even more than at present, the locus for economic vitality in Asia.

We do not want to overstate the significance of short-term economic forecasts here. However, there are important structural features of the Pacific Rim economies, which will be discussed below, that make their return to their high growth (6% per year or over) trajectories unlikely. Many of the Pacific Rim economies now have low population growth, most are getting reduced flows of FDI, and savings rates (which can fund domestically financed investment) are down from the levels in the early 1990s.

Table 3.2 illustrates the broad slowing of the Pacific Rim growth rates from a different perspective: comparing average growth rates by decade. There are a number of problems with this approach, because important economic events are sometimes hidden in ten-year averages, and there are other instances when big changes take place just at the turn of decade, and this method tends to overemphasize those turning points.[4] Nevertheless, with these caveats, we see the very pronounced slowing of the Northeast Asian economies, the deceleration in Southeast Asia, and a slight uptrend in South Asia.

Also, it is worth noting that China has been consciously trying to restrain its growth since 2003, so in China's case the figures should not be seen as loss of vigor. In addition, as we noted in the preface, Chinese statistics are suspect and may be *understated*.

If we now turn to population growth, we can see another key part of Asia's economic and social transition. In Table 3.3, it is clear how successful family-planning efforts have been throughout Asia. Except for Laos and Pakistan, all the countries are expected to have average annual population growth rates below 2 percent per year in

Table 3.3 Estimated average annual population growth rates (in percent)

	1980–1998	1998–2015
Southeast Asia		
Cambodia	2.9	1.5
Indonesia	1.8	1.2
Lao PDR	2.4	2.2
Malaysia	2.7	1.6
Myanmar	1.5	1.1
Philippines	2.5	1.7
Singapore	1.8	1.0
Thailand	1.5	0.9
Vietnam	2.0	1.2
Northeast Asia		
China	1.0	1.0
Hong Kong	1.6	1.0
Japan	0.4	−0.1
South Korea	1.1	0.6
South Asia		
India	2.0	1.3
Pakistan	2.6	2.3

Source: World Bank http://www.worldbank.org/depweb/english/modules/social/pgr/datasia.html (June 10, 2004).

the 1998–2015 time period. This means that for most Asian states, income growth will translate more directly into increases in per capita income.

The population figures are relevant in another key regard: the very slow growth of population in South Korea and the actual loss of population in Japan will mean that both economies will have to continually seek increases in productivity per person so as to increase incomes. The more advanced economies cannot count on increases in labor force participation as a spur to growth. This is a notable difference between the higher-income countries and the labor-surplus ones, where there is still excess labor to move from the agricultural sector to higher-productivity employment.

Japan is, of course, a high-income society with a mature economy, and such economies rarely grow at over 3 percent per year for extended periods. Many Japanese are more concerned with achieving stability than growth.[5] Some citizens of Hong Kong and Singapore may also be less concerned with domestic growth than they are with the success of their overseas investments. Nevertheless, South Korea, Taiwan, and most of the Southeast Asian states are middle-income countries, and their citizens see growth as essential. So, lower growth prospects in the Pacific Rim affect both economic and political calculations.

The availability of excess labor is clearly one of the main attractions for foreign investors in China.[6] Conversely, rising wages in South Korea, Taiwan, and Hong Kong have made them less desirable places to locate manufacturing enterprises. Table 3.4 shows patterns of FDI *into* Asia since 1980.

It is interesting to see how different the development strategies of South Korea and Japan were from their Southeast Asian neighbors. Japan, the world's second-largest economy, never admitted more than $3 billion of FDI until 1997, and South Korea

Table 3.4 Inflows of foreign direct investment (millions of U.S. dollars)

		1980	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Japan	Stock	3,270	9,850	33,531	29,940	27,080	26,064	46,115	50,322	50,319	78,140	89,729	96,984	100,899
	Flow	278	1,753	41	228	3,224	3,193	12,741	8,323	6,243	9,239	6,324	7,816	2,775
Brunei	Stock	19	39	649	1,303	2,004	2,578	3,325	3,874	4,401	5,436	7,445	9,017	9,292
	Flow	−20	7	583	654	702	573	748	549	526	1,035	3,375	212	275
Cambodia	Stock	38	38	356	942	927	1,199	1,431	1,580	1,729	1,874	1,958	2,090	2,471
	Flow	1	–	151	294	168	243	232	149	149	145	84	131	381
China	Stock	1,074	20,691	101,098	128,069	153,995	175,156	186,189	193,348	203,142	216,503	228,371	245,467	317,873
	Flow	57	3,487	35,849	40,180	44,237		40,319	40,772	46,846	52,743	53,505	60,630	72,406
Hong Kong	Stock	21,175	45,073	70,952	80,662	249,360	225,078	405,266	455,469	419,348	336,278	381,342	453,031	532,956
	Flow	710	3,275	6,213	10,460	11,368	14,770	24,596	61,939	23,775	9,682	13,624	34,032	35,897
Indonesia	Stock	4,680	8,855	20,564	26,758	31,436	31,195	29,330	24,780	15,203	7,103	10,329	15,858	21,118
	Flow	180	1,092	4,346	6,194	4,677	−356	−2,745	−4,550	−3,279	145	−597	1,896	5,260
South Korea	Stock	1,327	5,186	9,457	11,469	14,109	19,149	28,597	37,189	40,881	43,856	47,641	56,001	63,199
	Flow	6	789	1,776	2,325	2,844	5,412	9,333	9,283	3,528	3,043	3,892	7,727	7,198
Laos	Stock	2	13	211	339	425	470	522	556	580	605	624	641	669
	Flow	–	6	88	128	86	45	52	34	24	25	19	17	28
Malaysia	Stock	5,169	10,318	28,731	36,028	42,351	45,065	48,960	52,747	33,972	36,983	41,667	43,803	47,771
	Flow	934	2,611	5,816	7,296	6,324	2,714	3,895	3,788	554	3,203	2,473	4,624	3,967
Myanmar	Stock	1	281	1,210	1,790	2,669	3,353	3,657	3,865	4,057	4,248	4,539	4,791	4,862
	Flow	0	225	318	581	879	684	304	208	192	191	291	251	300
Philippines	Stock	1,281	3,268	6,086	7,367	8,420	9,305	11,412	12,810	10,433	11,888	12,216	12,896	14,028
	Flow	−106	550	1,459	1,520	1,249	1,752	578	1,345	982	1,542	491	688	1,132
Singapore	Stock	6,203	30,468	65,644	75,022	74,768	87,295	101,343	112,571	121,436	136,833	144,363	166,844	186,926
	Flow	1,236	5,575	8,788	8,608	10,746	6,389	11,803	12,464	10,949	7,338	10,376	14,820	20,083
Taiwan	Stock	2,405	9,735	15,736	17,600	19,848	20,070	22,996	17,581	38,025	28,061	37,131	40,304	41,929
	Flow	166	1,330	1,559	1,864	2,248	222	2,926	4,928	4,109	1,445	453	1,898	1,625
Thailand	Stock	981	8,242	17,684	19,706	13,333	25,481	31,114	29,915	33,268	38,180	47,534	52,855	56,542
	Flow	189	2,562	2,068	2,271	3,626	5,143	3,561	3,350	3,813	947	1,952	1,414	3,687
Vietnam	Stock	1,398	1,650	7,150	10,065	13,282	15,647	18,183	20,596	23,022	26,055	27,505	29,115	31,135
	Flow	0	180	1,780	1,803	2,587	1,700	1,484	1,289	1,300	1,200	1,450	1,610	2,020

Source: UNCTAD Handbook of Statistics On-line.

did not encourage FDI until the Asian financial crisis forced it to do so. In contrast, Taiwan, Hong Kong, Indonesia, Malaysia, Thailand, and Singapore all received substantial FDI from at least 1990 onward. Yet, after 1997, Indonesia actually lost FDI on a net basis, and the flows into Thailand and Malaysia reduced. Moreover, China now receives more FDI annually than the rest of Southeast Asia combined.

The most important comparison here is between China and India. Because of Beijing's "One Child Policy," the total labor force in China will level off in 2015 and actually start to decline by 2020. Since wages in China are rising now, they would presumably rise even faster if the country attempts to maintain its rapid economic growth. Thus, China will, in the near future, no longer be able to count on low wages to give it an absolute advantage vis-à-vis its neighbors. India, on the other hand, will have an expanding labor force for least another generation. This will give India a decided advantage in attracting low-wage manufacturing, if the high rates of illiteracy can be reduced to provide a modern work force.

If we look for the overarching patterns in these data, we see slowing growth in the Pacific Rim economies, the end of their labor surplus, and the preference of foreign investors for being in the faster-growing locations, most specifically China.[7] India is now opening up to more FDI, but hostile political parties, militant labor unions, and antiquated infrastructure make it unlikely that FDI inflows to India will approach the level that China has received in recent years.

The Major Economies

By examining specific issues in each of the major economies, we will add to the analysis of the macro trends discussed above. Because the United States is the first or second trading partner with most of the countries in Asia, it is reasonable to start with a brief overview of American economic trends.

The United States

There have been significant changes in the United States' economic performance in the past 25 years. The 1970s were a period of "stagflation"—low growth and high unemployment and high inflation. In 1979, Paul Volcker, the chairman of the Federal Reserve Board, raised interest rates to the highest levels in the twentieth century and, eventually, choked off inflation. Even so, in 1980, the United States had 13 percent inflation and over 6 percent unemployment.[8] Since that period, however, administrations of both parties have agreed with the leadership of the Federal Reserve to keep inflation low.[9]

There has also been a dramatic improvement in productivity growth, which has averaged 2.7 percent per year since 1989.[10] As the world's largest economy and the one that generates the largest number of patents and technical innovations, the United States appears to be thriving. Two deep structural problems, however, remain: the domestic *budget* deficit and the *trade* deficit. Both deficits have important implications for Asia.

The budget deficit was 3.2 percent of GDP in 2004 but rose to over 5 percent by 2006. This deficit is the largest, as a percentage of GDP, since World War II.

In addition, in 2006, the trade deficit has been averaging over $60 billion per month. At present, Asian central banks are massive purchasers of U.S. Treasury bonds. By the end of 2004, for example, Asian official holdings of U.S. securities were $1.4 trillion.[11] These holdings give Asian governments access and influence in the United States and buttress foreign exchange reserves that could be used in future financial crises.

The dilemma is this: if the United States takes a harder line on its trade deficit by pressing for appreciation of Asian currencies, would the Asian states continue to buy American treasury bonds? Because the budget deficit stimulates American growth, it also facilitates increased imports to the United States from Asia. As long as Asian governments fund the U.S. budget/savings gap, there is less pressure on Americans to close either the budget or trade deficit. Yet, it seems unlikely that the rest of the world will fund this American overconsumption indefinitely.

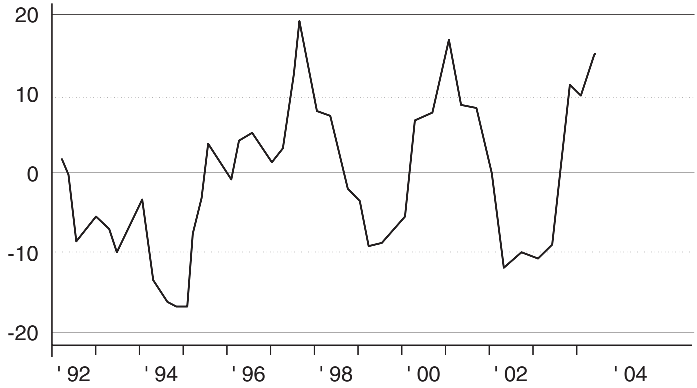
Alan Greenspan, the former chairman of the U.S. Federal Reserve Board, addressed this issue directly and took a relatively optimistic view.[12] He has stated that both the budget and current account deficits can be dealt with gradually if appropriate policies are followed.[13] Greenspan's position is that domestic debt, inside the United States, is manageable because individuals have greater assets than in the past, and the current account deficit is manageable because foreign financial institutions are less tightly regulated and will buy more U.S. stocks and bonds.[14] The number of variables here is so great that predictions about the precise course of the budget or trade deficit is of limited value. Nevertheless, some correction in U.S. policy seems inevitable. Either American savings rates need to increase or Asians need to direct a smaller part of their exports to U.S. markets. Otherwise, U.S. securities will be sold on a massive scale, the value of the dollar will drop, and U.S. interest rates will rise, possibly soar.[15]

Japan

For the first time since 1991, the March 2004 *Tanken* survey of 10,000 Japanese companies showed "strong optimism" about Japan's business prospects. The Bank of Japan decided to keep interest rates near zero in 2004; however, by 2005, as growth picked up, it raised interest rates. Yet, the country still faces daunting problems, especially with its financial sector.[16] Since 2004, the prospects for Japanese economic performance have continued to improve. In 2005, Japan's growth was the best record in a decade (2.7%), and growth in 2006 and 2007 is expected to average over 2.0 percent. This is a dramatic change from the stagnation and slide during the 1990s.

Figure 3.2 shows the volatility of net investment in Japan during the past decade and highlights one of the key issues that policy makers in Tokyo still face. Business capital expenditures have declined in three periods: 1992–1994, 1997–1998, and 2001–2002. In these periods, there was so much pessimism about the country's future and so little domestic demand that commodity prices began to decline in the late 1990s and have continued to do so into 2004. This *deflation* meant that the public had little incentive to buy consumer durables, because they were supposed to be less expensive in the future.

Therefore, during the latter half of Japan's "lost decade," the two principal sources of rising demand were from government expenditures and exports. This led to charges that Japan was trying to "export its way" out of its recession. Although the Bank of Japan did eventually adopt a stimulative monetary policy, it did so only after



Source:
Far Eastern Economic Review, April 22, 2004, p. 42.

Figure 3.2 Japan's business capital expenditures.

the fiscal policy had led to extraordinary levels of domestic debt.[17] Japanese public works expenditures actually peaked in 1998, but the deficit soared as social security transfer payments rose and tax revenues declined.

The question then arises, Now that growth appears to be returning, will consumer demand pick up and the government be able to return to a more normal monetary policy (and to work down the debt levels) without triggering a new recession?[18] This question is critical because Japan is about to face a declining population and serious problems with restructuring in its smaller, less efficient businesses.[19]

Thus, Japan has much better news than in the 1990s, but major concerns remain in reducing debt, increasing efficiency in its service and agricultural sectors, and dealing with a rapidly aging population. Strengthening a weak financial system and reducing unemployment and underemployment will be key indicators of whether Japan can return to a steady, self-sustained growth.

If Japan were to continue with its current structural adjustments (corporate downsizing and improving service sector efficiency), it could possibly sustain a per capita growth rate of 2 percent per year. Although this is modest by past standards, it could double living standards every 36 years.[20] Will the next generation of Japanese be satisfied with this? Will fertility rates increase so that the burden of supporting the aged will be shared across a larger population? Will Japan start admitting more foreign workers (especially in the health care sector)?

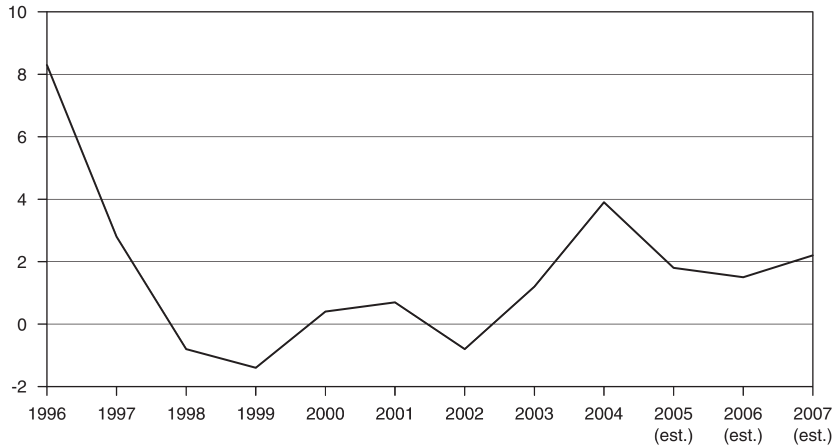
CHINA

As discussed in Chapters 1 and 2, the most remarkable economic transformation in Asia has been in China. In three decades the country moved from the chaos and Marxist excesses of the Cultural Revolution to being the most dynamic economy in the region. The central question facing the Chinese leadership in 2006 is, Can they slow the economy from a 9 percent growth rate in the past two decades to a more manageable, 6–7 percent rate without causing major social and economic disruption? In essence, is a "soft landing" possible?

The Chinese Communist Party (CCP) is now in its fourth generation of leadership.[21] Since the party has, basically, abandoned Marxism but is still not willing to risk a true democratic referendum on its leadership, many observers conclude that the party is basing its legitimacy on economic performance. Few could fault it for more than quadrupling national income in the 1980s and 1990s, but policy management will become more difficult in the years ahead.[22] The sprawling rural population (over 900 million), the state-owned enterprises, and the limping financial system will all require skill and resources to handle.

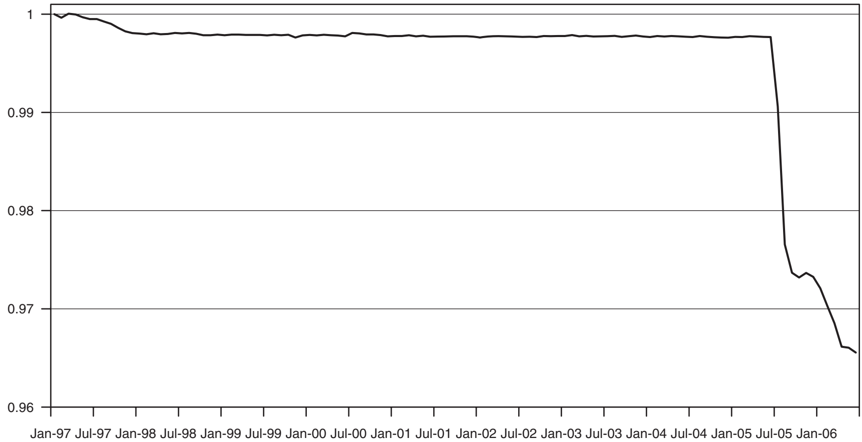
The macroeconomic fundamentals for China are very promising. Two different studies of China's growth potential give evidence that, despite its inefficient use of capital and labor, the country can probably grow, on a sustained basis at 6–7 percent per year.[23] What is the basis of this calculation? China can expect 4–5 percent growth per year from its high savings rate (40–45% of GDP), 1 percent annually from its labor force expansion, and another 1–3 percent per year from gradually increasing efficiency (total factor productivity).[24] It is also important to note that the over $50 billion that China has been receiving annually in FDI is bringing the efficient technologies for the manufacturing, transportation, and power sectors, which will spread its effect through the entire economy.

Figures 3.3 and 3.4 also show that China has been very prudent in its monetary policy. Inflation dropped from the 8 percent range in the mid-1990s to, essentially, zero in the 1998–2004 period. There was even concern that China would face a problem with deflation as the surge of new labor force entrants drove wages down and the rapid increase in manufacturing capacity meant that producers wanted to sell their goods even at reduced prices. Yet, unlike the recent situation in Japan, there appears to be adequate consumer demand to prevent a long period of deflation. The decision to keep the exchange rate within a narrow band and allow only limited appreciation has been a stimulus to growth. Many analysts have concluded that Chinese goods are significantly undervalued in the international marketplace.



Source:
IMF, The World Economic Outlook (WEO) Database, September 2006.

Figure 3.3 China's inflation.



Source:
University of British Columbia;
Pacific Exchange Rate Service.

Figure 3.4 Chinese yuan exchange rate in U.S. dollars.

One crucial aspect of China's development strategy is its use of FDI. In the early 1980s, Deng Xiao-ping made the decision to permit FDI in special economic zones along China's eastern coast and to use FDI as a stimulus for growth. Then, as the Chinese government became more confident of its ability to control the political and social impact of the foreign presence in China, restrictions on FDI were eased: FDI could go inland, more sectors were opened for investment, and foreigners were gradually allowed to own a controlling interest in many businesses.

Yet, FDI in China became far more than just a source of capital: it became the lynchpin for the rapid modernization of the industrial sector. China is now the largest recipient of FDI in the world, surpassing even the United States. Table 3.5 demonstrates how widespread FDI in China is. Although Fujian and the Pearl River Delta (near Hong Kong) are still major FDI recipients, the Yangtze Basin is now leading in new investment and the Bohai Rim is close behind.

The flood of foreign capital has provided high performance equipment for China's industrial sector, while channeling domestic savings toward (1) a thriving private sector and (2) bank deposits that have been loaned to industry and to local governments for dramatic improvements in infrastructure (railroads, highways, power systems, and ports). Thus, China's surge in growth has been achieved through drawing excess labor into the modern sector and applying massive amounts of capital. For example, capital is almost twice as important in explaining growth in China as it is in India, and total factor productivity is 50 percent higher in China than in India.[25] Hence, FDI has allowed China to modernize both its manufacturing and infrastructure without accumulating large foreign borrowings.

Thus, the "Soft Landing" would require China to keep the fundamentals of growth in place but slow the rate of monetary expansion while it deals with the inefficient state-owned enterprises and prepares for importing more fuel and providing better social services for the poor.[26] The overextended banking and financial

Table 3.5 China's actual foreign direct investment (in billions of U.S. dollars)

	2002	2003	% Change
Yangtze Delta	**17.60**	**21.00**	**16.2**
Shanghai	4.30	5.46	21.2
Jiangsu	10.20	10.56	3.4
Zhejiang	3.10	4.98	37.8
Northeast	**4.00**	**3.33**	**−16.8**
Heilongjiang	0.36	0.32	−11.1
Jilin	0.24	0.19	−20.8
Liaoning	3.40	2.82	−17.1
Bohai Rim	**8.83**	**10.69**	**17.4**
Beijing	1.72	2.19	21.5
Tianjing	1.58	1.53	−3.2
Hebei	0.80	0.96	16.7
Shangdong	4.73	6.01	21.3
West	**2.01**	**1.71**	**−14.8**
Chongqing	0.20	0.26	23.1
Sichuan	0.56	0.41	−26.8
Guizhou	0.04	0.045	11.1
Yunnan	0.10	0.08	−20.0
Tibet	0	0	–
Shanxi	0.36	0.33	−8.3
Gansu	0.06	0.023	−61.7
Qinghai	0.05	0.025	−50.0
Ningxia	0.022	0.017	−22.7
Xinjiang	0.019	0.015	−21.1
Neimenggu	0.18	0.088	−51.1
Guangxi	0.42	0.42	0.0
Guangdong (Pearl River Delta)	**11.33**	**7.8**	**−31.2**
Other Key Provinces	**3.84**	**2.6**	**−32.3**
Fujian	3.84	2.6	−32.3
Total	**47.61**	**47.13**	**−1.0**

Source: China Ministry of Commerce, www.fdi.gov.cn, December 2005.

systems must be restructured as well. This will be an exceptional balancing act for the leadership.

Related to the economic adjustments are a series of sensitive political changes as well. In 2006 President Hu Jintao launched an effort to reduce the income gap between the interior and the coastal areas in China and has also sought to reduce corruption within the ruling CCP. Hu engineered the arrest of the CCP secretary Chen Liangyu in Shanghai and has initiated an anticorruption drive in Tianjin, Fujian, and Hunan.[27]

These moves clearly reflect concern within the Chinese leadership that the poor are growing increasingly resentful of those with greater economic opportunities. Riots protesting land confiscation by government officials are now frequent. These signs of discontent and the negative environmental effects of rapid industrial growth have led the People's Bank of China to repeatedly raise interest rates and tighten terms for credit as a means to slow growth along the coast and in nearby areas. Moreover, protectionist sentiment has led Chinese financial regulators to limit foreign investment in banks and insurance companies and to ban new stakes in brokerage firms.[28]

In addition, because of China's ever-mounting trade surpluses—$18.8 billion in August 2006 alone—the Chinese must plan for the contractionary effect that will result when they finally up-value the yuan closer to its real market value. A "revaluation" of the yuan will be unpopular with marginal exporters who then face increasing competition from such low-wage countries as Indonesia, India, and Bangladesh.

The combination of all these cross-pressures means that the leadership in Beijing is looking for new ways to prepare the public for slower growth. At the CCP's Central Committee Meeting in October 2006, it settled on a new code phrase, "Harmonious Society," as its ideal for resolving the growing conflicts within China.

India

The questions we pose for India are the converse of concerns in China about slowing growth. In India, the central questions are: Can the recent 6–8 percent growth rate be sustained? What are the chances for increasing growth from 6 percent to 8 percent for an extended period?

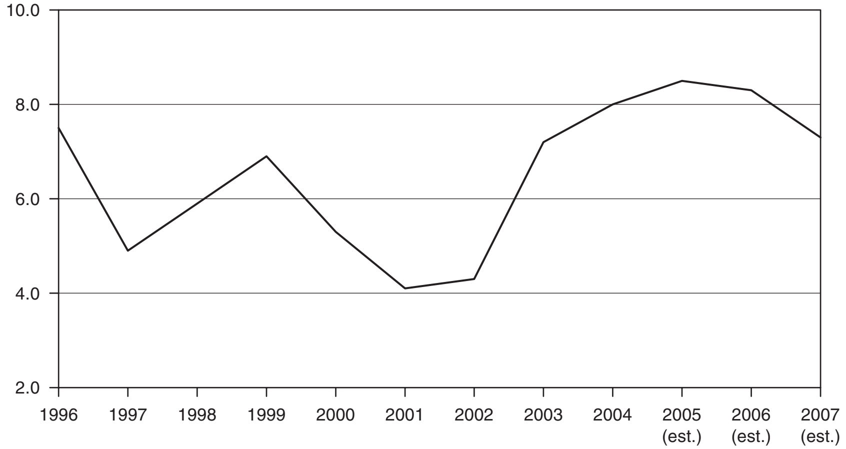
That these questions are even being raised is an indication of how much economic policy has changed since the 1960s, when India was mired at growth in the 2–3 percent range.[29] The sources of India's current dynamism are well known: it has a first-rate scientific and engineering sector, which has been especially successful in computer software development; its English-speaking college graduates are ideal candidates for low-wage "outsourcing" from higher-income countries; and the two major political parties that have led coalition governments since 1990, the Congress and the Bharatiya Janata Party (BJP), have been willing to somewhat weaken the hold of socialist and protectionist ideologies.[30]

Initial attempts at liberalizing the economy in the 1960s failed because left-wing political parties and the business community favored protectionism.[31] By the 1990s, however, India was falling so far behind the more rapidly growing countries in East Asia that the burgeoning middle class demanded a growth-oriented set of policies.

However, because India is a lively democracy and has been led in the past two decades by coalition governments of many parties, policy directions have not always been consistent. So, although the modern sector has forged ahead rapidly, the national government has maintained more protectionist policies than in China and has been less open to foreign investment.

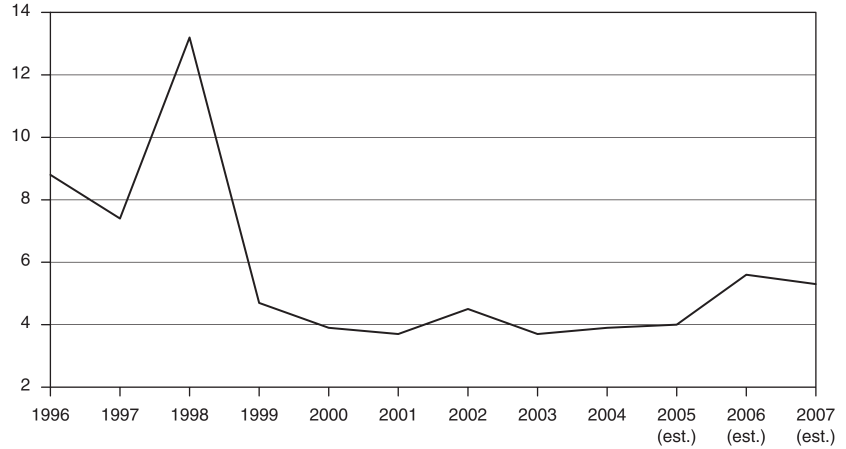
Also, if we look at Figures 3.5, 3.6, and 3.7, we see far more volatility in India's growth, inflation, and exchange rates than experienced in China in the same period. This reflects a higher percentage of GDP coming from agriculture, lower foreign exchange reserves, and lax fiscal policy. In addition to the problems of managing coalition governments, India has to deal with federalism and substantial autonomy in the economic policies of its states.

Indian political economists see an advantage in New Delhi pursuing a gradualist approach to economic transformation.[32] Alternating between set-asides for small business and affirmative action programs on the one hand and trade liberalization on the other gives governments the ability to say that they are doing something for all groups. The problem is that it sends mixed signals. Foreign investors are not comfortable when they are unsure how well the national government will protect them from capricious state governments, and local businesspeople are still likely to sequester funds abroad as a form of insurance should the government turn far to the left.[33]



Source:
IMF, The World Economic Outlook (WEO) Database, September 2006.

Figure 3.5 India's real GDP growth.



Source:
IMF, The World Economic Outlook (WEO) Database, September 2006.

Figure 3.6 Indian inflation.

India has a number of advantages that still elude China: it has a legitimate democratic government, a solid tradition of the "rule of law," an independent judiciary, and a moderately developed financial system that responds more to market signals than to political pressure. Nevertheless, India's drawbacks are glaring as well: widespread corruption, long lag times for setting up new businesses and getting investment approvals, and frequent stalemates in the Parliament because of diverse constituencies in the governing coalitions.[34] India has oscillated between secular, left-leaning governments and communal, conservative governments, which has often given mixed signals to foreign investors.[35] The most encouraging sign of India's economic

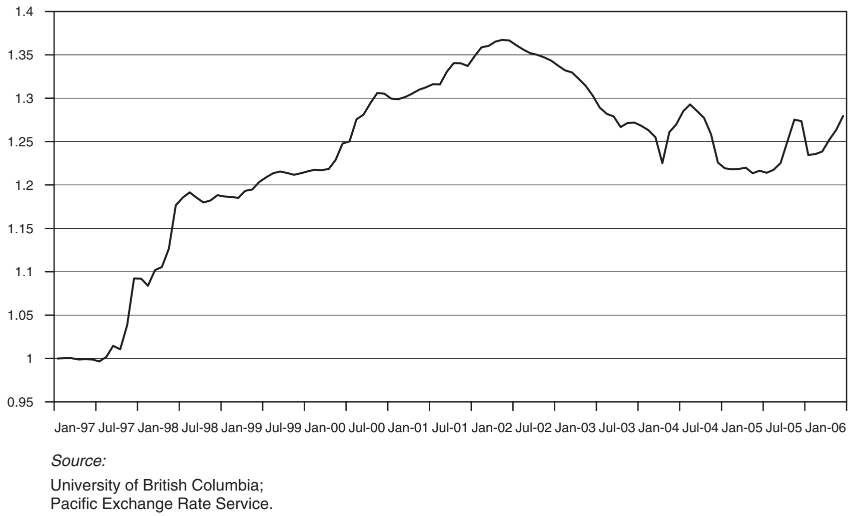


Figure 3.7 Indian rupee exchange rate in U.S. dollars.

transformation, however, is the average increase in worker productivity, from 0.86 percent per year in the 1970s to over 3 percent per year in the 1980–2000 period.[36]

With the Congress coalition (the United Progressive Alliance) unseating the BJP in May 2004 and installing a national government that includes the Left Front as well as various regional ethnic parties, it will require a talented ringleader to keep the disparate factions in tow. Manmohan Singh, the new prime minister, is well regarded and was an architect of the Congress's 1991–1994 efforts at economic liberalization, but with the Communists as a vociferous part of his coalition, he has notable constraints on his mandate this time.[37] On balance, however, India's economic direction is positive, and its market size and technical expertise will increasingly become the focus of world attention.

With the GDP expanding at 7.5 percent in 2005 and possibly faster in 2006, the economic commentary on India has been very bullish. There are two fundamental problems that pose structural difficulties nonetheless: (1) social rigidities arising from caste, and (2) stark differences in policies and growth rates in different regions within India.

Caste remains an ongoing problem because most of India's over 350 million illiterates are from either lower or untouchable castes. Although these groups have political power, they are still marginal to the economy. They want various types of "affirmative action" programs and are likely to be increasingly militant in their demands.[38]

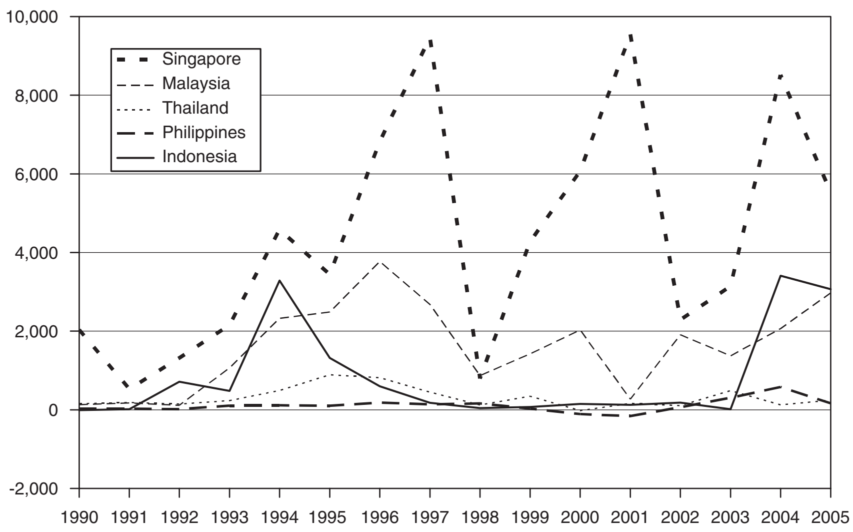
Problems of caste are linked to the vast differences in levels of economic development between the Indian states, because lower-caste members form a higher percentage of the population in southern India. This means that the rise of regional political parties further complicates decision making at the national level. In certain states, differences in economic opportunities heighten antiforeign and anti-middle-class sentiment. Although the Congress is secular and has long had a significant part of the lower-caste vote, it cannot push too fast on economic modernization without leaving a key constituency behind. When the BJP is in power, it typically represents middle- and upper-caste Hindus, but then faces hostile opposition parties.[39] This can often produce stalemates when economic reform is needed.

The Midsize Economies

Earlier in this chapter we reviewed the macroeconomic reasons why many observers expect India and China to grow faster than the Pacific Rim economies, at least for the near-term future.[40] We noted that the Pacific Rim savings rates have declined along with investment rates, inflows of FDI have dropped, and in all but the Philippines, Thailand, and Indonesia, surplus labor has been absorbed into the modern sector. This means that for most of the Pacific Rim economies, future economic growth needs to come, predominantly, from stimulating innovation and improvements in efficiency.

Growth through improved efficiency seems feasible in Japan, South Korea, Taiwan, Hong Kong, and Singapore, but less likely in the other Pacific Rim states, because they face a comparative disadvantage vis-à-vis China, which is getting more FDI and more recent technology. Also, South Korea, Thailand, and Indonesia face the additional problem of high levels of domestic and foreign debt resulting from unwise loans before 1997 and subsequent bailouts of local firms.

In Figure 3.8 we see an additional concern for Southeast Asia. In the early 1990s, the largest ASEAN economies were beginning to invest abroad, which is helpful to build up foreign subsidiaries that will market exports. However, after 1997, only Singapore had enough extra savings to continue expanding investments overseas.[41]



Source:
UNCTAD Handbook of Statistics On-line.

Figure 3.8 Outflows of FDI from Southeast Asia.

So, in addition to losing new FDI inflows (Table 3.4), the bulk of the Southeast Asian states have had to curtail their efforts at overseas development. This will affect their ability to market exports.

Beyond these general issues, which have an impact on many of the Pacific Rim states, we now turn to country-specific factors that warrant attention.

South Korea

The Koreans have a number of key assets: first-rate mathematics and engineering training, high levels of general education, world-class manufacturing facilities, and a growing reputation for high-quality consumer products. Nevertheless, they have two major factors that will slow their economic growth: (1) militant labor unions, and (2) uncertainty about security and how to deal with North Korea.

Labor union militancy is nothing new in Korea. During the years of military rule, union activity was sharply limited. The first round of bitter and violent labor activity came in 1987, after democratization began.[42] Since then, the labor union movement has gained strength and played a key role in electing Presidents Kim Dae Jung in 1997 and Roh Moo Hyun in 2002. In the April 2004 legislative elections, the unions made further gains by supporting many of the Uri party candidates, who got control of the national assembly.[43]

In South Korea, unions are influential in the banking and insurance sector as well as in manufacturing, so coordinated strikes frequently have a disruptive effect on business. This raises wages and makes South Korea a significantly less attractive place to locate manufacturing than China or Southeast Asia. This was not as critical to South Korea when savings rates were high and most investment was financed domestically. Now, however, when public and private debt levels are high and foreign investment is a larger part of development plans, union militancy is a key constraint.

South Korea also has ambitious goals to become a regional hub for transportation, finance, and insurance in Northeast Asia. If Seoul were to shift to a truly free-trade direction, this could conceivably develop. Yet, it would probably happen only if the *chaebol* firms and the public gave up their protectionist stance and tried to link their future with open flows of capital, goods, and technology. Moreover, South Korea would have to make significant shifts in its response to foreigners and change pubic opinion about the desirability of a liberal economic regime for the "Hub Strategy" to work.[44]

Nevertheless, the biggest problem in South Korea is not internal; it is the perpetual uncertainty over what to do about North Korea. The discussion in Chapters 5 and 6 pursues this in greater detail, yet it is important to understand that this is not just a national security threat. North Korea poses a deeply fractious, domestic political problem within the South. There are millions of South Koreans who want to be reunited with family members in the North and are worried that they will die before they can do so.[45] Also, an increasing number of other South Koreans are convinced that allying with the United States to deter the North is unnecessary.[46] These factors have an effect on the economy, because they weaken those inside South Korea who want close relations with the United States and a focus on market-oriented policies. Since the Chinese are consciously slowing their economy, which could reduce the surge in Korean exports to China, it remains to be seen how pragmatic the South Koreans will be in crafting their policy choices. Will they continue their courtship of Beijing? Will they seek a neutral ground? Or, will a pro-Western stance win out?

The North Korean announcement on October 9, 2006, that it has exploded a nuclear weapon further exacerbates the situation. Fear in South Korea that this could lead to a military conflict certainly diverts attention from economic activities. Also, divergence between the Americans and Japanese, who want to take a firm stance toward North Korea, and the Chinese and Russians, who are more accommodating, makes the Korean Peninsula a site of growing controversy. At a minimum, this reduces the chances of South Korea becoming the type of Asian financial and commercial hub that it seeks to be.

Taiwan and Hong Kong

Although the internal structures of the economies in Hong Kong and Taiwan are very different, both face the same basic, painful dilemma. How do they plan future growth for a mature economy when the Chinese mainland is a lower-cost location and is currently incorporating first-rate technology in newer manufacturing facilities?

The leadership of Hong Kong has answered this question by acknowledging that manufacturing will die out and asserting that the future will be in financial services, design, and entrepot activities. Although there is not yet the political will to enforce international standards of conduct on investment banks and brokers in Hong Kong, the Heng Seng Exchange is the second largest in Asia and still has a number of advantages over Shanghai, so financial services are definitely viable.[47]

Yet, there are deep structural problems in Hong Kong that are somewhat similar to Japan's: falling marriage rate, declining birth rate, and an aging population. This will slow demand for new housing, so future growth will have to come through servicing the mainland and through new exports.

Taiwan has, of course, a larger land area and population and a much better scientific and technical capability than Hong Kong. Yet, its business community is no longer confident about Taiwan's future. The massive outflow of capital to the mainland not only drains the island of investible resources but also provides an incentive for the most talented young Taiwanese businesspeople to go to China. Will this lead Taiwan toward greater emphasis on technical innovation as its comparative advantage?[48] Or, will greater government intervention be necessary to provide incentives for attracting FDI and encouraging domestic economic activities?[49]

Recent political turmoil inside Taiwan, with splits in the president's ruling party and widespread calls for his resignation on corruption charges, appears to have had only a minimal effect on economic activity. Exports rose by 10.5 percent between May 2005 and April 2006, and there was buoyant growth in the electronic products, information technology, plastics, and agricultural and raw materials sectors.[50] Although this is raising profits for Taiwanese corporations, imports are growing faster than exports, and real household income grew by only 1.7 percent between 2005 and

2006. This means that Taiwan must continue its search for higher value-added products to compensate for manufacturing activities being transferred to the Chinese mainland.

The ASEAN States

ASEAN essentially has three types of economies: (1) the low-income states of Indo-China and Myanmar, (2) the semi-industrialized, middle-income states of Malaysia, Thailand, Indonesia, and the Philippines, and (3) the wealthy enclave of Singapore.[51] The centerpiece of the ASEAN region, however, is Indonesia. Because it has the largest GDP and largest population and spans the region from west to east, the economic future of ASEAN really hinges on Indonesia.

If Indonesia becomes a stable democracy and is able to reestablish a steady, if not rapid, growth, then the region has a solid core.[52] If Indonesia splinters or becomes an ongoing source of ethnic or religious radicalism, it will be hard for those around it to insulate themselves. Thailand could, conceivably, reduce its southern ASEAN contacts and focus predominantly on China to the north, but Malaysia, Singapore, and even the Philippines will all be under stress if Indonesia continues to teeter on the edge of chaos. Moreover, if Islamic radicals are able to polarize the region between Muslims and others, it will, ultimately, make battlegrounds of the Philippines, Malaysia, Indonesia, and Thailand, and cycles of violence will ensue.[53]

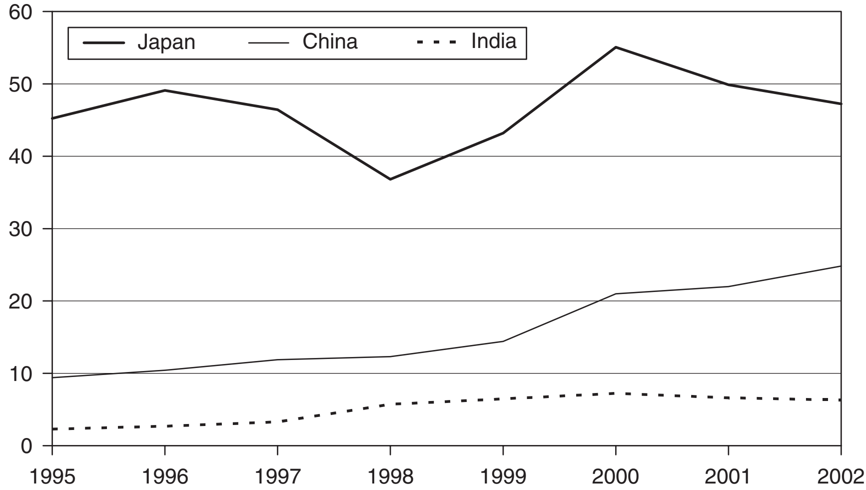
Thus, Indonesia, with its staggering problems of domestic and foreign debt, a net loss of foreign direct investment in the 1998–2004 period, and declining manufacturing employment, is ASEAN's major question mark.[54] Indonesia has had good years since 2004, when it elected a pragmatic president, Susilo Bambang Yudhoyono. Since then its economy has been growing at over 5 percent annually. The new president has tried to ease lingering investment and ethnic tension with China and Singapore specifically.[55] Singapore has vitality and talent but is highly dependent on its neighbors' performance.

Vietnam has been growing rapidly since 2000 (see Table 1.1). In certain ways, Hanoi appears to be imitating China's cautious steps at opening its economy in the early 1980s. Yet, per capita income is low and the economy so small that it has only a limited effect on the ASEAN region as a whole.[56]

This brings us to the basic question of development strategy facing the ASEAN states: If growth is going to be moderate from inside the region, with which outside powers should they link their futures?

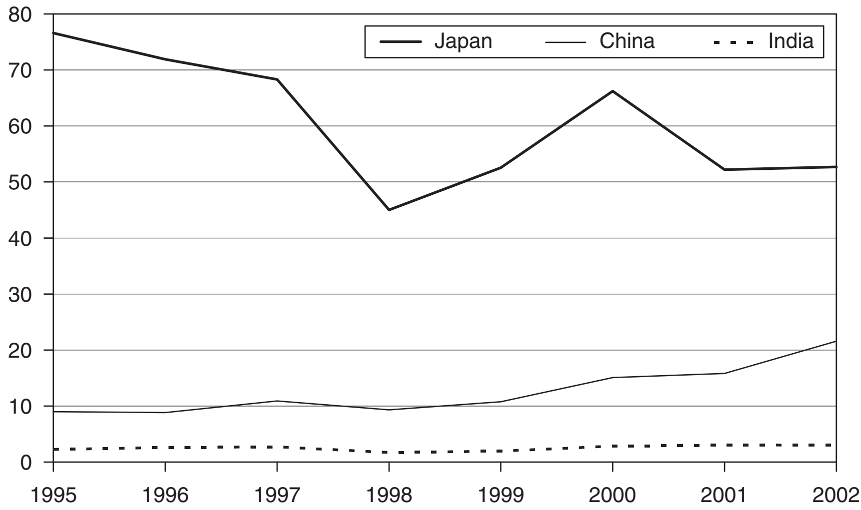
The basic trade data between ASEAN and India, China, and Japan give an indication of where future economic interests may lie. Figure 3.9 shows that Japan has been the largest Asian export market for the ASEAN countries in the past, but China is rapidly eclipsing it. China has thus become the principal focus of attention for Southeast Asian businesspeople. In Figure 3.10 we see that Japan was the largest Asian supplier to ASEAN, but its sales have declined over 30 percent in the 1995–2002 period, whereas China's exports have more than doubled.

It is also interesting to note that India is not yet either a major supplier or purchaser for ASEAN. Yet, it is significant that India imports more from ASEAN than its exports, so it has inducements to offer in its net purchases.



Sources:
IMF, Direction of Trade Statistics Yearbook, 2003.
Own calculations.

Figure 3.9 Imports from the ASEAN-5 countries.



Sources:
IMF, Direction of Trade Statistics Yearbook, 2003.
Own calculations.

Figure 3.10 Exports to the ASEAN-5 countries.

Thus, on balance, we see ASEAN fitting into the Pacific Rim pattern: its growth is slowing from prior decades, it faces major economic restructuring, and its chances of getting large flows of FDI to help in that transition are limited.[57] Both Japan and China can offer major economic incentives, but India will have to open its economy substantially to be a realistic economic competitor.

Conclusion

There are fundamental reasons to expect that China and India can maintain high economic growth rates in the near future. Their prospects hinge on high savings rates, surplus labor, and improved efficiency, which all seem obtainable. The Asian Pacific Rim countries, on the other hand, face a series of generic and specific problems, which are likely to keep their growth rates lower. None of these factors are immutable, and it does look as if there is finally a reasonably steady recovery from the aftereffects of the 1997 financial crisis.

However, as we turn now to the impact of these economic trends on regional institutions, strategic alignments, and U.S. policy, we will see in the Pacific Rim states the growing influence of bilateral links to the major powers.

Chapter 4

The Mixed Record on Political and Economic Integration in East Asia

Introduction

The most dramatic recent development in East Asian integration was the formation of the ASEAN-China Free Trade Area (ACFTA) in January 2004. This launched an economic bloc with 1.8 billion people and over $2.5 trillion of combined GDP. Because China has a trade sector that is roughly equal in size to its GDP and Southeast Asia also has very open economies, their combined trade sectors in the ACFTA started at $2.1 trillion. This is an economic powerhouse.

The ACFTA also has immediate political implications. It signaled that China had overcome its Cold War legacy of hostility with the Southeast Asian states. It also showed that Beijing has a lead over Tokyo in regional economic diplomacy because Japan's offer of an ASEAN-Japan Free Trade Area came two months later and was much more limited in scope than the one China offered.

Between 2004 and 2006, trade has surged ahead between ASEAN and China. Beijing offered an "Early Harvest" to the Southeast Asian countries, letting them export agricultural products and raw materials to China at low tariffs in 2004 and at a zero-tariff rate beginning January 2006. Not only was this a major stimulus to trade, but it also emphasized the differences between the Chinese and Japanese approaches to integration: Japan continues to protect its agricultural sector and is pressing for market opening in services and investment as well. Nevertheless, despite the undoubted success of the ACFTA, we are still left with the following questions: Will China-ASEAN trade be the basis for broader regional integration? *Or,* will other factors dominate and limit trade as the cornerstone of comprehensive regional integration?

East Asia's Record on Economic and Political Integration

Economic linkages within East Asia have grown rapidly in the past two decades, first with Japan in the lead and now with China in the forefront. Yet, there is no single governmental organization providing an overarching framework to go beyond economic ties—as the European Community did for Europe in the 1950s. The problems to overcome appear daunting, and most of the states involved can achieve a substantial part of their economic and security objectives through bilateral arrangements.

The six propositions below set out the current situation:

1. Ethnic, religious, linguistic, historical, and ideological differences have all limited cooperation in East Asia.
2. The most impressive form of integration has been economic.
3. There are many Asian regional organizations, but they have a mixed performance record.
4. Since World War II, regional security has been provided mostly by outside powers.
5. As yet, there is no multilateral security arrangement to substitute for U.S. dominance.
6. East Asian integration is proceeding incrementally. Instead of a grand, multilateral scheme, integration is being achieved mostly through a complex web of bilateral linkages, some official, some informal. The most important new bilateral linkages are between the ASEAN states and China.

This chapter will explain the factors shaping the pace and extent of integration in East Asia, and then, in the conclusion, comment on what different directions integration may take in the future.

Although the ASEAN Free Trade Area (AFTA) is multilateral and the Chiang Mai Initiative is designed to provide multilateral assistance in a currency crisis, these are modest achievements in comparison with the surging trade and investment in the region, which is occurring primarily because of the private sector and assorted bilateral trade and investment agreements.

Thus, it is important for us to recognize that *East Asian integration is happening* but is *not* following the European model. The forms of government in Asia differ significantly, and there is no shared consensus on security arrangements. Moreover, as China extends its Free Trade Agreement with ASEAN, it will have the effect of strengthening a broad range of ties between Beijing and the Southeast Asian capitals. The ACFTA will also tend to divert trade and investment, and thus attention, away from ASEAN's ties with Japan, Europe, and the United States. Therefore, as we proceed through the evidence about East Asian integration, we need to look for both the bilateral and multilateral features of current developments. Also, as the Indian economy has grown and diversified, New Delhi has begun to offer the East Asian states assorted inducements for access and influence.

This means that three regional powers (China, Japan, and India) and one outside power (the United States) will all be competing for favor. The United States is clearly dominant militarily and is the largest single market, but East Asian states will have a growing range of alternative linkages in the future. So, the attraction of these bilateral ties, and the commitments they entail, will shape the character of evolving multilateral institutions in the region.

WHAT ARE THE MAIN DIVISIONS WITHIN EAST ASIA THAT MAKE COOPERATION DIFFICULT?

Before we deal with this exceptionally complex question, some caveats would be appropriate. It is not being claimed that the differences within Asia are necessarily greater than those found in Europe before the integration movement began there. What is being asserted is that the differences are still so noticeable that few Asian leaders, in the post–World War II period, have seen sufficient political capital to be gained to make a major effort at regional integration. In essence, the domestic price of compromise has not appeared to be less than the gains from the gradually ceding sovereignty to international bodies.

ASEAN's experience will be discussed in detail below. Southeast Asia is clearly the Asian arena where multilateral efforts have proceeded the farthest. Yet, even there, where political cooperation is substantial, each of the countries has sought formal or informal security guarantees with outside powers, and nationalist sentiment is such that there are distinct limits to integration. So, even with 37 years of multilateral efforts within ASEAN, integration has not even proceeded to the stage that Europe reached in 1958 with the creation of the Common Market. The AFTA has lowered trade barriers within Southeast Asia, but there is no common external tariff.

Three principal differences *within Asia* make cooperation difficult.

ETHNIC, RELIGIOUS, AND LINGUISTIC DIVERSITY

The dozens of different ethnic groups and languages in East Asia have posed a dilemma and have been a source of divisiveness for millennia.[1] Although English has become the Asian language for international commerce and diplomacy, understanding the complex interaction between ethnicity and language is essential for interpreting Asia's political geography. Japan and the Korean Peninsula are the only two parts of the region where the populations are ethnically homogeneous. Every other state has had to deal with choices about discouraging or permitting diversity, while still creating a sense of national cohesion. Thus, it is not surprising that after spending great resources to blend multiethnic states, leaders have been hesitant to cede sovereignty to regional institutions. Moreover, because Southeast Asia has significant minorities of "overseas Chinese" and Indians, local leaders have long been concerned about the basic loyalties of many of their citizens.[2]

Religion poses another major complicating factor. China has a long tradition of being a secular state, but most other countries in East Asia have used religion as a means to reinforce state power.[3] This produces resentment among believers who do not share the majority's views. For example, in the Philippines, over 80 percent of the population is Roman Catholic and the minority is Muslim, while in Thailand, over 90 percent of the public is Buddhist and the principal minority is Muslim. In both cases the minority sees itself as persecuted, and both countries have a long history of violent protest.[4]

An even more complex situation exists in Malaysia and Indonesia, where the leadership has been predominantly secular, but where Muslim groups have long sought to make the countries religious states.[5] The bitter divisions between those who favor a secular versus religious regime have been accentuated after September 11, 2001, when the United States crushed the Taliban government in Afghanistan, invaded and occupied Iraq, and began an active worldwide effort to suppress terrorist groups.

Muslim identity and violence poses a particular challenge to Asian integration now because underground groups, such as the *Jemah Islamiyah,* function in the Philippines, Malaysia, Indonesia, and Thailand and directly oppose these secular states, arguing for the creation of a universal, Muslim nation.[6] Members of the other major religions of the region (Buddhism, Christianity, and Hinduism) as well as some of the smaller sects, such as the Cao Dai and Hoa Hao in Vietnam, would all find a Muslim state undesirable. Hence, the more secular elites, who have been responsible for mobilizing the economic transformation in the region over the past three decades, are very likely to resist the further intervention of Islam into governance. Given the fervor that some young Muslims bring to their faith and the absolutist teaching common in many *madrassas,* the probability of future conflict over religion, especially in Southeast Asia, seems high.[7] This issue is significant among the original six members of ASEAN, with the Philippines, Thailand, and Singapore worried about the Islamist influence and Indonesia, Malaysia, and Brunei more tolerant of it.[8]

Bitter Memories of Past Conflicts

It would be easy to fill an entire volume with summaries of past Asian conflicts that have led to present-day resentments. Our purpose here is not to review that history, but to show how deep the bitterness is and how it appears to be affecting willingness to cooperate within Asia.[9] For example, in the second half of the twentieth century, each of the following pairs of countries has been involved in a major conflict or controversy, and memories of those altercations remain vivid: Russia-China, Russia-Japan, Korea-Japan, China-Taiwan, the Philippines-Malaysia, Singapore-Malaysia, Singapore-Indonesia, Vietnam-Cambodia, and India-China. In most of these cases, local textbooks are still written criticizing the neighboring state, and in some countries, a national sense of being persecuted is still widely discussed.[10] Moreover, three major territorial disputes create distrust: (1) disagreements over the Spratly Islands in the South China Sea, (2) differences between China and Japan over the Diao-yu/Senkaku Islands and neighboring economic resources in the East China Sea, and (3) overlapping claims by Japan and South Korea to the Dokto/Takeshima Island in the Sea of Japan.

In Southeast Asia, primarily through the auspices of ASEAN, the political leadership has been the most active in trying to mitigate past tensions. At the time of ASEAN's creation, President Suharto took a very direct role in reassuring his neighbors that Indonesia would not repeat his predecessor's policies of confrontation, and Filipinos and Malaysians decided that de-escalation of the Sabah territorial dispute was in their mutual interest.[11]

Myanmar (Burma) poses special problems for ASEAN. Its oppressive military junta has repeatedly resisted urging by other ASEAN states to improve its human rights record and allow Aung San Suu Kyi's National Alliance for Democracy to operate openly. One of ASEAN's motivations for accepting Myanmar (and its governing junta) into membership in 1997 was to limit Chinese influence in Southeast Asia's westernmost state. There was, also, hope that full participation in ASEAN would encourage Myanmar's military leaders to modernize the society and participate more fully in regional economic development. Just as the hopes for a political opening have been dashed, so have the plans for the greater economic integration of Myanmar's population in ASEAN. Myanmar's new economic links are overwhelmingly with China, with India showing renewed interest as well. ASEAN shows no enthusiasm for putting real pressure on Myanmar for change, so ASEAN gets criticism from Europe and the United States without the benefit of having a committed regional participant.[12] Also, because the United States maintains sanctions on Myanmar and American leaders refuse to participate in meetings with Myanmar's government officials, the standoff limits Washington's closeness to ASEAN.

In Northeast Asia, almost the converse has been the pattern: political leaders have used historical experiences and resentments as a continuing means of solidifying domestic support. In China, the legacy of Japanese occupation and brutality is remembered directly only by those over 60 years old, but references to the Japanese presence are widespread and are a key element of Chinese nationalism today.[13] Even more virulent anti-Japanese sentiment is pervasive in South Korea and serves as a constant motivator for Koreans to outperform their former occupiers.[14] Although there are many other features involved, anti-Japanese feeling is one of the emotional aspects of growing Chinese-South Korean ties.[15] These Chinese and Korean sentiments have led to periodic protests and riots, such as the widespread disorders in China in 2005 protesting bias in Japanese textbooks and the visits of the then prime minister Koizumi to the Yasakuni Shrine.

The Japanese, for their part, have tended to downplay the behavior of their troops during World War II and have concentrated on the shame of their defeat in 1945.[16] Recent statements by Prime Minister Shinzo Abe have reopened this controversy.

There is also a small, but influential, conservative segment of the Japanese populace that thinks that Japan has done enough penance for World War II and should not be hesitant to defend its own interests and reassert its national prominence.[17]

These bitter memories in Northeast Asia may gradually fade, but they clearly complicate the process of regional integration. When the memories are combined with present-day ideological differences, they form more formidable barriers.

Ideological Divisions

Between 1945 and the end of the Cold War, the ideological divide in Asia was every bit as great as it was in Europe. Whether a state was Marxist or non-Marxist was one of the first identifying characteristics that shaped its international relations. The Soviet Union and China each had extensive ties with North Korea and North Vietnam and at various times provided arms and financial support to Cambodia and Laos, as well as to various insurgent groups in Southeast Asia.[18] Moscow and Beijing also had links with non-Marxist states. Notably, the Soviet Union had long-standing close ties with India, cemented with a treaty in 1972; and China had, and continues to maintain, strong ties with Pakistan.

In the 1950s, the United States extended the Containment Policy it had launched in Europe to Asia, forming a set of bilateral alliances with Japan, South Korea, the Philippines, and Thailand. In addition, the United States created two multilateral alliances, the Southeast Asia Treaty Organization (SEATO) and the Australia, New Zealand, Unites States Security (ANZUS) Treaty. Although SEATO and ANZUS have not survived intact to the present, the bilateral treaties have, and Washington maintains a very close working relationship with Canberra.[19]

Asia is one of the few regions of the world where Marxist governments still exist. North Korea, Vietnam, Cambodia, and Laos all have Marxist leadership and show few signs of giving up the faith.[20] China is a mixed case, where the Communist Party still controls all vital levers of power, but by the early 1990s, it was clear that the political leadership was committed to using the market and foreign investment for the country's economic modernization.[21] "Market socialism" became Beijing's favored term to describe the Chinese approach. Therefore, many analysts would conclude that China is a curious hybrid: Marxist-Leninist in its political structure but increasingly capitalist in its economic policy.[22]

If we look at Figure 4.1, we see another interesting pattern: Vietnam, Laos, Cambodia, and Myanmar are the poorest countries in Southeast Asia; three of them are quasi-Marxist and the fourth, Myanmar, combines socialist rhetoric with a harsh military dictatorship.[23] There are no reliable economic statistics on North Korea, but given its extended famines and crumbling infrastructure, it is fair to say that the country is probably the poorest in East Asia.[24] Thus, except for China, the Marxist-influenced states are the least advanced and poorest ones. So, their leaders are likely to be hostile not only to globalization but also to regional integration. In Asia, there is no one state that can serve as an adequate counterweight to China. Japan has a substantially larger GDP than China, but its population is still only one-tenth as large.[25]

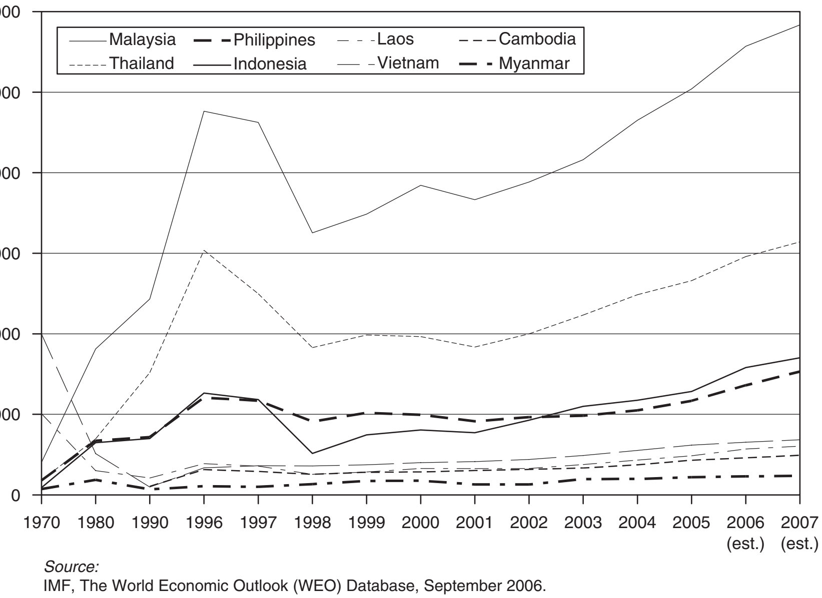


Figure 4.1 Southeast Asian per capita GDP.

China's population is twenty times that of Vietnam, Thailand, and the Philippines; each forty times that of Malaysia; three hundred times that of Singapore; and four times that of Indonesia.

Because China's population is larger than the rest of East Asia combined and it appears to be on a trajectory to have the largest GDP in the region by 2025, discussions of economic integration essentially focus on how to relate to China and what ties to keep with Japan. If all the other countries of East Asia could form a trading and financial bloc, they could balance China. However, because China is in the middle of the region, it would be grossly inefficient to divert trade to more distant and slower-growing partners. Hence, China holds key advantages in negotiations about the future of Asian integration.

The energy and skill that China has shown in its diplomatic initiatives toward Southeast Asia are truly impressive. For example, in the 1980s, China did not even have diplomatic relations with Indonesia because of Jakarta's suspicions that Beijing has been involved in the 1965 coup attempt (which led to the downfall of the Sukarno government). Since that time, however, China's diplomatic visibility has soared.

China was invited to be a consultative partner and attend the ASEAN Post Ministerial Conference (PMC) in 1991. After that, there was a virtual string of diplomatic successes: China became a member of the ASEAN Regional Forum in 1994, became a full dialogue partner of ASEAN in 1996, and began an annual series of ASEAN-China summit conferences in 1997. In 2002, the Framework Agreement on ASEAN-China Economic Cooperation was signed, which set the stage for the ACFTA. China heightened its visibility in the security area by signing two declarations: (1) the Conduct of Parties in the South China Sea, and (2) Cooperation on Non-Traditional Security Issues.[26] Thus, in a period of 15 years, China has gone from being a looming, distant presence to becoming central to the economic and security arrangements in Southeast Asia. In November 2006, China held a conference with the ASEAN states commemorating those 15 years of increasingly close ties.

Why Has Economic Integration Made the Most Progress?

As discussed in Chapters 2 and 3, there has been a fundamental transformation of East Asian economic policy preferences in the past three decades. In 1970, China was still in the middle of the Cultural Revolution, the Vietnam War was raging, and most of the countries in the region were following protectionist, import substitution industrialization (ISI) strategies.[27]

By 1980, the picture was significantly different. Although many Asian countries had not given up their protection of domestic markets, there was a striking shift toward export-oriented growth.[28] In rough order, Japan, Hong Kong, Singapore, Taiwan, South Korea, and Thailand took the steps to restructure their economies to benefit from exporting, rather than focusing primarily on internal markets. Malaysia and Indonesia followed suit. This meant developing the infrastructure, quality control in manufacturing, and support services (banking, insurance, and market research) necessary to compete successfully in foreign markets.[29]

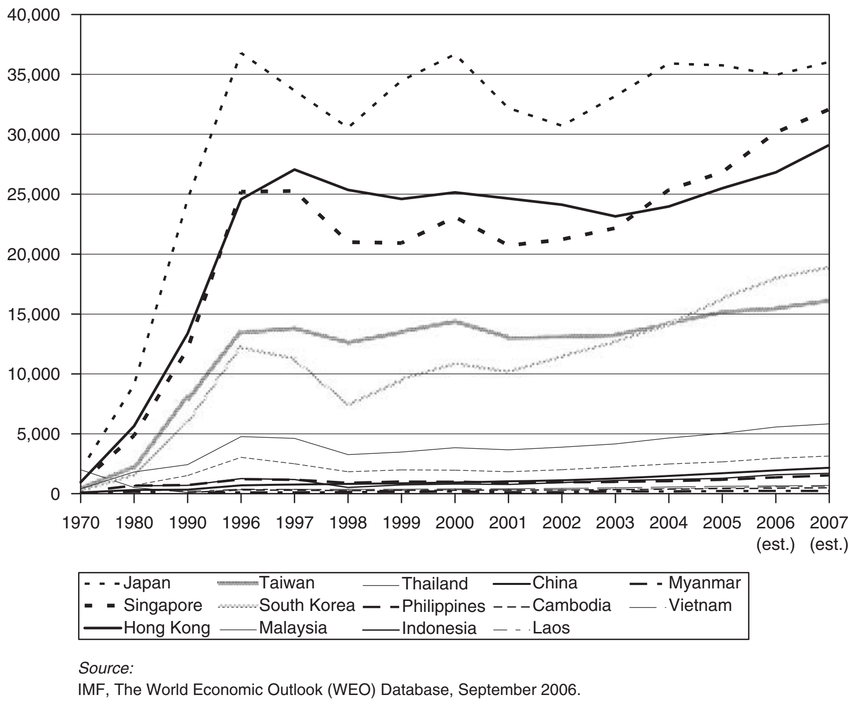
Another key element in this transformation was the American willingness to accept Asian exports without expecting full reciprocity. This meant that during the

1975–1996 period, Asian governments and businesspeople could count on long-term access to the U.S. market for their exports, without fully opening their own markets.[30]

Some countries (South Korea, Malaysia, Singapore, and Indonesia) followed aspects of the Japanese model of extensive state intervention in the planning and implementation of industrial growth.[31] Others (Hong Kong, Taiwan, and Thailand) took a less interventionist direction, but virtually all the fast-growing East Asian states relied on exporting to power their advance. However, this did not produce Asian integration per se. The focus was on export markets in the United States and, to some extent, in Europe. In ASEAN, for example, trade *within* Southeast Asia stayed at about 15 percent of total trade through most of the 1970s and early 1980s.[32]

It was only in the late 1980s and 1990s that intraregional trade picked up momentum within ASEAN.[33] In the same period in Northeast Asia, the focus was also still predominantly on the American market. Nevertheless, two decades of export orientation prepared the countries of East Asia for greater intraregional ties because they had mastered the process of identifying markets, getting financing, and changing equipment to manufacture new products.[34] As Figure 4.2 illustrates, in the period from the mid-1970s to the mid-1990s, per capita incomes in the export-oriented countries rose sharply and distinguished these countries from others still following a planned economy or an ISI strategy.[35]

The process of acquiring competitive technology has been a central aspect of China's development strategy. Beijing has very much encouraged foreign investment



Source:
IMF, The World Economic Outlook (WEO) Database, September 2006.

Figure 4.2 East Asian per capita GDP.

that would upgrade the Chinese industrial base, and it has been successful at establishing a multinational supply-chain system, as discussed in Chapter 1. This pattern has become a triangular one where, usually, (1) *design* is done in the United States, Japan, and Taiwan; (2) *parts manufacture* is done in the Pacific Rim states or in the most advanced Chinese provinces; and (3) *assembly* is completed (mostly for export) from low-wage locations throughout China.

These informal arrangements, which involve businesses, families, and assorted joint ventures, have transformed the Chinese industrial landscape in two decades. Moreover, though China does not yet compete directly in designing products, it is getting a first-rate manufacturing capability, and it can compete with many middle-income developing countries (such as Mexico and Malaysia) that have per capita incomes many times that of China.[36]

Ironically, the 1997 financial crisis became a key impetus for economic integration in East Asia for two reasons: (1) much of the financing for export to the United States and Europe was halted, temporarily, as many Asian financial institutions and corporations were in distress, and (2) China continued to grow rapidly, was in the process of opening its markets for compliance with its commitments to the World Trade Organization, and became a very attractive source of export demand for its Asian neighbors.

In the turmoil surrounding the 1997 financial crisis, it was unclear which Asian banks would survive, which corporations would continue to function, and how commerce would be transacted. Bankruptcy laws in many Asian countries are imprecise, and their administration by local courts often favors local firms.[37] Thus, new lending by foreign banks came to a halt while "financial restructuring" was being negotiated. One advantage that Chinese businesspeople had in this period was that they often extended credit on the basis of personal ties, not formal lending agreements.[38] So, the Chinese were able to finance imports from Southeast Asia without waiting for the formal documents that Western financial institutions required.

The surge in intra-Asian trade (which we will analyze in greater detail below) was feasible because most of the Pacific Rim countries had already mastered export-oriented growth and desperately needed new markets to help revive their economies. It was fortuitous for the ASEAN states that, in the late 1990s, the Chinese economy was surging ahead and Beijing had decided to end its protection of local markets. This led to a dramatic reorientation of trade within East Asia.

Thus, economic integration within Asia has accelerated since the 1997 financial crisis. China has become a more attractive market for Asian exports because of its soaring demand for raw materials and parts, its minimal barriers to trade, and its ability to finance imports while much of the Southeast Asian banking system was being restructured.

Why Has the Performance of Asian Regional Organizations Been So Limited?

There are a number of factors that have combined to limit the scope and impact of the numerous Asian regional organizations. We will not attempt to cover all the factors or comment in depth on any one organization but, instead, will attempt to provide an overview of the issues involved. There are five principal reasons why governmental and quasi-governmental organizations in Asia have had a limited purview.

ASPIRATIONS HAVE BEEN TEMPERED BY THE OBSTACLES INVOLVED

In Southeast Asia, the founding member states of ASEAN (Thailand, Malaysia, Singapore, Indonesia, and the Philippines) were all anticommunist and wanted to create solidarity without forming a military alliance.[39] In 1967, leaders of these countries were worried about North Vietnam's military strength and were unsure how long the United States would maintain its commitments to South Vietnam.

After 1975, when the United States withdrew from Vietnam, ASEAN began its most cohesive period. In 1979, it opposed the Vietnamese occupation of Cambodia and continued to press, throughout the 1980s, for international sanctions to reestablish an independent Cambodia.[40] ASEAN was only partly successful, as Vietnam was able to keep its preferred choice as Cambodia's leader in power. Yet, Vietnam did formally withdraw from Cambodia, and after the collapse of the Soviet Union, Hanoi decided that its future lay with a noncommunist Southeast Asia. By 1994, Vietnam had dramatically reversed its course, joined ASEAN and begun trying to attract FDI.[41]

In 1997 the members of ASEAN made the fateful decision of admitting Cambodia, Laos, and Myanmar, reasoning that this would lead to a more influential regional grouping.[42] As discussed above, this meant that ASEAN would have countries with vastly different levels of economic development and with very different political systems. The admission of Cambodia, Laos, and Myanmar was completed by 1999; however, by then, ASEAN was reeling from the crash of 1997, and it was no longer a confident or effectively functioning group. Since 1999, ASEAN has been attempting to recoup its former luster but has not been in a position to propose major efforts at Asian integration.

As will be discussed in Chapter 5, ASEAN did sponsor the "East Asian Summit" (EAS) in Kuala Lumpur in December 2005. Some of the sponsors thought the EAS might form the building blocks for a regionwide political grouping. The EAS was an outgrowth of the ASEAN + 3 discussions and drew the heads of government from throughout the region. The EAS pointedly excluded the United States, but did include Australia, New Zealand, and India (which are not in ASEAN + 3). Nevertheless, on balance, the EAS was inconclusive, as there was no consensus on an agreed future agenda. The EAS might be the first formative step toward a truly Asia-wide political and security organization, but this cannot be discerned from its initial meeting.

In Northeast Asia, the legacy of tension between China and Japan and the major ideological differences during the first three decades after World War II have meant that integration was simply not a plausible option. From the 1950s to the early 1990s, Japan was clearly the economic leader in the region. As recently as 2000, China was still trying to extract concessions from Japan regarding World War II, and this resulted in public outrage during the then Chinese president Jiang Zemin's 1998 visit to Tokyo.[43]

The growing tension between China and Japan has further complicated developments within ASEAN + 3. As noted in Chapter 1, the decision of Prime Minister Koizumi to make repeated visits to the Yasakuni Shrine—which honors Japanese who died in World War II—deeply angers many in China and South Korea. Japan's neighbors are upset not because the shrine honors those fallen in war, but because it is seen by many as a symbol of Japanese militarism. In addition, only two post–World War II Japanese prime ministers have even visited it while in office. Although the current Japanese prime minister, Shinzo Abe, appears likely to avoid the Yasakuni visits and has started his term with conciliatory meetings in Beijing and Seoul, this issues remains in the background of all Japanese-Chinese official discussions.

Japan's economy began to gain some momentum after 2004, but because China's economy has been booming for two decades, Beijing has gotten most of the recent attention from its neighbors. The Chinese took this an as opportunity to propose expanding the China-ASEAN Free Trade Area to an even broader one including China, South Korea, Japan, and ASEAN. Since the Japanese want to continue to protect domestic agriculture and certain key industries, they would not agree to a regionwide FTA.

In mid-December 2003, at a Japan-ASEAN summit, Tokyo made something of a counteroffer and proposed a significant increase in aid, made a commitment to join the ASEAN Treaty of Amity and Cooperation, and advocated a "comprehensive economic partnership," a euphemism for selective free trade (but only by the year 2012).[44]

Therefore, in the post–World War II period, there have been various times when Japan, ASEAN, and China have each shown leadership on economic integration, but there has never been a time when all three, simultaneously, were sufficiently confident about their own internal economic performance to make big moves on integration.

There Has Not Been an Asian Leader Who Could Speak for the Region as a Whole

In Europe, during the late 1940s and early 1950s, Jean Monnet and Robert Schuman provided the vision and the analytical support for the concept of the European Community, but major political figures, such as Chancellor Adenauer of West Germany, were willing to use political capital to provide momentum.[45] This allowed the Europeans to move in a clear progression from the European Coal and Steel Community in 1953, to the European Economic Community in 1958, to the European Monetary System in 1979, and the Maastricht Treaty in 1991.

In Asia there have been leaders who commanded international attention. Sukarno, Zhou Enlai, Mao Zedong, Yasuhiro Nakasone, and Lee Kuan Yew each, in their own time, have been major spokesmen for different causes.[46] However, there has not been any one figure to carry the torch for broad-based East Asian integration. Mahathir Mohamad, the former prime minister of Malaysia, tried to play this role with his proposal for an East Asian Economic Group (EAEG), but he was thwarted by the then president Suharto of Indonesia and others who saw this as an anti-Western initiative which might cause trouble with the EC countries and the United States.

Each of the Asian Regional Organizations Has Had a Defined Purpose, but, as a Group, They Have Not Become the Building Blocks for Broader Integration

For this brief discussion, it is useful to divide the Asian regional organizations into three categories: trade, monetary cooperation, and political and security groups.

Trade

The Asia Pacific Economic Cooperation (APEC) has been the leading governmental organization promoting freer trade in Asia.[47] APEC was started in 1989 and achieved important initial status and visibility because it was the only Asian regional organization where heads of government came to an annual summit meeting.[48] It reached its apex of influence in 1994, when the Indonesian president Suharto proposed an APEC free trade area for developed countries (and others wishing to join) by 2010 and a mandatory free trade area for all members by 2020.

At the time, it appeared that the APEC would provide the organizing principles for a trading regime in the Pacific Basin, which included all the large East Asian economies. However, as we see in Appendix 4.1, since the mid-1990s, there has been a virtual proliferation of Asian trade agreements and most are *bilateral,* not multilateral. The United States, for example, has a bilateral FTA with Singapore and similar agreements are likely with Thailand and the Philippines.

Thus, APEC's goal—to provide a multilateral trading environment—has been superseded in reality by an elaborate network of bilateral arrangements. This has been the result of two principal factors: (1) a recognition among APEC members that the World Trade Organization (WTO) provides the best forum in which to negotiate multilateral trade agreements, and (2) the desire of individual states to offer certain benefits and concessions to other countries that cooperate with them.[49]

Neither of these two factors that limit APEC's influence is likely to go away. The WTO is now well-established, and the Doha Round stalled. Thus, no state has an incentive to negotiate multilateral concessions with APEC and then turn around to do a different set of negotiations, on a global basis, with the WTO.

Nevertheless, there is some chance that APEC will achieve a slightly higher profile. At the November 2004 APEC meetings in Santiago, Chile, the members endorsed the Santiago Initiative for Expanded Trade in the Pacific region. Specifically, they agreed to do an assessment of whether the 1994 Bogor goals of free trade in the APEC region for developed countries by 2010 and for lower income countries by 2020 are being met.[50] The dilemma is that the current governments in both Japan and the United States prefer bilateral free trade agreements to multilateral ones. Bilateral FTAs facilitate sector-by-sector bargaining and allow each government to write specific exceptions that are not feasible for multilateral FTAs.

So, though it would be more efficient to negotiate an FTA on a Pacific Basin–wide basis (through APEC), that process would take away the political advantages that particular countries gain from offering an FTA to a favored country. For example, Japan was willing to offer an FTA to Singapore because their industrial sectors were compatible and because Singapore had no agricultural goods to export and was no threat to the Japanese farm lobby. Canada has proposed that APEC begin discussions of moving to a full APEC free trade area, but the chances of this succeeding appear slight.[51] Hence, APEC has served a useful function and its annual summit is a superb forum for discussions among heads of government, but it is not shaping the trade agenda in Asia.

Despite being signed in 1992, the full provisions of the ASEAN Free Trade Area (AFTA) did not go into effect until 2003. In the early 1990s, several ASEAN states sought exceptions that would protect key industries, and then the turbulence surrounding the crash of 1997 created further uncertainty about whether AFTA would be implemented in the midst of the recovery from 1997. Yet, by definition, AFTA is for the ASEAN states, and as the ASEAN-China FTA is coming into force, AFTA is being eclipsed. Necessarily, this will heighten China's influence in Southeast Asia vis-à-vis South Korea, Japan, and Taiwan. It remains to be seen if ACFTA is a strong building block for the future or more of a superbilateral agreement. Yet, there is little doubt ACFTA will enhance China's influence throughout ASEAN.

Monetary Cooperation

One of the newest areas of Asian economic cooperation is on monetary policy and external monitoring of member states' fiscal policies. In 2000, the ASEAN states plus China, South Korea, and Japan agreed to set up a means for countries to request bilateral swaps of currencies in periods of need.[52] This initiative, launched in Chiang Mai, Thailand, was seen as a partial resurrection of the idea originally proposed by Japan in 1997 for an Asian monetary fund.

In 1998, the U.S. Treasury opposed the Asian monetary fund concept on the grounds that it would duplicate capabilities of the International Monetary Fund and be less rigorous in its criteria for crisis lending. This American position was resented in Asia because the United States had not contributed to the Thai bailout fund and taken a hard line, supporting the IMF in its negotiations with the Indonesian government. So, many governments in Asia vowed to build up their own foreign exchange reserves and to seek currency exchanges within the region if possible. Both moves have come to fruition. Asian foreign exchange reserves reached an all-time high in 2005 and 2006, and in the first four years the Chiang Mai Initiative was in effect, there were $36 billion in bilateral swaps between governments.[53]

In addition, with the encouragement of the Asian Development Bank, the members of the Chiang Mai Initiative have established an Asian Bond Fund to reduce their reliance on U.S. Treasury securities and stimulate Asian bond markets. The range and breadth of the Asian private sector financial instruments has also expanded with a boom in options and currency futures.[54]

Progress in the recovery from the 1997 crisis and growing confidence about sharing financial data has led, also, to initial efforts at reciprocal monitoring of monetary and fiscal policies. As Figure 4.3 shows, most Southeast Asian governments have moved from budget surpluses before the 1997 crisis to steady deficits thereafter. Many Asian governments want to demonstrate that they can handle their own economic policy without IMF intervention, so it may prove to be more acceptable politically to get advice from neighbors than from IMF technocrats in Washington.

If these assorted financial moves continue, they could signify the beginning of an Asia-wide form of economic cooperation. Although the foreign exchange reserves are overwhelmingly concentrated in Tokyo and Beijing, the effort involves countries throughout East Asia and this is one arena where Japan brings more cards to the table than China does. Hence, Japan is likely to continue to press for cooperation in this area, and the Asian states can make progress without global negotiations or approval from Washington.

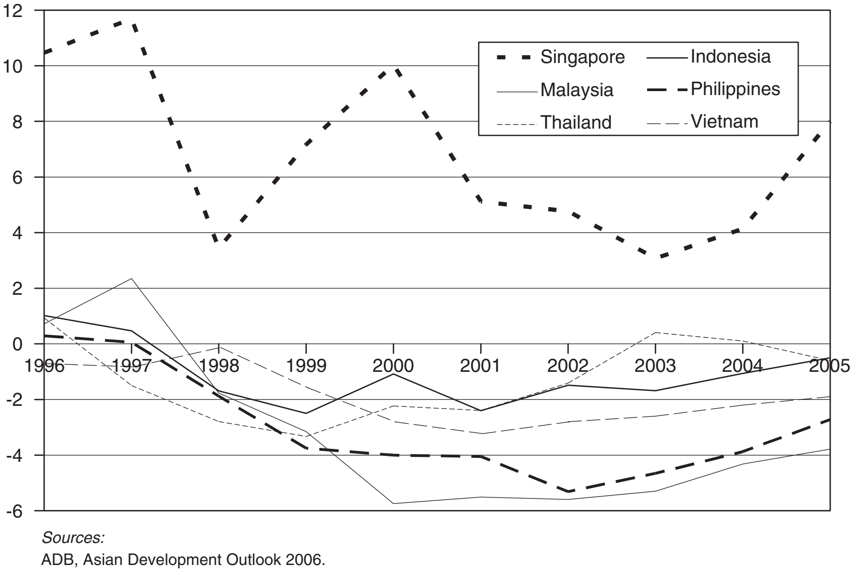


Figure 4.3 Southeast Asian central government budget balances.

Although it was five years after the 1997 financial crisis, the United States did announce a program, the ASEAN Cooperation Plan (ACP) to strengthen U.S. ties with Southeast Asia. At the 1992 Brunei Post-Ministerial Conference, Secretary of State Powell proposed this plan with three principal components: (1) support for ASEAN integration through legal aid and assistance to civil society groups, (2) co-operation on transnational issues, such as limiting drug smuggling, piracy, and AIDS, and (3) efforts to strengthen the staff and management of the ASEAN secretariat. There are dozens of small projects that have grown out of this U.S. effort, many linking the private and nongovernmental organization sectors with counterparts in Southeast Asia. These projects are meant to develop analytical and managerial capabilities inside the ASEAN region and, in some respects, are similar to the non-trade development projects that APEC is sponsoring.[55]

Political and Security Cooperation

There are six organizations or forums that could, in theory, become the essential building blocks for an Asia-wide security agreement: ASEAN, the ASEAN Regional Forum, ASEAN + 3, the East Asian Summit, the Shanghai Six, and the "six-party talks" (regarding North Korea's nuclear programs).[56] Each of these organizations involves key players that would need to be a part of a broader Asian security effort. However, there is probably only one, ASEAN + 3, that has the potential to evolve into a true regionwide organization.

ASEAN alone cannot draw in its Northeast Asian neighbors and maintain its current operating style of consensus decision making. Dewi Fortuna Anwar aptly describes ASEAN as mimicking the Javanese style of "leading from behind."[57] The Northeast Asian states will not be comfortable with ASEAN's style of operation, and Japan and China would want a guaranteed special position in an Asia-wide security arrangement.

Yet, it is precisely because no Southeast Asian state asked for a privileged position that ASEAN was able to function so amicably for close to four decades.

In February 2004, the government of Indonesia urged its fellow ASEAN members to create an “ASEAN Security Community.” The Indonesia proposal had seventy specific elements, including broader promotion of democracy and human rights, advocacy of free and regular elections, and a more open flow of information within the region. The security element was the most controversial, however, as its principal feature was the creation of a regional peacekeeping force. The Indonesian government saw this as a “regional solution to a regional problem” and as a way for ASEAN to develop a more autonomous security policy.[58] Indonesia’s neighbors expressed their reservations by requiring that the proposal be rewritten before it was even formally discussed, and there was concern, within the region, that this was Indonesia’s effort to reassert its prominence within ASEAN. Yet, new language on democracy and human rights was eventually accepted. However, it is fair to conclude that, if ASEAN is not willing to create its *own* peacekeeping force, the group’s cohesion is not yet sufficient to bargain with the Northeast Asian states on a broader set of East Asian security arrangements.

When the ASEAN Regional Forum (ARF) was created in 1994, it appeared that the ASEAN states were making their first step in an Asia-wide security effort, and its Track II meetings have provided many candid discussions. However, its membership became very broad, and the group has not been willing to deal with tough issues, such as the Spratly Islands, Taiwan, or Korean Peninsula questions.[59] The ARF’s strengths are also its weaknesses: the broad membership means that it is the only Asian organization that includes India, Russia, Canada, and the United States, but, since the interests of the participants are so diverse, the group has chosen only noncontroversial subjects to discuss. The ARF should not be excluded from being a building block for future integration, but it has not produced a record of solving problems and so has not developed many strong supporters.

The Shanghai Six (Security Cooperation Organization) and the Asia-Europe Meeting (ASEM) are two other potential candidates for larger roles, though both have a limited focus. The Shanghai Six was started in the mid-1990s to establish cooperative relations between China, Russia, and the Central Asian states. Some thought it might become the basis for an anti-Western bloc, but after 9/11, both China and Russia decided to cooperate with the United States and not immediately contest American involvement in Central Asia. By 2005, however, both Russian and Chinese leaders were becoming uncomfortable with the continuing presence of the United States near their Central Asian borders. Thus, leaders in Moscow and Beijing began to see the Shanghai Six differently—as a useful means to put pressure on the United States to withdraw from Central Asia. Hence, it appears that the Shanghai Cooperative Organization (SCO) has a significant role to play in Asian politics, but it is not a natural starting point for Asia-wide cooperation.

ASEM was designed to be ASEAN’s effort at broadening its support by developing a constituency in Europe that would provide links with major powers other than China, Japan, and the United States. Hence, it was seen as having the potential to balance the influence of APEC and as a way for the Asian states to develop a regular dialogue with the major market and political power that Europe represented.

ASEM grew out of the 1980 EC-ASEAN Cooperation Agreement and has produced frequent meetings at the ministerial level. The 14th ministerial meeting was held in Brussels in 2003.

ASEM faced a stalemate, however, over European objections to participating in discussions with ASEAN once Myanmar had become a member. This standoff demonstrated that European commitments to human rights were strong and that the ASEAN states would have to choose between strengthening their ties with Europe and maintaining rapport between Southeast Asian neighbors.[60]

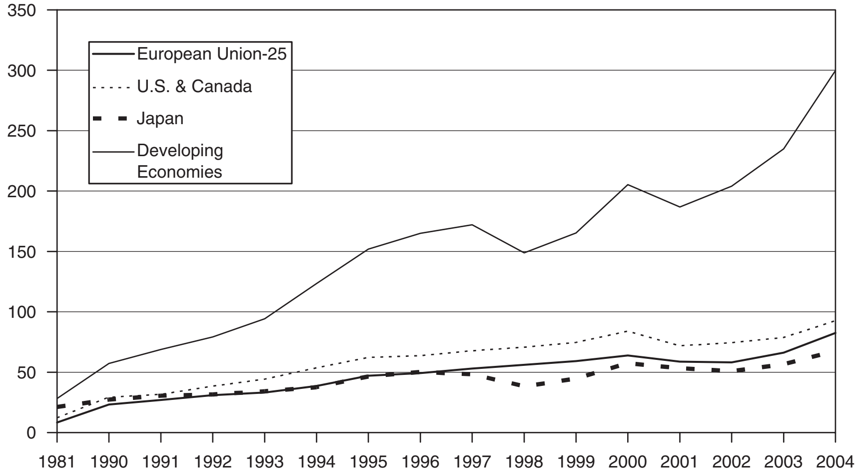
The East Asian Summit (EAS) is another candidate organization that could evolve into a broader security arrangement. (See the more detailed discussions of this in Chapters 5 and 6.) However, at present, the EAS is having trouble developing a clear focus. Moreover, the EAS excludes the United States, which is the security guarantor for Japan, South Korea, Taiwan, Thailand, and the Philippines. Trust and confidence building in Asia would have to proceed very far before the states relying on American commitments would give them up for the guarantees from a new organization.

Hence, of the major Asian organizations that might be the basis for broader regional integration, we are left with the most promising, ASEAN + 3. Why is ASEAN + 3 the subject of increasing attention and interest?

ASEAN + 3 includes all of ASEAN plus China, Japan, and South Korea. Therefore, its membership says something important about the group: it has the principal players in Asia but it *excludes* Russia, India, and the United States. This means that both China and Japan have potential leadership roles in it without having to worry about other major powers. This has a great deal of intrinsic appeal in Beijing and Tokyo because each has been frustrated, in the past three decades, with having to share power and influence with non-Asian states.[61] The drawback, which we will discuss below, is that neither Japan nor China is yet ready to be the security guarantor for the region; however, both see ASEAN + 3 as a vehicle by which their longer-term objectives might be achieved. Moreover, a true Asian security organization would have to involve India and Russia. The inclusion of New Delhi and Moscow in the East Asian Summit reflects that reality.

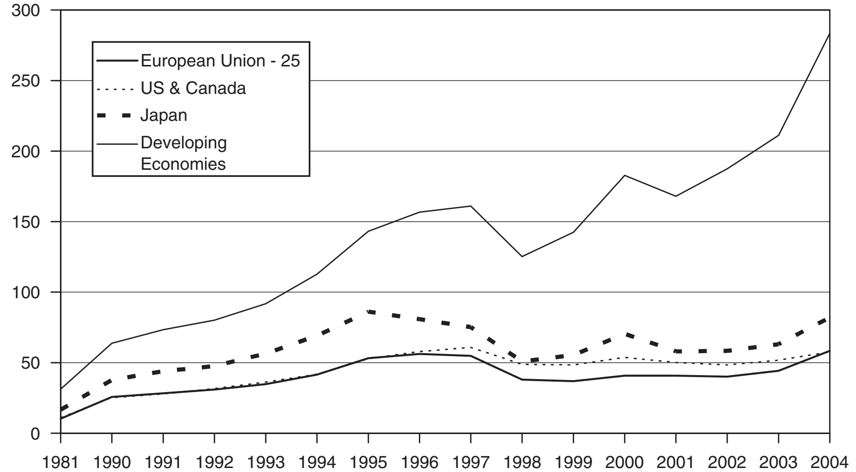
If we return to economic interests, we can see why ASEAN + 3 is so important to the Southeast Asian countries. Figures 4.4 and 4.5 demonstrate a critical trend. Exports to the United States, Canada, and Europe began to level off even before the 1997 crash and the main increase has been in "developing economies," that is, the other Asia (Hong Kong, China, Taiwan, and South Korea). ASEAN imports follow a similar pattern, with those from the United States and Europe actually declining after 1994 (Figure 4.5), but a surge of goods coming in from Northeast Asia (other than Japan).

The sharp rise in Southeast Asian economic ties with China gives added appeal to using ASEAN + 3 as a means for a host of links with Northeast Asia. Although it was only launched in 1997, ASEAN + 3 has now identified sixteen areas, from high technology to agriculture, where the members have agreed to cooperate.[62] The most visible aspect of these links is China's offer of a free trade area with ASEAN. However, if the other areas of interaction proceed as anticipated, it will provide a mechanism for thousands of individuals to move back and forth within the region in a cooperative manner.



Source:
UNCTAD Handbook of Statistics On-line.

Figure 4.4 ASEAN exports to main destinations.



Source:
UNCTAD Handbook of Statistics On-line.

Figure 4.5 ASEAN imports from main destinations.

It is not yet clear whether the Southeast Asian states can preserve their role in shaping the agenda in ASEAN + 3. However, the Second Bali Concord of 2003, which stated that ASEAN was a three-part community (based on political, security, and social roots), was an attempt to avoid economic issues dominating all others. Although neither South Korea nor Japan will offer a general free trade area (because of their desire to protect various sectors), both are likely to offer a range of other inducements to avoid ASEAN + 3 becoming a purely Chinese venue.

Thus, the new surge in economic opportunities for the ASEAN states is in Northeast Asia, and few Southeast Asian political leaders will resist the opportunity to participate in an organization that gives visibility to new sources of employment and income.[63] Also, in the period after 9/11, when many Asians see the United States taking an anti-Muslim stance and focusing predominantly on the Middle East, an organization of Asians (shaping their own security plans) is doubly appealing. Therefore, ASEAN + 3 is thriving and receiving attention. Time and events will tell if it becomes the foundation for Asian regional integration.

The Major Powers See No Reason to Sacrifice Key National Objectives for Asian Integration

The United States does not formally oppose economic integration within Asia, but it has a long record of preferring organizations that have a Pacific Basin or trans-Pacific charter so that the issue of American participation does not arise. The "hub-and-spokes" strategy (to be discussed in Chapter 5) not only is trans-Pacific but also places Washington at the center of decision making on Asia. During the Cold War, when the United States was vital for Pacific Rim security, the American desire to make the principal decisions could not be denied. Now, when threat levels have receded, the desire of leaders in Washington to shape major decisions on Asian security rankles Asian leaders. For example, the George W. Bush administration views counterterrorism as its highest concern, while few states in Asia share that priority. Yet, it is clear that Washington is not going to voluntarily cede its influence by favoring organizations that focus on relations inside Asia rather than trans-Pacific relations.

Japanese leaders have ambivalent attitudes toward an "Asia-only" grouping. As noted above, an organization such as ASEAN + 3 raises the chances that Tokyo will be a principal player, but it risks losing American enthusiasm for its security guarantee. The Japanese are increasing the range of their "out-of-area" deployments (to the Indian Ocean, Afghanistan, and Iraq) and are going ahead with a space program that has obvious security implications. Yet, for Tokyo to shift to an "Asia-only" or "predominantly Asia" focus would be too risky at present. Leaders in Japan will explore what regional organizations can give them but are not yet likely to shift allegiances.

China would, doubtless, be the principal beneficiary of "Asia-only" security arrangements, but even Beijing sees advantages in having the United States involved in keeping Japan nonnuclear. Moreover, Chinese strategists clearly see the danger of having a U.S.-Japan-India entente arrayed against them. So, for the present, it is a lower-risk strategy for Beijing to make subtle efforts at decreasing American influence without triggering a full-scale strategic realignment.

India has been extremely active in broadening its ties with ASEAN. India's presence at the East Asian Summit was an indication that Southeast Asians were willing to accept a higher profile for India in East Asian affairs. New Delhi has also established itself as a "dialogue partner" and is a full member of the ASEAN Regional Forum (ARF) and the East Asian Summit (EAS). India has a framework agreement on economic cooperation that anticipates an India-ASEAN free trade agreement. As part of its effort to be seen as a constructive neighbor, India has also acceded to the ASEAN Treaty of Amity and

Cooperation. In addition, it has joined with Indonesia, Malaysia, Singapore, and Thailand in forming the Indian Ocean Rim Association for Regional Cooperation.

Moreover, two potential infrastructure projects, the Mekong-Ganga Cooperation Group (India, Myanmar, Thailand, Cambodia, Laos, and Vietnam) and the India-Thailand Road could form the basis for mutual gains between India and the ASEAN states.[64]

Since World War II, Outside Powers Have Primarily Provided Major Asian Security Guarantees

This issue is well understood by specialists but is not addressed adequately in public debates. American treaty commitments to Japan, South Korea, the Philippines, and Thailand have been in place for 50 years. Those commitments are transparent and ratified by legislatures in all the treaty-party states. It is also significant that Vietnam still maintains its security ties with Russia.

What is not so frequently discussed is that, despite all of China's emphasis on self-sufficiency, Beijing relied on Soviet guarantees from 1949 to 1959 (the start of the Sino-Soviet split).[65] Then, once the United States made its overture to China under the Nixon administration, Beijing got implicit support from the United States to balance out pressure from the Soviet Union along its northern border. Moreover, Beijing was also concerned that the Soviet entente with India presented a threat on China's southwestern borders.[66] So, despite florid rhetoric about the dangers of foreign intervention in Asia, China has been quite willing to seek outside support when it was necessary. Hence, in the current period, when China is so anxious to get access to American markets and to get capital and technology from abroad, it appears unlikely that Beijing would risk derailing its economic development plans to push for Asia-only security arrangements.

It is also worth noting that, despite ASEAN's stated neutrality, most of the non-communist ASEAN countries have had confidential security agreements with the United States. Indonesia has given the U.S. Navy special access to its waters, and Singapore and Malaysia have a variety of repair contracts and access agreements with U.S. forces.[67] In addition, the Philippines and Thailand have received the designation of "Major Non-NATO Allies" of the United States, which emphasizes their closeness to Washington and the visibility of American security guarantees. Finally, Vietnam has made various overtures to the United States in hopes of enticing American forces back to bases they left over three decades ago.

Since this pattern of foreign security guarantees has gone on for decades in Asia, it will require a major change in the environment for countries in the region to rely predominantly on their neighbors for protection.

Conclusion

Economic integration in East Asia is proceeding rapidly. Surging levels of intraregional trade and investment show every indication of continuing.

Although multilateral trade agreements, such as AFTA and the ASEAN-China FTA, help facilitate economic integration, they are not the principal cause of it. The private sector, with its drive for greater efficiency, is the principal motivating factor behind the specialization and subcontracting that is occurring throughout East Asia.

China's decision to follow an open economic development strategy, rather than a protectionist direction, has been critical in establishing the "supply-chain" links throughout the region. Because the Chinese market is so open, so large, and growing so rapidly, countries on China's periphery have, recently, focused on this as an economic opportunity and not as a challenge. However, if China's growth rate were to slow significantly or China's exporters were to start targeting East Asian markets instead of the United States for its principal exports, sentiment in the region would change quickly.

Political and security cooperation in East Asia has taken a much different path. ASEAN has been highly successful in Southeast Asia as a mechanism for reducing tension and potential conflict among its members. President Suharto made the decision at the time of ASEAN's founding that Indonesia could lead the group through low-key measures and that President Sukarno's rhetoric and confrontational stance toward Malaysia, from the early to mid 1960s, had been counterproductive. Thus, with skillful Thai and Indonesian leadership in the 1970s and 1980s, ASEAN was able to forge a compelling model of economic links and political cooperation in Southeast Asia.

Unfortunately, ASEAN ran into two unanticipated barriers in the 1990s: (1) the 1997 financial crisis showed the region's economic weaknesses, and (2) the inclusion of Cambodia, Laos, and Myanmar into ASEAN created so many difficulties that the organization was no longer seen as able to successfully manage its own affairs.

In Northeast Asia a variety of factors have kept potential integration, of the European type, out of the picture. Moreover, there is sufficient distrust of neighbors' intentions that security guarantees are sought form outside powers. It could be that growing economic ties will produce sufficient mutual confidence that security arrangements can be worked out within the region, but it will not be soon.

Hence, it appears that the most plausible direction for East Asian development is a *two-track policy:* closer economic integration, but strong bilateral political and security links. This means the continuation of a large role for the United States and, probably, an expanding role for China, Japan, and India in the medium-term future.

Appendix 4.1 East, Southeast, and South Asia Free Trade Area: Agreements between nations

Agreement	**Countries**	**Status**	**Date**	**Description**
ASEAN FTA	ASEAN	Implemented	January 1992	AFTA; phased tariff elimination
ASEAN-China FTA	ASEAN, China	Implemented	January 2004	ACFTA; Early Harvest Program and Trade in Goods Agreement for tariff elimination/reduction in agricultural and manufacture goods; the service agreement is still under negotiation
ASEAN-South Korea FTA	ASEAN, South Korea	Implemented	July 2006	Thailand continues to negotiate due to concerns about agriculture
Australia-New Zealand CERTA	Australia, New Zealand	Implemented	1983	ANZCERTA, Australian-New Zealand Closer Economic Relations Trade Agreement; elimination of all tariffs
Australia-Singapore FTA	Australia, Singapore	Implemented	July 2003	SAFTA; services agreement included
Australia-Thailand FTA	Australia, Thailand	Implemented	January 2005	Closer Economic Relations FTA, covering trade in goods, services, protection of intellectual property rights, and creation of new investment privileges.
Australia-U.S. FTA	Australia, United States	Implemented	January 2005	AUSFTA; comprehensive agreement with chapters on market access for goods, agriculture, services, and dispute settlement
China-Hong Kong-Macau FTA	China, Hong Kong, Macau	Implemented	January 2004	Closer Economic Partnership Arrangement, tariff elimination on goods and comprehensive market accesses for services; service agreement included
China-Thailand FTA	China, Thailand	Implemented	October 2003	Early Harvest Program for tariff elimination for vegetables and fruits
EFTA-Singapore FTA	EFTA Singapore	Implemented	January 2003	European Free Trade Association (Iceland, Norway, Liechtenstein, Switzerland)-Singapore FTA, service agreement included
India-Afghanistan PTA	India, Afghanistan	Implemented	March 2003	The Preference Trade Agreement granted preferential tariff to 8 items from India and 38 products from Afghanistan
India-Bhutan FTA	India, Bhutan	Implemented	March 1995	Comprehensive tariff eliminations
India-Nepal Treaty of Trade	India, Nepal	Implemented	June 2002	The Treaty of Trade allowed dutyfree access without quantitative restrictions
India-Singapore CECA	India, Singapore	Implemented	January 2005	India-Singapore Comprehensive Economic Cooperation Agreement (CECA), covering trade in goods, services, and investment protections

(*Continued*)

Appendix 4.1 (*Continued*)

Agreement	Countries	Status	Date	Description
India-Sri Lanka FTA	India, Sri Lanka	Implemented	March 2000	ISFTA; complete and phased elimination of most tariffs for trade in goods
Japan-Malaysia EPA	Japan, Malaysia	Implemented	July 2006	Japan-Malaysia Economic Partnership Agreement
Japan-Mexico EPA	Japan, Mexico	Implemented	June 2006	Agreement between Japan and the United Mexican states for the Strengthening of the Economic Partnership.
Japan-Philippines EPA	Japan, Philippines	Implemented	September 2006	Japan-Philippines Economic Partnership Agreement
Japan-Singapore EPA	Japan, Singapore	Implemented	November 2002	JSEPA, Japan-Singapore Economic Partnership Agreement; elimination of almost all tariffs (except in agriculture), Services agreement included
Japan-Thailand EPA	Japan, Thailand	Implemented	September 2005	Japan-Thailand Economic Partnership Agreement
New Zealand-Singapore FTA	New Zealand, Singapore	Implemented	January 2001	Service agreement included
New Zealand-Thailand CEPA	New Zealand, Thailand	Implemented	July 2005	The New Zealand–Thailand Closer Economic Partnership Agreement
South Asian FTA	Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka	Implemented	January 2006	SAFTA; tariff reduction for trade in goods
South Korea-Chile FTA	South Korea, Chile	Implemented	April 2004	Services agreement included
South Korea-Singapore FTA	South Korea, Singapore	Implemented	March 2006	KSFTA; comprehensive and substantive, covering trade in goods, services, investment, customs procedures, mutual recognition agreements, intellectual property rights, competition policy, government procurement, and cooperation in a wide range of areas
Singapore-Jordan FTA	Singapore, Jordan	Implemented	August 2005	SJFTA; covered the flow of goods, services and investments between the two countries; Service agreement included
Singapore-New Zealand CEP	Singapore, New Zealand	Implemented	January 2001	ANZSCEP, Agreement between New Zealand and Singapore on Closer Economic Partnership; elimination of all tariffs
Singapore-Panama FTA	Singapore, Panama	Implemented	July 2006	Comprehensive agreement, covering issues such as trade in goods and services, customs procedures, financial services, investment, telecommunications,

Appendix 4.1 (*Continued*)

Agreement	Countries	Status	Date	Description
				e-commerce, competition policy, and government procurement
Taiwan-Guatemala FTA	Taiwan, Guatemala	Implemented	January 2006	Phased tariff elimination for trade in goods
Taiwan-Nicaragua FTA	Taiwan, Nicaragua	Signed	September 2004	The agreement is expected to go into effect at the beginning of 2007
Taiwan-Panama FTA	Taiwan, Panama	Implemented	January 2004	Phased tariff elimination for trade in goods
Thailand-Peru FTA	Thailand, Peru	Signed	November 2005	Phased tariff reduction for trade in goods
Trans-Pacific SEP	Brunei, Chile, New Zealand Singapore	Signed	June 2005	Trans-Pacific Strategic Economic Partnership Agreement; the agreement is expected to enter into force by the end of 2006 for Chile, after it has completed its domestic processes
U.S.-Singapore FTA	Singapore, United States	Implemented	January 2004	Service agreement included
Negotiation				
ASEAN-Australia and New Zealand FTA	ASEAN Australia, New Zealand	Negotiation	2005	The 9th round of negotiations was held in October 2006
ASEAN-India FTA	ASEAN, India	Negotiation	2003	The Framework Agreement was signed in 2003
Canada-Singapore FTA	Canada, Singapore	Negotiation	October 2001	The 6th round of negotiations was held in September 2003
Canada-South Korea FTA	Canada, South Korea	Negotiation	June 2006	The 6th round of negotiations was held in 2006
India-Chile PTA	India, Chile	Negotiation	2005	The Framework Agreement was signed in 2005
India-GCC FTA	India, Gulf Co-operation Council	Negotiation	2006	The 1st round of negotiation was held in March 2006
India-Mauritius CECPA	India, Mauritius	Negotiation	2003	The 5th round of negotiations was held
India-Thailand FTA	India, Thailand	Negotiation	2003	The 10th round of negotiations was held in January 2006
Japan-Mexico EPA	Japan, Mexico	Negotiation	July 2002	The 5th round of negotiations was held in April 2003
Japan-ASEAN EPA	Japan, ASEAN	Negotiation	November 2002	The 4th round of negotiations was held in June 2006
Japan-Indonesia EPA	Japan, Indonesia	Negotiation	July 2005	The 6th round of negotiations was held in October 2006
Japan-Chile EPA	Japan, Chile	Negotiation	November 2005	The 4th round of negotiations was held in September 2006
Japan-Vietnam EPA	Japan, Vietnam	Negotiation	October 2006	The 1st round of negotiations will be held in January 2007
Singapore-Mexico FTA	Singapore, Mexico	Negotiation	July 2000	The 6th round of negotiations was held in October 2006

(*Continued*)

Appendix 4.1 (*Continued*)

Agreement	Countries	Status	Date	Description
China-Australia FTA	China, Australia	Negotiation	May 2003	The 6th round of negotiations was held in 2006
China-Gulf Cooperation Council FTA	China, GCC	Negotiation	2004	The 3rd round of FTA negotiations was held in January 2006
China-New Zealand FTA	China, New Zealand	Negotiation	2004	The 7th round of negotiations was held in 2006
China-Pakistan FTA	China, Pakistan	Negotiation	2005	The 4th round of negotiations was held in September 2006
China-Singapore FTA	China, Singapore	Negotiation	2003	The Joint Expert Study Group was formed in 2006
India-ASEAN FTA	India, ASEAN	Negotiation	2003	The Framework Agreement was signed in October 2003
Shanghai Cooperation Organization FTA	SCO	Negotiation	2003	The Framework Agreement was signed in 2003
Singapore-Pakistan FTA	Singapore, Pakistan	Negotiation	August 2005	The 3rd round of negotiations was held in March 2006
U.S.-Malaysia FTA	United States, Malaysia	Negotiation	2006	The Trade and Investment Framework Agreement (TIFA) was signed in May 2004; the FTA negotiation was launched in 2006.
U.S.-South Korea FTA	United States, South Korea	Negotiation	May 2006	The 5th round of negotiations was held in October 2006
U.S.-Taiwan FTA	United States, Taiwan	Negotiation	1997	The negotiation of Trade and Investment Framework Agreement (TIFA), as predecessor to a real FTA has been blocked by the United States since 1997 on the grounds of Taiwan's poor record in protecting U.S. intellectual property rights

Chapter 5

Strategic Realignments in Asia

The Setting

By 1953, as the Korean War ground to a halt, the current security architecture for the East Asian region began to take shape.[1] After some ambivalence in the late 1940s, the United States had projected its power across the Pacific with strong bilateral ties to Japan, Taiwan, and South Korea and with multilateral treaties in Southeast Asia (SEATO) and with Australia and New Zealand (ANZUS).[2] Although SEATO did not last, the United States subsequently established bilateral security treaties with Thailand and the Philippines and numerous executive agreements with other East Asian states.[3] This "hub-and-spokes" set of American commitments created links directly to Washington and has lasted, with minor adjustments, for 50 years.

The original rationale for the American commitments in the region was the "containment" of the Soviet Union and China and their Asian allies, North Korea and North Vietnam.[4] After the Sino-Soviet split, the picture became more complicated, with the United States initially concentrating on the Vietnam War. Then, after 1971, the growing rapprochement with China facilitated an unusual pattern: the United States maintained its bilateral links with the noncommunist states of Asia, while working closely with China.[5] This arrangement limited the expansion of Soviet influence in Asia during the 1970s and 1980s but left the hub-and-spoke aspects of American policy in place.[6] Chinese worries about Japan and a preference, at the time, for U.S. oversight of Japanese defense capabilities facilitated this set of links.

After the Tiananmen Square crisis in 1989 and the collapse of the Soviet Union in 1991, Sino-U.S. relations have moved through several cycles of more distant and then closer relations. China was no longer necessary as a balancer against the Soviet Union, and relations with the Beijing regime began to involve a complex calculus of trade, investment, human rights, and regional-influence issues. Although current relations between Washington and Beijing are stable, both sides recognize that their interests could diverge at any point. Thus, there is little likelihood that the United States will establish the kind of "strategic partnership" with China that it has maintained for two generations with Japan and South Korea.

The question then arises, what could change this picture in a fundamental way? The answer is twofold: (1) important shifts are under way in relative economic strength among the Asian states that will affect their long-term ability to modernize their armed forces, and (2) the region's three most critical flash points (China vs. Taiwan, North vs. South Korea, and India vs. Pakistan) could each lead to escalating tension and violence in the next decade. Hence, if there are fundamental shifts in economic strength and new balances of power in the principal crisis areas, the security architecture of the 1950s may have to be modified.

Aspects of Asian Security

Because the security arrangements in East Asia have been in place for very long and intraregional relations are clearly defined, analysis of regional security tends to emphasize three different, but important, factors: the persistence of bilateral ties, the overlap between economic links and political leverage, and the clear presence of strategic rivalry.

Bilateral Ties Bind

The bilateral treaties that the United States signed with Japan, South Korea, Taiwan, Thailand and the Philippines have formed the backbone of its security links to Asia.[7] James Kurth has noted that this pattern of bilateral ties is fundamentally different from the pattern of American relations with Europe.[8]

In U.S.-European security and economic treaties, the obligations are mutual and multilateral. The North Atlantic Treaty Alliance (NATO) is a collective security agreement, where an attack on any one member is considered an attack on all. Economic issues were first handled through the General Agreement on Tariffs and Trade (GATT) and are now dealt with in the World Trade Organization (WTO).

In Asia, many security treaties are one-way guarantees, where the United States is committed to defending its allies, but the allies are not necessarily obligated to defend the United States—unless U.S. forces are attacked within their sovereign territory or waters. So, for example, if China were to attack the United States mainland, Japan is not legally obligated to come to the United States' assistance, whereas the converse is true.

Most American citizens do not know that the Japan-U.S. Mutual Security Treaty is not mutual and is not fully reciprocal. In fact, starting with President Carter and continuing to today, U.S. presidents have consistently tried to get the Japanese to commit more resources to defense and to come to the United States' assistance in a broader range of circumstances.[9] Similar efforts at "burden sharing" have been made with the other Asian allies.[10]

In the 1980s, the Japanese prime minister Nakasone launched a major political effort to strengthen security ties with the United States and began the process of expanding Japanese military capabilities. The last two prime ministers of Japan, Junichiro Koizumi and Shinzo Abe, have taken the process much further. They not only have set the stage for a serious, national debate about amending the Japanese constitution to permit a more assertive foreign policy, but have taken specific steps to redefine Japan's defense objectives.

Amending the Japanese constitution, if it occurs at all, might take a decade.[11] However, the former prime minister Koizumi moved boldly on redefining Japan's security interests. In the 2004 National Defense Program Outline, he shifted Japan's military priorities from tanks and artillery to developing missiles and missiles defenses, which are a clear signal to China and North Korea that Tokyo will counter the buildups that it sees to its north and west. Moreover, it is also building up its own rapid reaction force in Okinawa. Japan has also become much blunter in identifying what it sees as threatening behavior. It has protested Chinese submarines transiting its territorial waters and, for the first time in 40 years, has said that it will provide military and logistical support if Taiwan is attacked.[12]

Koizumi also cooperated closely with the U.S. and allied efforts in Afghanistan and Iraq by providing logistical support in Afghanistan and some police units in Iraq. These are mostly symbolic steps, but controversial, nevertheless, in Japan, where any troop deployment outside the country's naval perimeter generates debate. In addition, the Koizumi administration has taken a strong stance against North Korea's attempts to expand its nuclear capabilities and has invested heavily with the United States in developing a ballistic missile defense system.[13] Unfortunately Japan's critics have portrayed these moves, which are entirely defensive, as indications of aggressive intentions.

Prime Minister Abe was confronted with how to respond to the North Korean nuclear test shortly after he took office in September 2006. Not surprisingly, his cabinet gave mixed messages. Foreign Minister Taro Aso said to Secretary of State Rice that Japan did not need nuclear weapons. However, Prime Minister Abe has privately made clear to reporters that he wants Japan's constitution revised and has not discouraged other party leaders from saying that Japan needs to consider a nuclear option.[14]

For the first four decades after World War II, there was a similar pattern of focusing on bilateral links in trade and investment policies. The United States did not demand full reciprocity and gave Asian states asymmetric access to American markets in exchange for cooperation on foreign and security policies.[15] This type of bilateral deal-making on economic policy declined noticeably during the Clinton administration, in the 1990s, as the United States decided to back the WTO and APEC. Yet, the G. W. Bush administration has reraised the importance of the hub-and-spoke approach by its focus on bilateral free trade agreements (as discussed in Chapter 4).

The American preference for bilateral arrangements reinforces the state-centric pattern of economic development that most East Asian countries have chosen. In Japan, for example, two generations of elite civil servants have managed the various requests of Americans and used the process to strengthen their links to elected politicians and the business community.[16] Most East Asian political systems reward pliant cooperation from interest groups, and, in return, key sectors have received government import protection, subsidies, and bank loans. Thus, American acceptance, from the 1950s to the 1980s, of Asian protectionism, in return for cooperation on foreign and security policy, has been a key method of bolstering bilateral ties.

When Prime Minister Koizumi rose to power in 2000, there was much anticipation that he would initiate a significantly different pattern of domestic politics, which was less dependent on patronage and more responsive to direct public opinion. Although this change partially occurred, there have been much bigger changes in foreign policy than in the domestic agenda. Japanese economic policy has been gradually transformed, but an iconoclast like Koizumi ran into deep resistance in his attempts to change the political system. Prime Minister Abe, on the other hand, does not seem inclined to keep jousting against the ossified political establishment.

Interestingly, despite the differences between the Japanese and Chinese political systems, both states are comfortable with Washington's emphasis on bilateral ties as a means of resolving issues.[17] The Sino-U.S. relationship, which blossomed in 1971 primarily for strategic reasons, has evolved now to the point where economic issues get a larger part of the attention.[18]

The Chinese have been developing a sophisticated blend of bilateral and multilateral initiatives within Asia. For the most sensitive issue—territorial disputes—Beijing has kept the discussions bilateral. For example, on the Spratly Islands controversy, the ASEAN states had wanted to bargain as a group but could not maintain cohesion in their coalition when China offered inducements to individual states.[19] Here, Beijing was willing to sign the anodyne accord on the Conduct of Parties in the South China Sea. Moreover, when it was in China's interest to host or encourage a large group, such as ASEAN + 3, Beijing has actively participated in a multilateral forum.[20] On balance, however, when the issues are critical, Beijing prefers a bilateral approach, and because relations with Washington are vital, the Chinese see little reason to challenge the hub-and-spokes aspects of U.S. policy now. The Chinese are quite willing to challenge U.S. ambitions indirectly, as they have done (through the Shanghai Cooperation Organization) in calling for a U.S withdrawal from Central Asia. Many in the United States are distressed over the bilateral trade imbalances with China and Japan, but there is no consensus in Washington on what steps to take to rectify the trade deficits.

ECONOMICS LEADS

The second major analytical approach to understanding international developments in Asia is to focus on the central role that economic performance plays in organizing and shaping state behavior. East Asian economic growth in the 1975–1995 period was truly extraordinary, and China has been able to sustain its growth rate even after the 1997 financial crisis.[21] Japan's meteoric rise in the 1950s and 1960s became the model that other states in the region sought to emulate.[22] Japan's most prominent economist, Saburo Okita, urged other Asian states to follow Tokyo's strategy of state-directed, export-led growth so that the region would become like "flying geese," with Japan leading its neighbors toward linked prosperity.[23]

As discussed in Chapters 2 and 3, few of the other East Asian states were able to implement the Japanese model efficiently. None had Japan's level of technical expertise, and none had as competent a bureaucracy. Yet, most did succeed at export-led growth, and most had high levels of savings and investments. In Southeast Asia, too, there was a high level of foreign investment.

Japan's economic stagnation during the 1990s and the 1997 crash combined to discredit many features of the East Asian growth experience, but there is little doubt that the quadrupling of national incomes that occurred between the mid-1970s and the mid-1990s created legitimacy for the governments that managed economic policy in that period. It also created a sense of sense of community in East Asia based on economic performance, which was separate from political ideology.

This focus on economic issues meant that organizations such as the Asia Pacific Economic Cooperation (APEC) could realistically claim to represent the region. APEC summits still draw not only Asian heads of government but also leaders from most of the world's powers. East Asian annual forecasts of economic growth are a source of civic pride.[24] Although all participants and observers have been chastened after 1997, there is still an infrastructure and a network of professionals that seeks to meld the Asian states into a massive market of increasingly open economies.[25] Also, if the 1994 Bogor Summit goals for APEC (free trade among the developed countries by 2010 and among all members by 2020) come to pass, then multilateral trade approaches will be strengthened.

The most important new factor that could affect this model of East Asia as a set of economies linked multilaterally is the surge to prominence of one of its own: China. Despite Japan's economy being much larger, new attention and new investment are being showered on the Middle Kingdom.[26] Although China has proposed a multilateral free trade area with the ASEAN states and is even willing to extend this to all of East Asia, the rapid growth of opportunities in China has led to a *relative decline* of APEC's importance.

There is another key difference in the situation today from the scene in the early 1990s. At that time, Japan's economic leadership was unquestioned and came from a country that had no offensive military capability. Thus, with Japan as the leader and APEC as the organizing mechanism, it was not unreasonable to assert "economics led" in East Asia. Today, economic links are still uppermost in the minds of most regional leaders, but the ties with China have a more complex context. Because the political leadership in Beijing openly aspires to a major-power status, smaller states need to calculate both their economic and strategic interests when deciding on expanded links with China.[27] Therefore, those who argue that "economics still leads" must add that prudent political decision makers are also looking over their shoulders to determine the strategic implications of their potential ties to a rising power.

Strategic Rivalry

The central contention of the strategic rivalry view is that Asia has four major powers (Russia, China, Japan, and India) and one superpower, the United States, all competing for influence. Although there may be long periods of calm, this is one area of the world where states may form coalitions to balance one another's strength.

Few would argue that Asia was not a cauldron for strategic rivalry in the period from 1945 to 1989. As noted above, the Sino-Soviet cooperation in the 1950s was designed to balance American power; then the Sino-Soviet split facilitated cooperation between the United States and China. Subsequently, the collapse of the Soviet Union raised the new possibility of direct competition between the United States and China.

To what extent does strategic rivalry underlie the motivations and actions of the key states in Asia?

Motivations are difficult to ascertain. Without access to classified discussions and documents, it is almost impossible to know what motivates specific policies. However, one can look for patterns, and if actions are repeatedly taken or costs are incurred that have significant military consequences favoring one state over another, then it is sensible to conclude that strategic factors are a key element in the calculus.[28]

If we swing in an arc from Russia along the Pacific Rim into Southeast Asia, we will not find any major power that currently advocates a revision of the basic security architecture.[29] Russia is focused on internally reconstructing its economy and maximizing its gains from its oil and gas exports, while Japan wants to avoid the expenditures necessary to have a truly autonomous foreign policy, and there is no state in Southeast Asia that has either the wherewithal or the intention to make major readjustments.

Nevertheless, this does not mean that strategic rivalry is not alive and well in East Asia. Most Russian strategists see their current actions as a holding pattern until their economy revives, many Koreans (north and south of the Demilitarized Zone) would like to rid the Korean Peninsula of foreign influence, many Taiwanese would like closer ties with a more assertive Japan and more explicit guarantees from the United States, and most of the Indonesian elite would make some sacrifices to return to their former leadership role in Southeast Asia.

The central issues then become: What are China's intentions? And, will India's aspirations broaden strategic competition to link East and South Asia? Much academic effort has been put into evaluating whether China is a "status quo" or "revisionist" power. This is one of the key issues that we will deal with below, and it is critical because leaders in Beijing have no intention of revealing their long-run objectives. Thus, outsiders are left to interpret conflicting evidence.[30]

Analysts who see strategic rivalry in Asia see it resulting from conflicting ambitions, deep cultural divides, and lack of any regionwide political institutions for mitigating differences.[31] There is also a history of interstate and intercultural conflict for over a millennium. The Chinese and the Koreans bear deep resentments toward the Japanese; the Taiwanese resent the Chinese; the Vietnamese have sharp memories of many foreign powers, while they themselves are bitterly remembered in Laos and Cambodia; and the Sino-Soviet and Sino-Indian rivalries have produced major schisms within Asia, at different times, during the past four decades.[32]

In addition, as the Japanese have found themselves on the defensive with China, they have raised the issue of when China will become a democracy. The Japanese foreign minister Taro Aso has said that he "welcomes China's return to center-stage, as it evolves into a liberal democracy," and leaders in Tokyo see this tack as a means to contrast the authoritarian systems in Asia from the democratic ones.[33]

Ultimately, for strategic rivalry to have geopolitical consequences, it must have a military component. There is a broad consensus among defense specialists that China now does not have the military capability to dominate the Asian mainland or to coerce its island neighbors. Yet its growth rate and its future potential have already changed strategic thinking in the entire region.[34]

Similarly, though India now does dominate South Asia, it is checkmated in the northwest by Pakistan and has not yet succeeded in using its navy or air force to project power far overseas. However, under the Bharatiya Janata Party (BJP), India was willing to shift strategic partners (away from Russia) and, in 2005–2006, under a Congress-led government, continued improving ties with the United States.[35] This could well give New Delhi a broader range of options in the future.

In the "Seeds of Realignment" section below, we will explore the calculus of each of the states that could plausibly affect the strategic balance in Asia, and explain why it appears that dominance is shifting to the continental powers (India and China) and away from the Pacific Rim countries. Nevertheless, this review of the theoretical approaches about the region suggests that each of the three main schools has something important to contribute to our understanding. The United States still is clearly dominant, so its bilateral ties do bind; economic performance is still the basis of legitimacy in most Asian states; and there is unquestioned maneuvering in anticipation of new strategic realignments in the region. Hence, we need elements from each of these explanations to understand the depth and complexity of the changes that are under way in Asia.

Recent Developments

The intent of this section is to highlight the principal recent politico-military events that have shaped strategic thinking in Asia today.

September 11, 2001

The al Qaeda attacks on the World Trade Center in New York and the Pentagon in Washington have recast and redirected many of the American links to Asia.[36] Instead of focusing on stability, U.S. government attention has been concentrated on a global antiterrorism campaign.[37]

Although public opinion in Asia about the G. W. Bush administration policies, especially the invasion of Iraq, has been extremely negative, many governments have quietly accepted the American focus on counterterrorism because it gives them maneuverability to pursue their own objectives. The most visible example of a negative public reaction to U.S. measures has been in Indonesia and Malaysia, where Muslim majorities have become deeply skeptical of U.S. motives.[38]

Nevertheless, each of the cooperating states has domestic reasons for its newly found interest in countering terrorism. Russians recognized immediately that an American administration focused on al Qaeda would be less critical of Moscow's desire to deal harshly with Chechen and other rebels; the Chinese saw that Washington would have trouble criticizing its policies toward Muslim separatists in far-western Xinjiang Province; decision makers in Tokyo had their own experiences with the Japanese Red Army and Aum Shinrikyu and are always intolerant of disorder; many Filipinos saw this as a long-awaited opportunity to get support for suppressing Muslim radicals in the southern Philippines; Prime Minister Mahathir Mohamad of Malaysia, long a critic of the United States, saw a chance to use the occasion to suppress local Islamic fundamentalists; and the leadership in New Delhi saw this as a chance to get a sympathetic hearing on guerilla infiltrators into Kashmir. Even the nationalistic Thaksin Shinawatra regime in Thailand decided that it would cooperate with Washington on dealing with al Qaeda and its affiliated groups.[39]

Whether this tactical cooperation will lead to long-term strategic links is unclear. It does appear, however, that even the major powers see no reason to challenge the United States on counterterrorism per se—even if there are fundamental differences on other issues. For example, neither China nor Russia was willing to support the American effort to get a second United Nations Security Council resolution to authorize the use of force against Iraq. So, since 2003, the United States has gotten more criticism from its NATO allies on its Iraq and Middle East policies than from China and Russia; however, both Moscow and Beijing have been willing to challenge the United States on issues they consider vital to their own interests.

Thus, for the present, it appears that the United States has been able to get the principal Asian states, in the APEC declaration on counterterrorism, to see terrorism as a general plague. The Asian states, in turn, have seen this as an opportunity to cooperate with Washington in one arena, while focusing on China and Japan for economic arrangements.[40] On the surface, it appears that the major Asian players now want to "bandwagon" with the United States on counterterrorism, but also subtly begin to "balance" against it on other issues.[41]

Hence, we see more conciliatory statements and positions from Beijing immediately after 9/11 than before.[42] Similarly, in 2001–2003, with Russia facing traumatic internal economic adjustments, President Putin wanted to focus the U.S.-Russia relationship on trade, technology, and capital transfers, not on short-term jousting over position.[43] Since then, as oil and gas prices have risen, the Russian leadership has felt confident enough to ignore the American criticism of its human rights policies and ambivalent position toward Iran's nuclear programs.[44] With the Philippines, Malaysia, Singapore, Thailand, and India all showing interest in cooperating, al Qaeda provided a basis for a broad American-led coalition on counterterrorism. Below we will discuss whether this unipolar coalition is sustainable on broader issues.[45]

THE AFGHANISTAN AND IRAQ WARS

In certain regards the Afghan and Iraq wars were an extension of the response to 9/11, but they elicited strongly differing reactions from the Asian states. The Afghan War was seen as fully legitimate because the Taliban regime had aided and abetted al Qaeda. In his September 30, 2001, speech, President Bush said that the United States would make no distinction between terrorists themselves and regimes that "harbored them." Since many countries had been attempting to deal with terrorists based in other states, the U.S. response was welcome.

In addition, the Taliban was a nuisance to many governments. China, Russia and the Central Asian republics resented Kabul's support of Islamic separatists, and India was frustrated by the links between the Pakistani intelligence service (ISI) and the Afghan government.[46] Although there were some protests in predominantly Muslim countries against the U.S. removal of the Taliban, world opinion was generally supportive. There was early optimism that the Karzai interim administration and international reconstruction efforts would bring peace to a country that had seen two decades of war.[47] The resurgence, in 2005–2006, of the Taliban and its ability to harass the subsequent elected Karzai government is a sign of the deep popular support for Islamic rule in the Afghan-Pakistan border region.

The speed of the Taliban government's collapse in 2001, however, led to many overoptimistic assumptions about the destruction of al Qaeda and the pace at which Islamist networks could be uprooted. Although General Pervez Musharraf, who reached the presidency of Pakistan through a coup in 1999, decided to align his government with the United States and discontinue Pakistan's official support for the Taliban, many of his subordinates were unwilling to abandon their previous ties.[48] This means that Islamabad gives mixed signals: officially it is aligned with the West and has permitted the operation of many military and intelligence functions in Pakistan, but unofficially the Taliban and al Qaeda are allowed to flee and hide. Also, the mujahideen's continued infiltration into Kashmir in late 2001 and early 2002 further antagonized India and made it harder for the United States to cooperate with both Pakistan and India simultaneously.[49] The American decision, in March 2004, to designate Pakistan a "major non-NATO ally" further cooled the enthusiasm among many in New Delhi but did not stop the development of a new U.S.-Indian strategic partnership, which blossomed between 2004 and 2006.

The mixed results in Afghanistan, thus, set the backdrop for the debate over Saddam Hussein's rule and what should be done in Iraq. Although, in November 2002, there was unanimity in the United Nations Security Council on Resolution 1441, which authorized the return of inspectors to Iraq and the threat of force if Iraq did not comply, world opinion split deeply when the United States began to push for a second resolution authorizing an invasion and the overthrow of the Baath regime.

The Asian states were divided over what to do and were, generally, unsympathetic toward the Bush administration's views. Ultimately, the United States and Britain had to withdraw their proposed resolution, and Washington was able to get only a few Asian states to even endorse the 2003 Iraq War. The governments in Japan, the Philippines, and Singapore supported the war but sent few troops, and most states either opposed it or took no position.[50] Most significantly, the nonaligned major powers in Asia (Russia, China, and India) all opposed the war. It remains to be seen how deeply this has hurt American leadership on other matters. Moreover, now there is strong evidence that in both the United States and Britain, prewar intelligence was used selectively to exaggerate the Iraqi threat. This will create deep skepticism about U.S. claims in the future.[51]

Also, the initial support in Asia for the Afghan intervention is fading and longstanding skepticism about the Iraq occupation has generated much anti-American feeling. If Iraq and Afghanistan can be stabilized soon and American troops are withdrawn, the United States could return to its traditional role in the rest of Asia. If, however, U.S. troops stay for extended periods in Iraq and Afghanistan as well as in Central Asia, the original military conflicts will have become Pyrrhic victories as anti-American sentiment and reactions spread.

THE NORTH KOREAN NUCLEAR CRISIS

In the "Seeds of Realignment" section below we will deal more extensively with developments on the Korean Peninsula and how they may have contributed to broader shifts in Asian alliances and linkages. Our focus here will be on the crisis since the fall of 2002, when the North Korean government acknowledged that it had been violating the 1994 Agreed Framework by running a secret program to develop nuclear weapons through enriching uranium.[52]

During a visit to Pyongyang by Assistant Secretary of State James Kelly in October 2002, the United States formally notified the North Korean government that it had convincing evidence that North Korea had undertaken a second nuclear program while putting its initial effort (plutonium reprocessing from the Yongbyon reactor) on hold.[53] The United States took the position that North Korea must immediately stop its uranium reprocessing or forfeit its fuel, food, and reactor construction under the Agreed Framework.

The North Koreans subsequently upped the ante by saying they would *not* stop efforts to develop nuclear weapons until the United States gave them a security guarantee, and in the meantime, Pyongyang would go back to the plutonium rods and begin reprocessing them. This was a more tangible threat because the rods, presumably, had enough plutonium in them to develop material for a weapon in a matter of months, whereas outsiders did not know how far along the North Koreans were with their uranium program. Pyongyang then took the additional provocative step of expelling all remaining International Atomic Energy Agency (IAEA) inspectors.

The crisis caused deep friction between the Bush administration and the newly elected government of Roh Moo Hyun because the South Koreans wanted to continue the conciliatory "Sunshine Policy" toward North Korea and saw Washington as taking too rigid a position.[54] By the spring of 2003 the Bush administration was preoccupied with the Iraq War and made several statements that the crisis was to be solved diplomatically, not militarily.[55]

There is no current, public information on how far the North Koreans have proceeded in reprocessing the plutonium, but it appears that the weapon exploded in October 2006 was from plutonium. Although the Chinese convened the six-party talks to facilitate direct discussions between North Korea, its neighbors and the United States, they were clearly unsuccessful at dissuading Pyongyang from proceeding with its nuclear weapons program. In 2003, the Japanese and ASEAN states began to be tougher on inspecting North Korean ships to be sure that they are not exporting nuclear materials.[56]

The Chinese role in hosting discussions is important because Beijing still supplies Pyongyang with fuel and food, so it could put greater pressure on North Korea if it so chose (and did so, briefly, in 2003, by cutting off fuel for three days). The cooperation among other Asian states is notable because this is the first significant joint effort to deal with North Korea's flagrant behavior.[57]

Two additional factors complicated this situation: signs that there were splits within the North Korean leadership and evidence that North Korea had supplied Libya with enriched uranium.[58] The question of North Korea's internal political stability is extremely difficult to assess because it is such a closed society. However, if it was true that Kim Jong Il was being challenged, that made it even less likely that China would put real pressure on Pyongyang until the regime's stability is assured. The prospect of North Korea supplying states other than Libya (which has since renounced its nuclear program) with nuclear fuel would, presumably, solidify cooperation between the United States, Japan, and Russia in the six-party talks.[59] Yet, because the North

Koreans see their nuclear program as their ultimate trump card, they only need to have Chinese acquiescence to delay a diplomatic negotiation indefinitely.

As the six-party talks got under way in 2003, the Bush administration took the position that North Korea must renounce its nuclear weapons *before* the United States would negotiate directly on a peace treaty (formally ending the Korean War of 1951–1953). This was done to put pressure on North Korea to make concessions and to avoid undercutting South Korea (which did not want Pyongyang talking directly to Washington, with Seoul excluded). In the spring of 2006, however, there were signs that the Bush administration recognized its stance toward North Korea had not achieved its goals. Also, military planners in Washington see that the U.S. armed forces are stretched thin by deployments in Afghanistan and Iraq, and the dangers of conflict with Iran and North Korea simultaneously are obvious. Thus, the U.S. government was evaluating the possibility of direct negotiations with North Korea as a way to get a fast dismantling of Pyongyang's nuclear program.[60]

Once the North Koreans exploded a nuclear weapon, however, the failure of the six-party talks took a new track. The United States had to recognize this new reality. This led, on February 12, 2007, to a new agreement, in which North Korea promised to halt its nuclear program in exchange for fuel oil and having its foreign bank accounts unfrozen. Special working groups were also set up to deal with Japan's concerns about its kidnapped citizens and the possibility of U.S.–North Korea diplomatic relations. It remains to be seen if these various parts of the February 2007 agreement will be honored.

Severe Acute Respiratory Syndrome (SARS), the Avian Flu, and Epidemics

During the winter and spring of 2003, SARS created panic in Asia and deep fears in the rest of the world. Over 1,000 people died from the disease, and thousands became grievously ill.[61] By the summer of 2003, the health advisory was lifted for each of the principal areas affected (China, Hong Kong, Taiwan, Singapore, and Toronto).[62]

SARS raises two questions of importance to this book: (1) Will the Chinese government manage future epidemics in a more competent manner? (2) Is SARS just the beginning of a growing pattern of an increasingly rapid spread of disease? The early measures by the Chinese and Hong Kong governments proved woefully inadequate in dealing with the early spread of SARS. Not only did the governments try to deny the importance of the disease, but they also accentuated its gravity by failing to quarantine infected individuals and by refusing to bring in specialists from the World Health Organization (WHO), even when volunteer aid and health workers were signaling an alarm about a new and unidentified illness. The Hong Kong authorities moved before Beijing, and both eventually took drastic measures to control the disease.

Some have argued that this experience has forced the Chinese government to be more open about its problems and to be more responsive to public complaints.[63] Others, however, see this as just a temporary loosening of standards to allay fears about a highly contagious disease by a government that remains committed to authoritarian rule.[64] Since both democratic and authoritarian regimes want to stop epidemics, we can assume that, regardless of their political direction, the Chinese will put greater effort into stopping future contagions. As SARS has caused both a decline in economic growth and a drop in foreign investment, the Beijing leadership has to see this as a dire warning signal about public health standards.

What we do not know is: Is SARS just one of the many potential epidemics? Is it just one of the inevitable dangers of globalization?

Nevertheless, China hurt its relations with its neighbors and demonstrated a potential risk in the movement of its citizens between the mainland and Hong Kong, Taiwan, and Singapore. China surely aggravated the situation by continuing to block, for political reasons, Taiwan's entry into the WHO.[65] (China relented somewhat in 2004, by acceding to Taiwan's participation in some WTO activities.) It is interesting to note that no cases of SARS have been reported in Japan or South Korea and that the ASEAN states were effective in creating a protocol in April 2003that required health checks for all new arrivals into Southeast Asia (once the seriousness of SARS was understood).[66]

The avian flu outbreaks in 2004–2007 were concentrated in Vietnam, Indonesia, Thailand, and southern China. Because of the SARS experience, the avian flu was dealt with more quickly and aggressively (by slaughtering all infected flocks of chickens, ducks, and geese). Since there are reported cases of transmission of the avian flu to humans, this could potentially be a major challenge like SARS, but at the time of this drafting, the full extent of the outbreak is unknown. ASEAN did move expeditiously on this issue and got full cooperation from all member states.

In 2006, epidemiologists were very concerned about the possibility of a flu pandemic similar to the one that killed millions in 1918. Governments in Asia have been working closely to help coordinate responses should a new flu spread rapidly, but the density of the population and the limited sanitary conditions in some Asian locations makes this an issue that warrants continuous attention.

Kashmir

The Indian state of Jammu and Kashmir has been a source of intense friction and repeated military conflict between India and Pakistan since the two states received their independence from Britain in 1947.[67] The convoluted history of broken promises and violated agreements has been a major source of debate and scholarship throughout the period.[68] Within two months of Indian and Pakistani independence, the two states were fighting over Kashmir. By January 1, 1949, when a UN-sponsored cease-fire went into effect, Pakistan controlled roughly the northern third and India the southern two-thirds of Jammu and Kashmir. Kashmir is the only Indian state that has a majority Muslim population.

The Kashmir dispute is of significance in this book because both India and Pakistan are now nuclear powers and their repeated clashes have almost led to war twice during the past four years. One instance was in April 1999, after the offensive in Kargil by Pakistan, and the second was in the winter and spring of 2002, when both sides built up their forces after the guerilla attack on the Indian Parliament House in December 2001.[69]

At present, several factors have tended to damp down tensions: (1) the United States needs Pakistan for its operations in Afghanistan, and the Pakistani leadership sees this as an opportunity to get resources from the West; (2) India wants closer ties with the United States through the civilian nuclear agreement announced in July 2005 and does not want to endanger the initiative through war with Pakistan; and (3) although China has been Pakistan's long-time ally (and frequent supplier of arms and technology), Beijing now wants a less confrontational relationship with India, so it is counseling caution to Pakistan.

In June 2003, the then Indian prime minister A. B. Vajpayee offered further reductions of military deployments and renewed direct talks between New Delhi and Islamabad as a means to avoid new flare-ups in Kashmir. The United States, on its part, has offered more aid to Pakistan but with stricter conditions.[70] In November 2004, after a change of Indian government, the new prime minister, Manmohan Singh, went to Kashmir and offered to open unconditional peace talks with any group willing to renounce violence. Singh also offered a $5.3 billion aid package for Kashmir. Between 2004 and 2006, violence in Kashmir has been sporadic and limited.

Another related development is progress in the courtship between India and China. Indian leaders are now meeting on a regular basis with their Chinese counterparts. In April 2005, Prime Ministers Wen Jiabao of China and Manmohan Singh of India reached an agreement to end their long-standing dispute over their countries' 2,200-mile Himalayan border.[71] The precise details of the border are to be worked out later; however, the agreement is significant because it limits tensions that have periodically flared up since the 1962 Sino-Indian Border War. Moreover, China recognized India's sovereignty over Sikkim and India recognized China's control over Tibet. These steps, plus eleven separate agreements in such areas as trade, investment, and joint military exercises, mean that New Delhi and Beijing have a closer relationship now than at any time since the 1950s.

If these agreements truly lead to a substantial warming of relations between India and China, Pakistan might be somewhat concerned about the ardor of China's support. Ironically, this might well strengthen Washington's hand in dealing with President Musharraf, because the United States would then become more critical of Pakistan's long-term security.[72]

In sum, the Kashmir dispute remains one of the most volatile issues in Asia today, but the strategic context in which India and Pakistan are operating is changing and we need to analyze this ongoing standoff in terms of the broader realignments discussed below.

Seeds of Realignment

The power hierarchy in Asia is determined by the following nine states, ranked below in descending order of importance for the military balance:

1 Superpower:	United States
2 Rising Powers:	China and India
2 Uncertain Giants:	Japan and Russia
2 Cold War Foes:	South and North Korea
2 Humbled Tigers:	Taiwan and Indonesia.

The following discussion attempts to summarize the calculus of the elites who shape strategic thinking in these critical nine states. It is intended to demonstrate that there are several revisionist countries that will put major efforts into advancing their interests over their neighbors. If they are successful at repositioning themselves, this will increase the likelihood of strategic realignment in Asia.

One Superpower: The United States

President George W. Bush campaigned in 2000 advocating a cautious and traditional, realist foreign policy. He critiqued the Clinton administration for making too many overseas commitments and for getting involved in nation building, rather than focusing on defending American interests.[73] This mainstream approach was reflected in his choice for secretary of state, Colin Powell, and in the basic orientation of his foreign policy until 9/11.

After 9/11, the president dramatically shifted his emphasis toward counterterrorism and, as discussed above, has led the United States into two wars and the continued presence in Afghanistan and Iraq. The three presidential speeches and the publication of the "National Security Strategy" and the "National Strategy to Combat Weapons of Mass Destruction" form the centerpiece of the second Bush administration's current foreign policy.[74]

Although the president's statements form the public edifice of his policies, the intellectual origins of the drive for dominance and primacy actually come from ideas initially floated by strategists and then appointees at the time of the first Bush administration. During 1991 and 1992, after the Soviet Union had collapsed and the United States had become the sole superpower, Samuel Huntington developed arguments in favor of primacy. These were echoed in Paul Wolfowitz's draft of the 1992 Defense Policy Guidance (DPG).[75]

Huntington's words reflected a new confidence in the American ability to shape its security environment: "Primacy is desirable not primarily to achieve victory in war but to achieve the state's goals without recourse to war. Primacy is thus an alternative to war."[76] Wolfowitz's phrasing was more threatening to opponents; he said that the United States should focus on "convincing potential competitors that they need not aspire to a greater role or pursue a more aggressive posture to protect their legitimate interests."[77]

The hailstorm of criticism that followed after the 1992 draft DPG was leaked led the first Bush administration to downplay the importance of the wording and to substitute a less domineering tone for the final version.[78] Yet the seed had been planted, and when Wolfowitz became the deputy secretary of defense in the second Bush administration, it was clear that an advocate for "U.S. primacy" was in place should the opportunity arise. The 9/11 attacks were a galvanizing event and strengthened the position of those at the Pentagon, the National Security Council staff, and the vice president's staff, who favored primacy as the U.S. objective.[79]

Hence, the combination of an intellectual rationale for dominance, key individuals who pushed the strategy, and traumatic attacks on the U.S. homeland made it possible for a more assertive stance to develop. These factors, linked with stunning improvements in U.S. military capacity (due to increased accuracy in weapons), made it clear that no power in Asia was going to directly challenge the United States.[80]

Thus, by late 2001, China had decided not to vigorously contest the increased U.S. arms supply to Taiwan, most of the Southeast Asian states were making private arrangements with the United States, and India offered overflight rights and refueling for American planes en route to Afghanistan.[81] This, along with the traditional bilateral alliances, meant that the United States has truly been preeminent in Asia since 2001.[82]

What Could Change This Situation?

Several factors are already changing the setting in which the United States operates in Asia. First, despite awe at, and in some cases fear of, the American military power unleashed in Afghanistan and Iraq, the turmoil on the ground in both countries after the major military operations were over has led many to sense that the United States does not have the political will to manage long-term efforts at violence suppression and nation building.[83]

For example, it is now widely agreed that the United States did not deploy enough troops in Iraq to fully suppress opposition and to keep the country from descending into chaos as Saddam Hussein's regime disintegrated. This, combined with weak planning for postwar recovery, has meant that both Afghanistan and Iraq are thought to illustrate the "limits to nonmilitary power."

Second, although the United States is able to project air and sea power to any point on the globe on short notice, there are clearly military limits to its deployments of ground troops. The British and French faced these problems in the nineteenth century, as they had to decide which parts of their domains to expand and which to merely defend.[84] In the early days after the U.S. troops entered Baghdad, some Bush administration officials began threatening Syria when it was thought that some Hussein regime members were in hiding there. The strong outcry against this approach showed that even some of the Bush administration's strongest supporters thought that wars in two countries simultaneously was enough of a burden.

Third, responding to terrorism in 2001 brought sympathy to the United States, but the invasion of Iraq was seen as unnecessary by most states in Asia. In fact, except for Singapore, none of the Asian states whose governments endorsed the American venture in Iraq had a majority of public opinion backing their governments. This was an indicator that further U.S. military expeditions would hurt, rather than reinforce, the U.S. strategy of leadership in Asia.

Finally, although the U.S. economy leads the world in scale and technical innovation, it is exhibiting a number of weaknesses that could constrain future military options. With annual current account deficits over $600 billion from 2004 onward, the United States has become the world's largest debtor.[85] Unless this trend is reversed, it will clearly limit the long-term ability of the United States to make overseas commitments.

As part of a broad-based redeployment of forces within the "Pacific theater," the U.S. government has decided to move many of the planes, ships, and troops to locations where they can be transported quickly to actual or potential conflict zones. Thus, after negotiations with the South Korean government in November 2003, the

Pentagon announced the intention to move most of its troops out of Seoul and away from the areas along the Demilitarized Zone (DMZ) with North Korea to locations in south-central Korea. To avoid the impression that deterrence would be weakened, the United States committed an additional $11 billion to upgrading of the infrastructure along the DMZ.[86]

None of the factors covered above is likely to affect U.S. goals in Asia in the short run. However, if the United States remains bogged down in Afghanistan and Iraq for the foreseeable future and an extended crisis develops on the Korean Peninsula, it would not be surprising to find many Americans calling for reduced commitments in Asia. At that point, the aspiring powers within the region will have their opportunity for greater influence.

Two Rising Powers: China and India

There is broad agreement among China specialists that the current leadership in Beijing has three overarching goals: (1) maintaining the power of the Communist Party, (2) preserving the country's "territorial integrity," and (3) increasing the state's prestige, power, and international position.[87] These are classic "realist" goals.[88] They are not radical (like Mao Tse-tung's goals), nor are they liberal internationalist (willing to have multilateral institutions play a key role in shaping outcomes).

An interesting test of the Chinese leadership's credentials came in 2001, when the United States proposed closer cooperation on counterterrorism. During the late 1990s, China had put considerable effort into courting Russia, in the hopes of creating a subtle entente with Moscow to begin balancing U.S. influence in Asia. The Shanghai Cooperation Organization (SCO), or the Shanghai Six, was established to strengthen Chinese influence in Central Asia and to provide a forum for Central Asian issues.[89]

After 9/11, the United States, for the first time, started basing troops in and expanding military cooperation with Uzbekistan and Kazakhstan. The Russians did not formally protest the American involvement in their former republics, but went ahead with a significant air force deployment in Kyrgystan as a sign that they were not giving up their role in Central Asia. The Chinese, on the other hand, were not willing to counter the growing U.S. role and even accepted a diminished role for the Shanghai Six to keep good relations with Washington. It could be that the Chinese assumed that Central Asians had no natural affinity with the United States and that the American role would be temporary, but Beijing clearly chose a low-key role when it saw itself outflanked by Washington. That was realism, not an ideological or nationalistic policy.

Other examples of realism by Beijing include the October 2002 decision to establish tighter restrictions on the export of missile and biological weapons technology, the willingness to chair the six-party talks on North Korea's nuclear program, and the decision to support the November 2002 UN Resolution 1441, which required more intrusive weapons inspections in Iraq.[90] Yet, when the leadership in Beijing sees the country's interests adversely affected, it is quite willing to challenge the positions of the international community, including the United States. Beijing was not willing to support a second UN resolution in 2003 that called for the removal of Saddam Hussein, nor has it chosen to exert its substantial leverage over North Korea to get Pyongyang to give up its nuclear weapons program. Also, as noted earlier, in 2005 China was willing to maneuver, behind the scenes, to get the Shanghai Cooperative Organization to call for the U.S. departure from Central Asia (albeit without directly confronting the Bush administration).

If the Chinese are now realists, have they accepted the status quo? Or, is this just a temporary period when they are concentrating on economic growth and good public relations?

There are essentially three prominent, contrasting views on these questions. One school argues that China has a long-term strategy for becoming a true major power, with the ability to project influence far beyond its borders.[91] A second school views China as aspiring to a significantly enhanced role, but notes the difficulties it faces in upgrading its military at the same time as it is trying to transform the overall economy.[92] The third school sees China as inherently a land power that will want to dominate its periphery and establish a clear Asian sphere of influence, but not develop a true global military posture.[93]

Since the Chinese have no incentive to reveal their long-run intentions (if they are potentially threatening) and every advantage to gain in focusing on their immediate concerns of economic transformation, there will need to be some major event or policy decision where their hawks win out before we can know if they are willing to sacrifice any significant economic or political gains for strategic objectives. The current Chinese leadership, announced at the Party Congress in October 2002, has consolidated its power and publicly stressed greater equity in internal economic development as its principal goal.[94] Both the leadership and the general public in China want the 2008 Olympics to proceed smoothly. Thus, it is unlikely that China will make any major moves internationally until after the Olympics are over. The 2009–2010 period will be interesting because there will be new presidents in the United States, Taiwan, South Korea, and Russia—so the Chinese could well face different policies around their periphery. This may lead them to take a different tack themselves.

Predicting India's likely direction is far easier. The Indian political and strategic elite is open and unabashed about its ambitions for world power status.[95] India has been gradually consolidating its dominance of the subcontinent: first occupying Goa, then consolidating its influence over Nepal, Sikkim, and Bhutan, and then splitting East Pakistan away from the West and developing a more pliant Bangladesh.

India, a vibrant democracy, has a sophisticated intellectual class and a free press, so there are frequent hot debates about what tactics to pursue. Yet, when India decided to proceed, in 1998, with its nuclear weapons testing, there was support across a broad spectrum of society and remarkably little dissent.[96]

From the perspective of this book what counts is that India has both the capability and the intent to purse a greater global role. Its economic growth rate has almost doubled since the early 1990s[97]; it is building a medium-range missile force[98] and is acquiring a blue-water navy and a high-performance air force. We do not know whether India will realize its ambitions, but it is not coy. Thus, it is reasonable to assume that India will persist in its current directions and that it will seek strategic realignments that advance its interests.

Moreover, the 2005 decision to implement the "strategic partnership" with the United States was a clear affirmation of India's great power ambitions. For the first 45 years after independence, Indian leaders placed emphasis on "nonalignment" even though they had a Friendship Treaty with the Soviet Union. Hence, the Indian rhetoric was about autonomy. Because China's economic surge and military modernization in the past two decades is a direct challenge to India, leaders in New Delhi concluded that they had no choice but to strengthen ties with the United States, the world's preeminent military power.

Pakistan poses several critical problems for India: (1) it is a hostile state directly on India's border; (2) it has been an antagonist in three wars (1947, 1965, and 1971); (3) it has successfully sought strategic protection from India's major strategic competitor, China; and (4) since 1998, it has possessed nuclear weapons.[99]

Few military analysts think that Pakistan could survive in an extended conventional war with India. So, the danger of having *any* war is that Pakistan might think of using nuclear weapons just to preserve its position. In reality, except for the disputed territory in Kashmir, India has little desire to control or occupy what is now Pakistan; most Indians wish they could focus on other issues, rather than their northwestern neighbor.

However, Pakistan is a permanent challenge for India. Because President and Army Chief Musharraf has been the target of several assassination attempts, planners in New Delhi are concerned about what would happen if Musharraf were replaced by someone more antagonistic to India.[100] Also, though China has courted India recently, it is unlikely that China will abandon Pakistan. Moreover, China is making major infrastructure investments in the port of Gwadar (west of Karachi on the Arabian Sea). These infrastructure improvements are nominally to help shipping and to provide a terminus for tankers, but could, under other circumstances, easily be ports of call for the Chinese Navy. Owing to these factors, Pakistan is an ever-present part of India's strategic calculus.

Before turning to other Asian states, it is worth noting that both China and India have the human capital and research sectors to underwrite their transformations to great power status. Table 5.1 shows the number of students enrolled in college or university in China and India, while Table 5.2 shows the dramatic increase in research capability in the two states in the past decade. Additionally, both states are making major investments in the telecommunications, satellite, missile launch and computer software sectors, which are essential for targeting distant opponents. Also,

Table 5.1 Education profile: China versus India in 2004

	China	**India**
Adult Literacy %	91	63
Average Years of Schooling	6.4	5.1
Primary Enrollment	115m	107m
Secondary Enrollment	70m	52m
College/University Enrollment	15m	13m

Source: C. J. Dahlman, "China and India as Emerging Technological Powers," April 26, 2006, mimeo (Washington, DC: Georgetown University).

Table 5.2. Technology input and output measures

	China		India	
	2004	1995	2004	1995
Number of Researchers	859,348	559,000	128,520	149,326
Expenditures	25.4		5.7	
Scientific and Technology Journal Articles in 2001	20,978	9,361	11,076	9,591
Patents Granted by the U.S. Patent Office	597	63	376	38

Source: C. J. Dahlman, "China and India as Emerging Technological Powers," April 26, 2006, mimeo (Washington, DC: Georgetown University).

since both New Delhi and Beijing are developing high-performance air forces and the nascent steps for naval power projection, each is clearly laying the foundations for critical new military strength.

TWO UNCERTAIN GIANTS: JAPAN AND RUSSIA

The academic and public fascination with Japan's rise to prominence in the 1970s and 1980s has faded with the decade-long slump and disarray of the 1990s.[101] Yet, Japan has begun to address the pervasive mismanagement in the financial sector, and corporate profits have turned up significantly after 2004.[102]

With an aging population, a strong aversion to immigrants, a younger generation that is concerned about improving lifestyles, and the highest levels of public debt among the industrial countries, many observers have expressed concerns about Japan's future.[103] It is also true that many Japanese are deeply conflicted about what role they should play on the world stage.[104] Long content with the strategy developed by Prime Minister Yoshida in the 1950s (of concentrating on economic growth and deferring to the United States on defense),[105] Japan now feels that the older formula is inadequate and that new directions in both economic and foreign policy need to be forged.

The irony is that, currently, it may be easier for the leadership in Tokyo to make changes in foreign policy than in economic areas.[106] A number of important foreign policy adjustments are under way: Japan went ahead with launching an intelligence satellite despite North Korean threats of retaliation, sent ships and logistical support for the Afghan War, and has even encouraged, in February 2002, a proposal for an Asian collective security organization. In addition, as indicated above, the former prime minister Koizumi has sent support troops to Iraq, and the Japanese pubic now favors taking a harder line in dealing with North Korea. The approval by the Japanese Diet of a missile defense system is even bolder—as the Chinese have clearly stated they consider this a hostile development.

Of Japan's neighbors, only Taiwan would like a larger Japanese military role in the region. The Chinese and Russians do not want competitors, the Koreans have long memories of Japanese occupation, and the ASEAN states prefer a U.S. guarantee. However, countries rarely get to choose ideal environments. At present, Japan is cautious and preoccupied with the internal economic reforms; yet it is still the world's second-largest economy and would be a formidable opponent if provoked. As long as there is no military crisis on the Korean Peninsula and no collapse of the Chinese economy (where so much of new Japanese investment is going), Japan is likely to avoid moving openly to major power status. Tokyo's high-profile economic role in the 1980s is over, but its more visible foreign policy reflects the changing public perception that the country faces a less secure environment.

Russia has some superficial similarities to Japan: its economy has been going through wrenching adjustments, its citizens are far more concerned about domestic issues than foreign policy, and its political leadership has been debating how to protect the country's international interests on a constrained budget. One interesting development in 2005 was the decision of both Moscow and Tokyo to commemorate the end of the Russo-Japanese War of 1905. These commemorative events were used by Moscow and Tokyo to stress closer, current cooperation between Japan and Russia and as a signal to China that their relations might become even closer in the future. Comparable celebrations of friendship with China in 2006 were meant to show Russia's new flexibility.

Nevertheless, Russia is an anomaly in many regards. It still has the world's largest supply of nuclear weapons and massive conventional forces; yet it cannot maintain them, because it is such a poor country, with a per capita income one-tenth of Japan's.[107] Its health system is a disaster, and it is the only industrial country where average life expectancy declined in the 1990s.

However, unlike the Japanese, the Russians are not ambivalent about power, and their economy is now turning around. After Russia's crash in 1998, its GDP has grown every year and is now expanding at an annual rate of 7.1 percent, its foreign investment is up, and its oil and natural gas revenues are soaring.[108] Although Moscow may not be able to sustain this growth rate, there is now a new sense of optimism about Russia's long-term economic prospects.

The economic turnaround will certainly affect Russia's strategic calculus. In the 1990s, Russia was in the humiliating position of accepting foreign aid from the United States to deactivate and destroy many of its nuclear weapons under the Nunn-Lugar Program, and it had little choice but to accept U.S. forces in Kazakhstan and Uzbekistan during the Afghan War.

Now, however, after seeing their prestige decline in Central Asia and the bitterness over the U.S. occupation of Iraq, the Russians are openly taking steps to restrain American influence near their southern border. President Putin has (1) expanded deployment of troops in Central Asia, (2) upgraded military ties in the Caucuses (notably Armenia), and (3) resisted U.S. pressure on Syria and Iran, which are both major purchasers of Russian weapons and technology.[109] Moreover, President Putin has shown his willingness to directly thwart various U.S. initiatives.

Is Russia a middle-income state attempting to deal with seven decades of communist misrule? Or, is it a volatile country with a capitalist economy and an authoritarian political system?[110] There is little doubt that President Vladimir Putin has shifted the country away from the more open democracy that President Boris Yeltsin favored. After the terrorist attack in Belsan, Putin overrode the Russian constitution and began appointing governors instead of having them elected, and he also changed the electoral system to multiparty districts, which favors his incumbent, United Russia Party. President Putin has also taken a more assertive stance toward Europe, stressing the leverage that the Russian state now has through its control over natural gas exports.[111] In addition, he has indicated his determination to deploy the Topol, a new ground-based intercontinental ballistic missile, and opposed U.S. proposals for missile defense systems in Western Europe.[112]

Like the Chinese, the Russians want Western technology and capital, access to global markets, and no major conflict that would disrupt their economic expansion. Yet, with experience as a global power and deep disappointments at the decline in their status, many Russians support a more assertive foreign policy. Whether their economic interests or their national pride will prevail is unclear, but the United States can certainly not count on Russian acquiescence to the expanded American role in Central Asia and the Middle East.[113]

Two Cold War Foes

Despite all the recent attention on North Korea's nuclear weapons programs, what is striking about the Korean Peninsula is how constant the basic issues remain. North Korea is the only remaining Stalinist regime on the globe, and it has been unremittingly hostile to South Korea and Japan since 1945. There was no peace treaty ending the Korean War; it was and is only an Armistice Agreement. The U.S.–Republic of Korea (South Korea) Security Treaty is 54 years old. This means that two generations of Koreans and Americans have had to deal with this stalemate, and all parties are understandably frustrated. In addition, the neighboring states have strong concerns as well: Japan has over a million Korean residents on its soil and is increasingly worried about North Korea's nuclear and missile capabilities,[114] the Russians are now more interested in South Korean trade and technology than North Korea but are worried about instability on their borders,[115] and the Chinese have been trying to coax Pyongyang into moderate reforms for years.[116] The worries about the collapse of North Korea, and the refugees that would follow, trouble both South Korea and Japan.

However, for the first time since the Korean War, the impetus for change may be coming more from Seoul rather than from Pyongyang.[117] Although there are indications the George W. Bush administration has now reduced its friction with President Roh Moo Hyun, it seems unlikely that the current U.S.–South Korean relationship can continue without significant adjustments. The U.S. decision to move its Army Command Headquarters out of Seoul will have an important symbolic effect, signaling that South Korea is increasingly in charge of its own defense. Similarly, the decision by Secretary of Defense Rumsfeld to redeploy U.S. troops from the DMZ to the central region of South Korea is meant to reduce the chance of American forces being caught in the initial stages of a conflict between North and South Korea. There are some sensible military reasons for these moves.[118] It should keep North Korea from targeting Seoul or the DMZ by removing the excuse that they are focusing on American troops. Nevertheless, the political significance is clear: if the South Koreans complain too much, the United States can leave the peninsula entirely.[119]

Hence, in addition to the North Koran nuclear standoff discussed above, the United States faces ambivalence on the part of a key ally. This is yet another seed for potential realignment. Moreover, although most South Koreans are skeptical of North Korean intentions, they are very worried that precipitate action by the United States could draw them into a disastrous war.

TWO HUMBLED TIGERS: TAIWAN AND INDONESIA

For two decades, in the 1970s and 1980s, Taiwan reveled in its status as an “Asian Tiger” that had rapid growth and unbounded optimism. Indonesia took longer to get noticed, but its compound growth rate was over 7 percent per year for the 20-year period from 1975 to 1995.

Although Taiwan was able to avoid much of the fallout from the 1997 financial crash by having a reasonably sound banking system and through its prior currency devaluation in 1994, the island is now facing a severe loss of confidence as capital, human talent, and trade all focus on the Chinese mainland.[120] Ironically, although Taiwan had a very smooth transition from an authoritarian to a democratic government, there is no consensus now in Taipei on how to deal with the loss of economic momentum or Beijing’s unremitting hostility to greater autonomy and recognition for Taiwan.

Indonesia has had not only a catastrophic financial crash, where virtually all of its banks went broke, but also a traumatic and uneven transition to democracy. Still further trauma has come from the devastating tsunami of December 2004 and the massive earthquake of May 2006.

Why are these two disparate states part of our realignment discussion? They are critical because they have been stalwart links in a pro-Western chain, from the Korean DMZ to the Straits of Malacca, and they are both in a tentative status. Taiwan’s political leadership is deeply split over whether to maintain its autonomy or compromise with the mainland, and this is slowing important decisions on military preparedness.[121] Indonesia faces even greater problems in dealing with corruption, radical Islamic groups, and separatist movements.[122] Moreover, there is deep internal division over how fast to further liberalize trade.[123]

In 2004, the voters of Taiwan gave a mixed message about “greater autonomy.” They reelected President Chen Shui-bian by a thin margin, but left the Kuomintang (KMT) and its coalition in control of their parliament, the Yuan. Chen Shui-bian’s Democratic Progressive Party (DPP) lost further ground in the local elections in 2005. So, for now, there are checks and balances in Taipei. Yet the leading candidate in the next presidential race is Ma Ying-jeou of the KMT. If elected president, Ma is likely to pursue cooperation with the mainland. If a KMT government were to accept some type of union with the mainland, it would have seismic strategic consequences. Beijing would then have full access to Taiwan’s technical and manufacturing capability as well as new influence on the sea-lanes of communication from Southeast to Northeast Asia. This would give China far more leverage over Japan and South Korea than at present and would require a fundamental rethinking of the U.S. military posture in the Western Pacific.

Indonesia made important progress in 2006, by reaching a negotiated settlement in its long-simmering dispute with separatists in Acheh. Nevertheless, government corruption is rampant, and, if this cannot be brought under control, it will strengthen the hand of Islamic challenges to the country’s secular tradition.[124] Although it now appears that President Susilo Bambang Yudhoyono does recognize the seriousness of Indonesia’s terrorist networks, it is not clear that enough will be done about it to coax foreign investors back.

Before the 1997 crisis, Indonesia was receiving $8–10 billion per year in foreign investment; however, between 2000 and 2004, it had net disinvestment of over $7 billion; 2004 was the first post-1997 year when there was a positive inflow of FDI. Because of its size and location at the center of Southeast Asia, Indonesia's stability is critical to regional stability.

Hence, as different as Taiwan and Indonesia are, either of them could be candidates for initiating a major realignment.

New Patterns Emerging

Each of the principal themes of this book links economic performance to strategy. This final section will review those themes and illustrate how broader, global patterns will affect Asia.

Economic Factors Dominating Strategy

The transformation of the U.S. military in the past two decades, through the use of the global positioning system (GPS) and real-time identification of targets, has meant that the United States can destroy opponents at any point on the globe. This revolution in military affairs (RMA) requires both technological sophistication and massive resources devoted to the military.[125] At present, no other state can match the United States, but over time, others will master much of the technology and be able to extend their military reach far beyond their borders. The questions here are: How soon will that take place? And, which of the governments in Asia will have workable use of the technology in the foreseeable future?

We cannot answer that now with certainty, as most states will not reveal their progress on the RMA until they have functioning, tested systems. We can make a guess, however: those with technical prowess (Japan, South Korea, China, Taiwan, Malaysia, Singapore, and India) are the logical candidates.[126]

It is also clear that states with fundamental economic problems will fall farther and farther behind as they have neither the research and development capacity nor the ability to buy finished RMA systems. Ironically, this may encourage the spread of nuclear weapons, as weaker states see them as their only deterrent.[127]

In the short run, this feature of the RMA may push Asian states to cooperate with the United States, but over longer periods, it will lead to cooperation with those states in the region that develop sufficient RMA to be a protector. This will tend to enhance the significance of China, Japan, and India.

Regional Multilateral Organizations Decline, Bilateral Ties Rise

Asian regional organizations (such as APEC, ASEAN, and ARF) have been eclipsed by global groups (such as the WTO) or by the enticements of bilateral ties, for reasons discussed above.[128] At present, American military dominance has meant that there are incentives for cooperating with the United States, but that dominance will not last indefinitely.[129] ASEAN + 3 is already becoming a grouping in which China and Japan are competing for influence among Asian states.

This pattern of bilateral inducements is likely to grow as India joins the search for allies beyond the subcontinent. If China, Japan, and India become the Asian states with a successful RMA, they will not be sharing it or providing guarantees on a multilateral basis. Bilateral linkages will trump over multilateral ones.

China and India Versus the Pacific Rim

What could derail the rise of India and China? Literally hundreds of factors or events could intervene. Political instability seems the most fundamental challenge for China, whereas protectionism and conflict with Pakistan appears to pose the biggest problem for India. However, look what these two states have overcome in the past 30 years. On China's part: the Cultural Revolution, a nationalistic reaction toward foreigners and foreign investment, and massive internal problems. On India's part: a stultifying socialist ideology, the need to develop scientific institutions and training, and widespread internal problems as well.

This is not to imply that these two countries are universal success stories, but it does mean that both have the scale, the will, and a political elite that wants to project power and influence. Japan has far more technical competence and more resources at its disposal than either China or India, but its historical experiences in the 1930s and 1940s and recent weakness in economic performance mean that it is not likely to assert itself unless provoked. There is simply no other state in East Asia that has both the will and the capability to realign security relations through its own actions.

Less powerful actors (notably Taiwan, Indonesia and, the two Koreas) can affect subregional balances by their choices, but cannot produce a realignment on their own. This means that if the Pacific Rim states continue their slower pace of economic growth, the only two Asian countries that can plausibly force change in the regional security environment are China and India.[130]

The Korean Peninsula Becomes the Pivot of Northeast Asia

If China and India do not directly trigger a realignment, could passive or indirect actions do so?

Korean specialists are concerned about three principal scenarios: (1) an event that will spark major North-South fighting (which now might be nuclear); (2) an unanticipated collapse of North Korea, with massive flows of refugees and a quick movement of South Korean troops and personnel into the North[131]; and (3) reunification, neutralization, and gradual absorption of the peninsula into the Chinese sphere of influence.[132]

Each of these three possibilities could cause sufficient disruption to destabilize the entire region. Therefore, China has been willing to accept, with minimal protest, the presence of U.S. troops so close to its borders for so long. However, the current situation is not sustainable indefinitely. When the U.S. presence is reduced, Korea will certainly be courted by both China and Japan. Yet, the Korean resentment of Japan makes an alliance very unlikely. If a reunified Korea ultimately decides to ally with China (while Japan is still allied with the United States), that would create a major shift in the regional balance of power. This shift could be potentially destabilizing as both sides compensate for the new reality.

China, Japan, and the United States would each rather have the current situation than a conflict or a reunified Korea joining with a competitor. Thus, the Korean Peninsula is a pivot and is potentially destabilizing if any of the major powers surrounding it see their interests being seriously, adversely affected.

In sum, we have shown that bilateral ties, economic links, and strategic rivalry each have a key part to play in explaining the current Asian security picture. Our focus has been on the underlying structural relations and the factors that could plausibly produce a shift in the strategic balance favoring the Asian continental powers, India and China.[133]

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Chapter 6

U.S. Policy and Asian Realignments

The Debate over U.S. Global Strategy

The collapse of the Soviet Union in 1991 took most foreign policy specialists by surprise.[1] Although there was jubilation in the West and great relief that the Cold War was over, it soon dawned on the American foreign policy and defense establishment that there was a need for a new military and foreign policy. What was the appropriate role for the United States in this new era when it had become the sole superpower?

There was no shortage of analysts and pundits willing to suggest a new direction for the United States. As we will see below, few anticipated that terrorism would become such a central issue in U.S. concerns, and the core of the debate centered on the extent to which the United States should act alone or continue to maintain its alliances and work through international institutions.[2]

In 1992, the United States found itself in an unprecedented position: its military spending was greater than the defense outlays of the next five largest military powers combined (this preponderance in military spending has grown even greater in the past 15 years.) In 1992, the United States also produced 25 percent of the worlds gross national product, it was the worlds largest trading nation, it had the worlds largest capital market, its research community was the leading generator of scientific research and patents, and its entertainment industry (TV, movies, video, and music) was global in scope. Moreover, American diplomatic efforts were considered crucial for dealing with most major international crises. For example, at the time, the chaos in Somalia and disintegration of Yugoslavia each drew widespread calls for American diplomatic, military, and humanitarian intervention.[3]

Nevertheless, on balance, the early to mid 1990s was an optimistic period. There was a strong element of confidence in both liberal and conservative commentary. Francis Fukuyama even argued that the "End of History" has been reached and claimed that liberal democracy and capitalism were the only serious candidates for political and economic organization; thus, there was no need for future ideological conflict.[4] This brought a host of critics, some arguing that Fukuyama was relying too much on Kant's assumptions about human nature, others who felt international institutions could not ensure peace and that nations would still try to exert their influence on one another. The most controversial critic, Samuel Huntington, argued that the real future tensions would be in clashes between civilizations.[5]

Yet, it is notable that few analysts were worried that the United States was embarking on a period of overcommitment. Paul Kennedy's warning about the excessive expansion and decline of the European empires did not seem to inhibit American aspirations of either the liberal or conservative variety.[6] In fact, some advocates of international organizations saw this as the moment when American military capability might provide the security to buttress international institutions.[7]

More conservative academic analysts and planners in the Pentagon saw the moment differently. Instead of accepting the formation of a new coalition of powers that would "balance" the might of the United States, some urged that the United States seek a new understanding where American "primacy" was the accepted norm.[8] Primacy would not mean territorial control or, necessarily, extensive interference in others' internal affairs, but it would mean that less powerful states deferred to American preferences on security matters.

Policy makers in the first Bush administration's Defense Department wanted to go even further. As noted in Chapter 5, in a draft of the 1992 Defense Policy Guidance, the document stressed the desirability of preventing the emergence of any rival power, particularly among the "advanced industrial nations." If implemented, this policy meant pursuing a stance that would limit the future strength of Britain, France, Germany, and Japan as well as any newcomer that could break into the fold of the advanced industrial states. When the draft was leaked to the press, there was, not surprisingly, an uproar from American allies and many inside the United States as well. The draft was changed and the wording about advanced industrial states was dropped, but the policy statement became a precursor to the thinking of the second Bush administration because it ended up advocating building military capabilities so daunting that there could be no rival at all to the United States.[9] As the George H. W. Bush administration was leaving office, few noticed that its final policy prescription incorporated this exceptionally broad mandate for American planners.[10]

The Clinton administration was, initially, preoccupied with domestic economic decisions. There was an effort by National Security Advisor Anthony Lake to set out a broader theme for the administration's activities, stressing "enlarging" the group of democratic nations and using this as a substitute for the former "containment policy."[11] Possibly it was the cumbersome nature of the term "enlargement" or the less than enthusiastic response from the foreign policy community, but, for whatever reason, the Clinton administration then dropped overarching themes and concentrated on traditional liberal, internationalist approaches to foreign policy. These included: strong support for the United Nations system, attempts to strengthen the arms control and nonproliferation regimes, trade liberalization, and commitments to longstanding allies in Europe and Asia. So, unlike the first Bush administration, Clinton's policy makers, typically, saw no merit in emphasizing primacy.

Secretary of Defense Les Aspin tried to redefine security issues by reorganizing the Office of the Secretary of Defense (OSD) and creating bureaus to deal with topics not previously covered in OSD, such as "environmental security" and "democratization." There was also a decline of interest in traditional (interstate) arms control agreements and a greater concern for developing more effective measures to limit proliferation of weapons of mass destruction (WMD).

This led to a series of major commitments. The Congress signed and approved the North American Free Trade Agreement (NAFTA). Despite domestic criticism and a limited military threat, the Clinton administration also kept substantial numbers of troops in Europe.[12] The Clinton Defense Department went even farther on commitments of troops in Asia: the "Nye Initiative" specifically promised the United States would keep 100,000 active-duty troops in the Pacific Basin.[13] This initiative, named for the then assistant secretary of defense Joseph Nye, was designed to show that despite the end of the Cold War, substantial numbers of American naval, air, and ground troops would stay in the Pacific Basin indefinitely. This was meant to reassure America's formal allies (Japan, South Korea, the Philippines, and Thailand) as well as other cooperating states that the United States would continue to play a "stabilizing" role in the region.

The final years of the Clinton administration's second term continued with many of the same approaches. In Europe, the focus on security policy was multilateral. After the United Nations and the European Union had failed stop the violence and ethnic cleansing in Bosnia and Kosovo, the U.S.-led NATO to take its first "out of area" actions and attack Serbia. The goal was to force Serbian leaders to withdraw military and economic support from paramilitary units in Bosnia and Kosovo.[14] The Serbs did withdraw from Kosovo and reduced support for insurgents in Bosnia, but both areas have needed semipermanent peacekeeping forces to maintain order afterward.

In Asia, the reaction to the Nye Initiative was mixed. American allies, generally, appreciated the commitments made, but Russia and China saw this as a clear sign that the United States was intending to maintain its lead role in the region. Leaders in Moscow and Beijing were not in a position to directly challenge the United States, but this reinforced their interest in cooperation. For the first time since the Sino-Soviet split in the 1960s, Moscow and Beijing saw a growing convergence of interests.[15] This rapprochement led to plans for Russian oil pipelines to China and made the Security Cooperation Organization (linking Russia, China, and the Central Asian states) a potential framework for additional Russian-Chinese ventures.

The Clinton administration's Asia policy ended on a conventional note. The *East Asia Strategy Report* of 1988 used much of the same language as the George H. W. Bush administration had.[16] In addition, Clinton's commander in chief of Pacific forces, Admiral Dennis Blair, had focused on low-key institution building, not on war fighting capability and power projection.[17] Moreover, the Clinton administration's departing statement on national security emphasized treaty compliance, nonproliferation, trade and economic security, human rights, drug trafficking, and democracy but had only a brief (four-page) discussion of East Asia.[18] The principal forewarning of later issues came from the Hart-Rudman Commission, which said that the U.S. forces were configured to fight the Soviet Union and were not ready to deal with terrorism, WMD, and smaller, unconventional conflicts.[19]

The second Bush administration entered office with relatively conventional statements on national security. George W. Bush had no foreign policy experience, and the 2000 presidential campaign had focused on domestic issues, notably education and tax policy. The country was enjoying its longest post-World War II economic expansion and the attacks on American embassies in East Africa and the destroyer *USS Cole* received little discussion.

The clearest statement of President Bush's likely policy came from Condoleezza Rice, who became his national security advisor. In her January 2000 *Foreign Affairs* article, she presented a realist critique of the Clinton administration's liberal internationalism.[20] Rice urged that the United States concentrate on maintaining its economic and military strength, focus on its principal allies, and avoid getting involved in marginal conflicts or nation-building efforts that would divert Washington from its central concerns.

There were two other low-key indications that the George W. Bush administration would make important changes in the Asia policy. The 2000 Bush campaign criticized President Clinton for assuming that the U.S. relationship with China could be a "strategic partnership" and instead stated China would be a "strategic challenge" or competitor.[21] Also, Richard Armitage, who became deputy secretary of state, had chaired a study group, which urged that Japan become the anchor for U.S. policy in Asia, with Japan receiving more attention and China relatively less.[22] These preinaugural plans were quickly overtaken by events.

The first foreign policy crisis of the George W. Bush administration was in April 2001 and resulted from a collision between a Chinese fighter plane and an American EP-3 reconnaissance aircraft. The EP-3 was unarmed, in international air space, and flying along the China coast to pick up electronic intelligence. The Chinese had long resented this and had their fighters trail the EP-3s. In this instance, the fighter got too close and actually hit the EP-3, causing the fighter to crash into the ocean and killing its pilot. The Chinese immediately sent up other fighters and made the EP-3 land, under duress, on a military air base on Hainan Island. The Chinese then detained the crew for eleven days and there was considerable tension between Washington and Beijing.[23] Although the crew was returned unharmed, the plane was disassembled to permit a Chinese analysis of its technical intelligence capabilities. This incident reinforced the view of some in the administration that China would be a major antagonist. The U.S. response was relatively mild: efforts were made to establish a better Washington-Beijing hotline and U.S.-Chinese military exchanges were kept limited.[24] Although polls at the time showed that the American public would have supported the imposition of trade sanctions on China in protest, the administration chose no direct punitive steps and urged that China proceed with its entry into the World Trade Organization.[25] Shortly thereafter, however, President Bush vowed to "do whatever it takes to defend Taiwan" and approved the sale of new, sophisticated weaponry to Taiwan.[26]

September 11, 2001, and Its Aftermath

In 2001, it had been almost 60 years since the last assault on American soil, when the Empire of Japan attacked Pearl Harbor on December 7, 1941.[27] Thus, the destruction of the twin towers of the World Trade Center and the extensive damage to the Pentagon were not only a shock but also a forced recognition that, despite its power, the United States was vulnerable. The Bush administration had given terrorism a low priority and had held only one meeting of the National Security Council on the topic during the first nine months in office.[28] Al Qaeda's attacks were different from Pearl Harbor in several important regards:

1. The United States was initially unsure who organized and carried out the assault.
2. The attacks were aimed mostly at civilian targets.
3. The purpose was symbolic—to demonstrate that the United States would have to pay a price for its foreign policies (especially those in the Middle East).

In a meeting at Camp David during the weekend following September 11, the president's advisors were divided on what the extent of the retaliation should be.[29] Apparently, Secretary of Defense Rumsfeld urged attacking Iraq, but it was agreed that the focus, initially, should be on Afghanistan, where the Taliban government had been giving al Qaeda sanctuary and a place to train its fighters.[30] It was also believed that the leader of al Qaeda, Osama bin Laden, lived in Afghanistan.

An important decision was made early on: American forces would make no distinction between the terrorists themselves and the countries that "harbored terrorists."[31] This meant that the war against al Qaeda and similar organizations would be worldwide, indefinite in duration, and involve many countries that did not completely control their home territory. Because the Taliban's military resistance quickly collapsed in Afghanistan and the U.S. forces and their local allies were in control of Kabul by November 2001, the question then arose: what next?

The president's State of the Union address, in January 2002, appeared to outline the administration's next moves. Iraq, Iran, and North Korea were identified as the "Axis of Evil," and many in the administration began to say that a "regime change" might be necessary to solve the problems in these countries.[32] However, the domestic and international reaction to the address ranged from questioning to incredulous. Why was the United States threatening other countries before it had established a stable government in Afghanistan? Although it might be feasible to defeat Saddam Hussein in Iraq, it would be a formidable task to take on Iran, and there was no obvious military solution on the Korean Peninsula where North Korea had thousands of artillery pieces within range of Seoul.[33]

The Bush administration then felt compelled to set out its policies in greater detail. This was done in two key documents: the president's speech to graduating cadets at West Point on June 1, 2002, and the *National Security Strategy of the United States,* released on September 19, 2002.[34]

Although these Bush policy statements included a discussion of accelerating global economic growth and expanding the "circle of development" by encouraging democratic institutions, the West Point speech emphasized the way in which terrorism had changed twenty-first-century warfare. The National Security Strategy (NSS) was a fully developed exposition of how the Bush administration saw the links between the rise of terrorism and the need for global American military dominance. Three key quotes illustrate the essence of the new Bush strategy:

> "While the U.S. will constantly strive to enlist the support of the international community, we will not hesitate to act alone, if necessary, to exercise our right of self defense by acting preemptively against such terrorists."

> "Iran, Iraq, and North Korea have obtained weapons of mass destruction despite nonproliferation efforts, . . . so we must defend against the threat before it is unleashed."
> "The United states must and will maintain the capability to defeat any attempt by an enemy . . . to impose its will on the United States, our allies, or our friends . . . Our forces will be strong enough to dissuade potential adversaries from pursuing a military buildup in hopes of surpassing, or equaling, the power of the United States."[35]

The breadth of ambition and sweep of the claims that President Bush demonstrated in these policy statements have been the subject of intense controversy ever since. When these policy positions are joined with the December 2001 decision to withdraw from the Anti-Ballistic Missile Treaty, the combination marks a fundamental departure in U.S. defense policy.[36]

If the NSS had been debated for a sizable time before it was put into effect, foreign policy specialists and the public might have developed a better appreciation for different approaches in dealing with terrorism. However, the NSS was released at the same time as the Bush administration was preparing for war with Iraq.[37] Hence, the strategy was never fully vetted, nor were its pros and cons widely debated publicly. Then, responses to the NSS became inextricably linked with what commentators thought about the Iraq War.

Because Iraq did not possess WMD in 2002 and the links between al Qaeda and Iraq were never proven, the dangers of "preemption" based on false or misinterpreted intelligence became obvious. Nevertheless, the NSS remains official U.S. policy and most Americans do not know that the country is committed to maintaining a military that is beyond that of any rival. The wording of the 2002 NSS is so sweeping that it could be interpreted to mean that the United States should remain unsurpassed in all aspects of military capability: naval, air, ground, space, and electronic warfare. No powerful nation or empire has ever undertaken such an ambition. In the past, specialization and identification of a nation's relative strengths were the essence of strategy; to attempt to lead in all areas is a monumental agenda.

The reaction to the NSS from allies and friendly states was almost as adverse as from traditionally hostile states. Major European allies saw this as an effort to keep them in a perpetual subordinate status. This followed on European complaints, in 2002, that the United States was acting in a "unilateral" fashion on a host of issues that had previously been handled in a consultative manner.[38] As we will see below, the Bush strategy of dominance and preemption had a significant impact in Asia as well, but it is worth spending some effort to put the debate about overall U.S. strategy in a broader context.

Perspectives on U.S. Foreign Policy

Robert Kagan's *Of Paradise and Power* concisely illustrates the dilemma over how U.S. power should be used.[39] Many Americans see power as having an intrinsically military component, while a large majority of Europeans, having suffered through two calamitous wars in the twentieth century, see force as a last resort.[40] Those who favor a limited use of force often argue that the United States fails to take effective advantage of its cultural, diplomatic, and economic power to shape circumstances so as to avoid violence.[41] Related to this is the constructivist approach to political analysis, which is based on the assumption that individuals and political leaders in states with competing interests can design nonviolent means for resolving their differences.[42]

The George W. Bush administration rejected many of the underlying assumptions in the less confrontational approach and takes the view that (1) international organizations and diplomatic efforts failed to stop WMD proliferation, and (2) that the United States has been attacked by a network of deadly opponents who only respect force and must be eradicated. Thus, to the leaders of the Bush administration, there is no choice but to use force and to form ad hoc coalitions to deal with different antagonists in different settings. The question then arises: What is the best means for getting cooperation on dealing with al Qaeda and similar threats?

Some commentators have argued that al Qaeda and related organizations are a direct threat to the physical existence of the Western states.[43] If one accepts that view, then massive force and preemption are justified because failing to act could lead to the annihilation of Western civilization. If, however, one takes the view that al Qaeda cannot destroy all or even a large part of Western civilization, then a more focused response is warranted.[44]

Table 6.1 provides a framework for categorizing the different intellectual traditions being drawn upon by the George W. Bush administration. Although the key figures in the administration see their efforts as a matter of military necessity and a noble cause, they make accommodations with groups from the realist tradition that accept the use of force but advocate a more limited set of objectives. There was a basic split, however, on the preferable style of leadership. The former secretary of state Powell favored, essentially, a "managing partner" role, while the former secretary of defense Rumsfeld saw the United States as the natural world leader, with others having to accept this reality.

The realist view dominates U.S. relations with China, an undemocratic and potentially challenging state, but one that is too formidable to dominate.[45] So, the Bush administration has been willing to repeatedly pronounce the virtues of democracy for the Middle East but has not been willing to press the same case for China.[46] A variant of realism sees U.S. intervention abroad not in balance of power terms, but mostly as a means to avoid further collapse and disintegration of weak states.[47] For

Table 6.1 U.S. global strategy

	Managing Partner vs. Dominance	
	Spheres of Influence Closest to classic "balance of power" Regional influence Influence in functional areas: economics, etc.	**Military Necessity** R. Cheney, "American Defense Strategy in the 1990s" (1993) G.W. Bush, "National Security Strategy of the U.S." (2002)
Variations in Approach	**Reluctant Enforcer** Failed states: Somalia, Haiti, Bosnia, Kosovo Limit proliferation: Pakistan, Russia Contain WMD: North Korea, Iran	**"Noble Cause"** Neoconservatives: democracy, transform regimes Democratic empire/hegemon Avoid descent into chaos

example, the decision to work closely with General Musharraf of Pakistan, who became president in a coup in 1999, was certainly not a preferred link but one that seemed necessary to prosecute the war in Afghanistan and get support for hunting down al Qaeda and the remnants of the Taliban. Moreover, when it became clear that Pakistan had been a major seller of nuclear technology to North Korea, one of the Axis of Evil states, the United States chose to play down the issue.[48]

Realists are, in general, comfortable with spheres of interest and would have no objection to focusing on U.S. influence in the Americas and the Pacific Basin if the Europeans would lead in Africa, and the Japanese and Chinese could agree on shared responsibilities in East Asia. Realists also would be pleased if certain states, such as Germany, which do not want an "out of area" military role, took on a larger role in economic policy. This issue of pragmatic choices versus striving for universal values has been a key difference among Republicans.[49]

Secretary Rumsfeld and Vice President Cheney saw U.S. dominance as a matter of military necessity. This grew out of Cheney's conviction, starting in 1993, that the United States needed to be preeminent. The vice president's convictions were strengthened after 9/11. After 2001, the vice president and Secretary Rumsfeld wanted to focus on crushing al Qaeda, not on transforming failed societies. The neoconservatives wanted a more idealistic approach that would provide an encompassing rationale for U.S. intervention abroad. This trade-off, between military and broader social goals, had surfaced during the 2000 campaign when the neoconservatives criticized George W. Bush for not supporting the Clinton intervention in Haiti.[50]

These differences were put aside, however, in 2002, when both the "military necessity" and the "noble cause" advocates agreed on the desirability of overthrowing Saddam Hussein. The Iraq War goals, thus, became a solidifier within the conservative wing of the Republican Party and within the Bush administration. Some wanted to transform the Middle East, making it into a democratic region, while others wanted to terminate Iraq's military capability; but both groups could agree that Saddam Hussein had to be removed.[51]

It was only later, as the scope of the Bush administration ambitions became more widely understood, that the issue of American Empire arose. Critics noted there were no obvious limits to U.S. overseas commitments under the 2002 National Security strategy and that, in addition to being very costly, there would be an inevitable backlash from countries that did not want an American overlord.[52] Supporters of the American Empire concept were fewer in number but no less enthusiastic. Some fit into the "noble cause" category, and had been longtime supporters, arguing that this is America's destiny.[53] A smaller group claims that the American Empire is a pragmatic solution and is the only feasible alternative because no other state or international organization can satisfactorily fill the role and provide world order.[54]

The Iraq War and its aftermath have moved this debate from the abstract level to the practical. Although the Iraqi military could not resist the full might of the U.S. military and its British allies during the active phase of the war (March–April 2003), the ongoing insurgency after the collapse of the Hussein government has been ferocious.

This has created a number of dilemmas that affect U.S. policy throughout the globe. First and foremost is the growing number of Americans who see a deep clash of values between the desire to create open, democratic societies and the force necessary to impose new institutions on a resisting country. Using force to occupy a country is intensely troubling even if the eventual benefits are high, but foolhardy if the result is chaos and disorder. The Iraqi national elections in January 2005 were an important step forward. Yet, at the time of this drafting, stability has not been restored to Iraq. So, it will only be after the violence stops that Americans and the rest of the world can decide if this war was worthwhile.

The initial reaction, outside the United States, has been strongly negative. Through extensive polling on a worldwide basis, the Pew Research Center documents a dramatic drop in support for U.S. policy. Between 2000 and 2003, favorable views of the United States have plummeted.[55] In South Korea, for example, support went from 58 percent to 46 percent. In two Muslim countries that receive American aid and where the governments cooperate with U.S. policy—Indonesia and Pakistan—the respective declines in support were from 75 percent to 15 percent and from 23 percent to 13 percent. Deep resentment of American policy has also been the norm in Europe and this had created a wide fissure within NATO.[56] Also, it appears that the American involvement in Iraq has fostered a nationalistic reaction in the Middle East and Asia, which could persist even if U.S. troops withdraw from Iraq.[57]

Moreover, there is now growing evidence that the Iraq War has diverted resources from pursuing al Qaeda and similar organizations.[58] The total number of international terrorist incidents rose after 2003, and many observers see the American intervention in Iraq stimulating terrorism, rather than suppressing it.[59] Moreover, as the Taliban recovered its strength in Afghanistan and as Iran widened its influence on its periphery, talk of an American-led remaking of the Middle East seemed hollow.

Hence, the complexity of these issues and the lack of a clear resolution to either the Iraq or Afghanistan wars make conclusions about them premature. Nevertheless, even the most committed supporter of the neoconservative agenda would have to admit that the intensity of the resistance to American intervention in Iraq was unanticipated. Also, so far, the Bush administration aspirations for postwar reconstruction have been unfulfilled. The Palestinian elections of December 2004, which brought Hamas to power, and the signs of growing Hezbollah strength in Lebanon do not bode well for a moderate Middle East. The neoconservative movement has lost support, and there is little doubt that the growing morass in Iraq has limited the Bush administration's ability to deal with Asian security questions like the Kashmir conflict, the China-Taiwan impasse, and North Koreas nuclear program.[60]

Bush Administration Policy in Asia

At the time of George W. Bush's inauguration in 2001, he had a seasoned, experienced team of advisors who became his first appointees. The group drew widespread commendation from mainstream analysts and, ironically in terms of developments after 9/11, criticism mostly from the neoconservatives.[61] As noted above, the basic directions of the Bush administration's Asia policy were agreed on among the principals: China was a strategic competitor, not a partner; the United States needed to rely more on Japan; the Korean Peninsula and Southeast Asia were problem areas; and the United States needed to develop a closer relationship with India.

Elements of this initial approach are still evident, but the changes are, in many ways, more notable than the similarities. China is still a potential long-run competitor, but Beijing's response to 9/11 and its repeated focus on a "peaceful rise" in influence have led to a more sanguine view of Beijing's near-term strategic capabilities in Washington.[62] Also, the United States has been too preoccupied with the Middle East to concentrate on China's growing stature.

The Korean Peninsula and ASEAN did prove to be problem areas. In March 2001, President Kim Dae Jung made a big effort to be the first Asian leader to visit President Bush, but the session did not go well and the differing perspectives on how to deal with North Korea became obvious. Many groups inside South Korea no longer saw North Korea as a military threat and democratically elected politicians have increasingly reflected their views.[63] This was anathema to many in the Bush administration who wanted South Korea to take a firm line toward the North and did not want to continue negotiations with Pyongyang on the same terms that the Clinton administration had maintained.[64]

ASEAN was still struggling with its economic recovery, and Indonesia, the largest country in Southeast Asia, was facing major ethnic, religious, and separatist tensions. With an open rebellion in Aceh, an independence movement in Papua, and repeated Muslim-Christian violence in Moluku, Indonesia could no longer lead ASEAN, and some even wondered if it would survive as a unified country.[65] Thus, there was uncertainty in Washington over how to deal with ASEAN if its largest state was no longer able to lead.

Readjustments after 9/11

Reflecting the changes in American strategic thinking after 9/11, there were major shifts in U.S. policy toward Asia. The most fundamental one was in dealing with China.[66] Although Chinese behavior had not changed significantly, U.S. concerns had. Washington could not run a global campaign against terrorism while trying to constrain China.

Thus, if the Chinese would agree not to contest a more aggressive American presence in Asia and would cooperate on antiterrorist actions, the United States would tone down its statements about China as a competitor. This was a double win for the Chinese as they realized that they could continue to suppress Tibetan resistance and Muslim dissidents in Xinjiang with less concern about "human rights criticisms" from Washington. At the same time, Beijing could actively seek high tech American investment and count on a more benign U.S. view of their emerging industrial strength. In the short run, the Chinese leadership would have to accept an American presence in Central Asia and expect less from the Security Cooperative Organization, but that was a small price to pay for avoiding the label "strategic competitor."

The shifts in U.S. policy toward Japan were more subtle but no less significant. The Bush administration had consistently favored free trade, but realized that if it did not do something about the massive trade deficit with Japan and the emerging one with China, it would come under domestic criticism. Since both China and Japan artificially maintained low exchange rates to keep their products competitive in the United States, a reasonable case could be made to have both countries revalue their currencies upward.[67]

Japan took major steps to support the United States in both Afghanistan and Iraq. In Afghanistan, the Japanese became major aid donors and organized an international pledging conference in February 2003. In Iraq, Prime Minister Koizumi went ahead with deploying troops despite major domestic opposition. Koizumi made sure that the troops would not be sent to combat zones and would only participate in reconstruction.[68] To show its gratitude, the Bush administration chose *not* to openly criticize Japan on economic policy, while it went to considerable lengths to urge China to raise the value of the yuan (by sending Treasury Secretaries Snow and, subsequently, Paulson to Beijing).[69]

Therefore, both China and Japan have received significant benefits by cooperating with the U.S. agenda after 9/11. In contrast, most European states, though quite supportive of the U.S. campaign in Afghanistan, have been either hostile or more questioning about the Iraq War.[70] After Secretary Rumsfeld's controversial comments about "the old versus new Europe," it is unlikely that the Bush administration can offer any new, general inducements for European cooperation in antiterror activities comparable to the subtle ones that it gave China and Japan.

Just as the United States shifted its attention in 2001 to counterterrorism, the process of economic integration in East Asia picked up momentum. In Chapters 2 and 3 we have discussed the growing trade linkages within Asia, but it is also important to see the significance of increased intraregional investment. Figures 6.1 and 6.2 show the dramatic increase in investment flows in and out of the principal Asian economies. (For investment data on the Southeast Asian economies, see Figures 2.11 and 2.12 in Chapter 2.) Part of the capital inflows to China come from Europe and the United States, but the biggest investor in China is Taiwan, and Japan could soon become the second largest supplier of new capital.[71] In 2002 alone, it is estimated that Taiwan invested $26 billion in the Chinese mainland.[72]

These investment flows within Asia not only facilitate trade among the countries but also create supporting interest groups within the sending and receiving states as

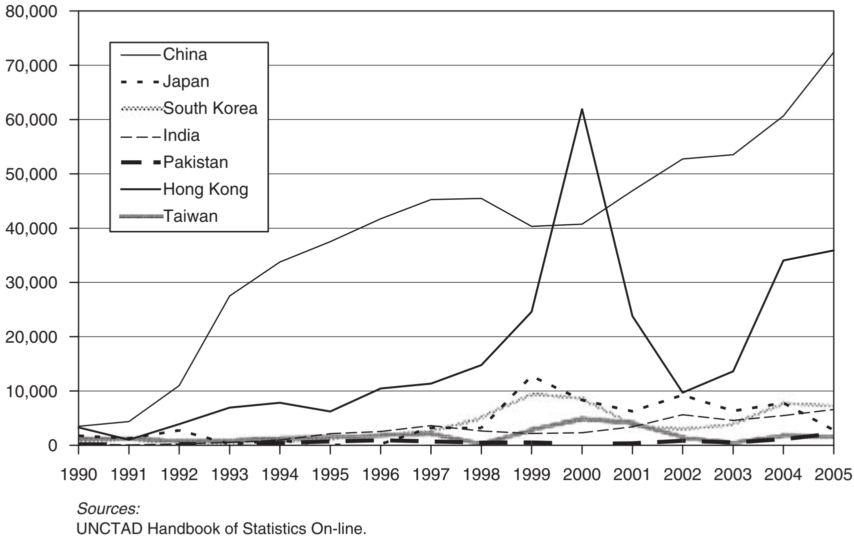
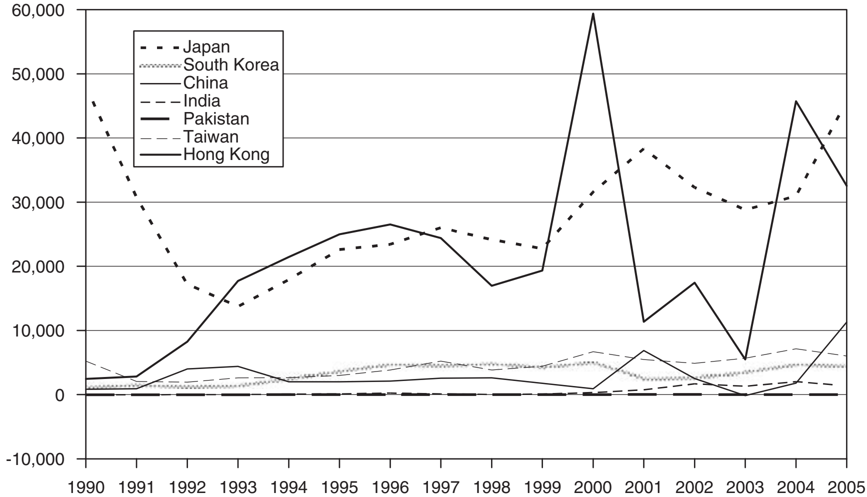


Figure 6.1 Inflows of FDI.



Sources:
UNCTAD Handbook of Statistics On-line.

Figure 6.2 Outflows of FDI.

well. Thus, as the largest recipient of FDI in Asia, China is not only getting massive amounts of capital (and state-of-the-art industrial equipment) but is building up an important set of ties, within the region, of businessmen and governments that want the interlinkages to continue.

Although Japan continues to be the region's largest supplier of FDI, its less accommodating stance toward foreign investors means that it gets only a fraction of the FDI inflow that China does.[73] It is notable that, during most of the 1990s, Taiwan, with one-fifth of Japan's population, got more FDI than Japan did.

After 9/11, in addition to the closer working relationships with China and Japan, the United States sought a new understanding with Russia and began actively courting both India and Pakistan. Like the leadership in Beijing, President Putin was delighted with the American focus on counterterrorism. The Bush administration gave up asking pesky questions about the treatment of the Chechens, and Putin realized that the United States could no longer press too hard on limiting the Russian role in Iran.[74] The quid pro quo was that Russia could not openly complain about the growing American role in Central Asia. However, most Russians assumed that the United States would not stay in Central Asia indefinitely, and as long as Moscow could maintain its relationships there, the Americans were seen as a temporary nuisance in Russia's backyard.

The renewed American interest in South Asia was one of the most significant changes after 9/11. During the Cold War, the United States had generally sided with Pakistan and had a tense relationship with India, which had signed a Friendship Treaty with the Soviet Union in 1972.[75] Although there had been periodic efforts at courting India in the 1980s and 1990s, they were not systematic and not notably successful. Then, in 1998, when India went ahead with its first nuclear tests since 1974 and Pakistan followed with its own nuclear tests, the Clinton administration put sanctions on both countries that limited U.S. influence in the region.

Because the United States needed Pakistan for the war in Afghanistan and in trying to suppress al Qaeda, a good link with Islamabad and President Musharraf was essential. However, because India had long had to deal with Islamic militants in Kashmir and then had a terrorist attack on its Parliament in December 2001, New Delhi was ready for closer U.S. ties as well. Although the situation temporarily looked grave as India and Pakistan both escalated troop deployments in Kashmir in 2002, both sides, ultimately, decided to stand down and end the impasse.[76]

These developments put the United States in the unusual situation of being on good terms with both India and Pakistan at the same time. Since Russia is no longer capable of being India's protector, leaders in New Delhi see considerable advantage in closer ties with the United States as they have long seen China as their most important regional competitor. Since China has been a longtime supporter of Pakistan, the Indians are willing to accept a greater U.S. role there as it relatively reduces Beijing's influence on India's border. Much of this calculus is dependent upon a stable, pro-Western government in Pakistan and that is by no means certain, given the Islamic militancy and frequent assassination attempts on President Musharraf. Yet, in 2004, the United States has pulled off a delicate balancing act and had close working relationships with both India and Pakistan.

In contrast, U.S. relations in Southeast Asia are decidedly mixed since 9/11. Though U.S. cooperation on counter-terrorism has grown with Thailand, the Philippines, and Singapore, relations with Indonesia, the Indo-Chinese states, and Myanmar have been strained.[77] Even Singapore, Washington's most vociferous ASEAN defender, has been willing to state openly that America's policy of siding with the Sharon government in Israel hurts the ability of the United States to get regional support. Moreover, seeing the U.S. deputy secretary of defense come to the southern Philippines to focus on a small group of insurgents and their links to Islamic radicals made many in Southeast Asia think U.S. priorities were wrong.[78]

In addition, when the U.S. commander in chief of Pacific forces stated in congressional testimony, in March 2004, that the United States was establishing a Regional Maritime Security Initiative (RMSI) to protect shipping in the Malacca strait, the plan drew immediate protests from Indonesia and Malaysia. Not only was this poorly handled diplomatically, but it also provided yet another example of the Bush administration acting unilaterally without adequate consultation with ASEAN.

There are similar resentments of American policy in South Korea, based on the fear that the United States is considering its own interests above the risks posed to Koreans. Several years after the start of the George W. Bush administration, a majority of South Koreans saw U.S. policy as "unfavorable." In Table 6.2, we see what a significant difference age makes in the South Korean attitudes toward the presence of American forces.

Table 6.2 Korean attitudes toward the withdrawal of U.S. forces

Age	**In favor**	**Opposed**	**Don't know**
20–29	47	42	10
50+	13	68	19
All ages	32	55	13

Source: R. J. Ellings and A. L. Friedberg, with Michael Wills, eds., *Strategic Asia, 2003–2004:Fragility and Crisis* (Seattle, WA: National Bureau of Asian Research, 2004).

In 2003, 47 percent of Koreans in their twenties favored the removal of the U.S. military, whereas 68 percent of those in their fifties favored keeping them. When all ages are combined, only a bare majority (55%) supported the continuation of the U.S. presence.

So, although U.S. relations with China, Japan, and India improved after 9/11, there has been deep resentment about U.S. directions in Korea and Southeast Asia. Although most of the Northeast and Southeast Asian governments have largely supported the United States, there is a growing gap between public sentiment in the region and official policy. This is especially notable in South Korea and Japan where both governments have supported U.S. policy on Iraq, but a majority of the public opposes it. This gap cannot continue too long in democratic societies or opposition figures will capitalize on it.[79] The problem is most acute in the Muslim areas of Southeast Asia (southern Philippines, Malaysia, Indonesia, and southern Thailand).

Setting Priorities in Asia

Before turning to the current priorities, it is useful to summarize, briefly, why U.S. security commitments to Japan, South Korea, and Taiwan have lasted for five decades. Since the Communist Party took power in China in 1949, the U.S. strategic conceptions in Asia have been based on forward deployment and keeping hostile powers from gaining control of vital locations.

There was a brief period, between January and December of 1950, when official U.S. policy *did not* consider Taiwan and South Korea inside the vital U.S. defense perimeter.[80] However, since then, the U.S. government has consistently maintained that pro-Western and pro-U.S. governments were essential in Taiwan, South Korea, and Japan. The United States also extended formal security guarantees to Thailand and the Philippines.[81]

This strategy of forward deployment and focusing on territorial control was feasible for the past five decades. Yet, as discussed above, it is now increasingly resented in South Korea, and the difficulties of continuing to defend Taiwan, without recognizing Taipei diplomatically, are putting a strain on this conception of security.

Even if American global strategy changed after 2005, the United States will still be the dominant world power. Hence, it is worthwhile to attempt to identify the key issues facing U.S. policy in Asia. For our discussion, we rank them in three categories: (1) immediate issues, (2) crises in the making, and (3) long-term strategic concerns—though there is necessarily some overlap in topics between them.

Immediate Issues

There is broad agreement that *North Korea's efforts at developing nuclear weapons* pose the most pressing security problem in Asia. However, beyond that there is no consensus. There are sharp disagreements on the facts of the situation and important differences in approach among the five nations (China, United States, Russia, Japan, and South Korea) currently negotiating with North Korea in the six-party talks. Thus, the impasse in negotiations was not surprising.[82]

The situation is extremely dangerous for two reasons: (1) any miscalculation could lead to massive bloodshed even if North Korea does not use its nuclear weapons, and

(2) other than its threat to use force, North Korea has few other bargaining chips to use.[83] So, if it gave up its bargaining leverage, Pyongyang perceives that it would be vulnerable. Hence, even if the February 2007 agreement holds, it seems highly likely that North Korea will continue to maneuver, for the foreseeable future, on the edge of war as its principal means of survival.

Few doubt that the North Koreans would fight if attacked, so the dilemma becomes: Are the security guarantees that Pyongyang accepted sufficient to end its game of nuclear blackmail?

As discussed in Chapter 5, most analysts assume that North Korea sees diplomacy as a useful tactic, but there is no evidence that the DPRK will agree to permanently give up the nuclear weapons it already has, or allow the type of ongoing, external inspections necessary to satisfy the international community. So, the neuralgia over the Korean Peninsula could continue even if the 2007 agreement is formally in place.

The *long-standing tension between China and Taiwan* is probably the second most troubling security issue in Asia. For over three decades, since the Shanghai Communiqué in 1972, the official American position has been that there is "one China" and that Taiwan is a part of it, but that force should not be used to achieve a reunification between Taiwan and the mainland. The essence of the problem is that Taiwan has had de facto independence since 1945, and all but about 10 percent of Taiwan's population favor keeping the status quo. Beijing finds this unacceptable because Taiwan is, in name if not in fact, an ally of the United States.[84] Moreover, as Taiwan became democratic in the mid to late 1980s, nationalistic sentiment, represented by the Democratic Peoples Party (DPP), became predominant. The DPP now controls both Taiwan's presidency.[85]

The political leadership in Beijing remains concerned that Taiwan's president, Chen Shui-bian, who formerly openly favored independence, will take every opportunity to widen the gap between Taiwan and the mainland. Thus, the PRC has taken various steps to intimidate Taiwan: building up hundreds of short-range missiles in the Chinese provinces opposite Taiwan, limiting Taipei's participation in international organizations, and asking assorted major powers to make public statements supporting Beijing. This does not appear to be an immediate crisis but is critical, nonetheless, because the United States is Taipei's principal defender. If China were to use force against Taiwan, it would almost certainly mean a conflict between the United States and China.

These circumstances mean that any relevant statement by Taiwan's government or the United States is interpreted in Beijing as having a direct bearing on the U.S.-China relationship. Though there is now a growing range of opinions within China on a host of issues, few Chinese would be so bold as to challenge the government's position on Taiwan. This means that virtually all foreign policy discussions, official or private, with Americans have a ritualistic element where the dangers of Taiwanese independence are raised.[86] This means that American policy makers are forced to view every move with Taiwan in a strategic context that might trigger a hostile reaction from Beijing.

If Beijing were to give Taipei a bit more room for its international activities and would engage in serious talks regarding force reductions along the Taiwan Strait, this powder keg would be less volatile.[87] In congressional testimony in April 2004, Assistant Secretary of State James Kelly implicitly warned Taiwan to take China's threats seriously and this seems to have affected President Chen's tone in his second inaugural address on May 20, 2004, and afterward. There have been dozens of proposals about how to resolve the China-Taiwan standoff; but, given the fact that most Taiwanese do not want to give up their autonomy, it is unclear how Beijing could achieve peaceful reunification with Taiwan without offering the continuation of de facto independence. Since Beijing has been so heavy-handed in its rejection of free elections in Hong Kong, it is not credible for the PRC to offer "one country, two systems" to Taiwan.[88] Thus, it seems this conundrum will continue, with one advantage over the Korean Peninsula: the protagonists are separated by 100 miles of water, which reduces the chances of an accidental escalation to war.

Although the pro-autonomy party in Taiwan, the DPP, got a setback in the December 2004 parliamentary elections (by failing to get a majority), Beijing has continued to increase its pressure on Taipei. In March 2005, China's National People's Congress passed an "anti-secession law," which sets rigid conditions for Taiwan. Several features of the law stand out: (1) China states Taiwan must adhere to Beijing's formula for negotiation and agree, in advance, that Taiwan is a part of China; (2) China intends to prevent Taiwan from using "constitutional" or "legal means through referenda" as a way to pursue autonomy; and (3) China gives itself the right to attack Taiwan if "incidents entailing secession" seem likely or even "possibilities for peaceful reunification are diminished."[89] In essence, China's leaders are publicly binding themselves to a hostile and aggressive stance. The Chinese National People's Congress is subservient to the Communist Party's wishes, so the legislation can, presumably, be changed or ignored as the Politburo determines, but the extensive publicity given to the "anti-secession law" will certainly complicate future negotiations between Taipei and Beijing.

In 2006, tension between China and Taiwan has continued to ease for two principal reasons: (1) Beijing wants the 2008 Olympics to proceed smoothly and a confrontation with Taiwan would be inconvenient, and (2) Taiwan's president, Chen Shui-bian, was caught in a corruption scandal, which has led to calls for his resignation.[90] With Chen's DPP on the defensive, authorities in China hope that the Kuomintang will win the 2007 Taiwan presidential elections and adopt a less autonomous policy toward the mainland.

The *Kashmir dispute* is the third imbroglio in Asia that could escalate at any time and have broader strategic implications. It is only slightly less volatile than the Korean Peninsula and the China-Taiwan situations because India and Pakistan have been through a series of wars and localized conflicts (1947, 1965, 1972, 1999, and 2002) and know that a complete victory in Kashmir, for either side, would probably trigger an all-out war.[91] Also, since 1998, when both Islamabad and New Delhi demonstrated functioning nuclear weapons, there has been an obvious hesitancy to press too hard and risk a devastating retaliation.[92]

The basic dispute is over territory: Kashmir has a majority Muslim population but was ruled by a country that is overwhelmingly Hindu. After partition in 1947, India kept control but many in Pakistan felt the province should have been part of its domain. The one factor that makes it different from the East Asian cases is the central role that religious animosity plays in the dispute.[93] Yet, despite the intensity of beliefs, it is important to note that the government expectations surrounding the Kargil incident of 1999 and troop escalations in 2002 were more cautious than in prior conflicts. This may explain the willingness of both sides to begin orderly withdrawals in 2002.

The United States played a key role in both incidents. In 1999, President Clinton made clear to Islamabad that Washington would not support any fundamental change in the border, the Line of Control, separating the Indian and Pakistani troops in Kashmir. Similarly, in 2002, when it was India that escalated first after the December 2001 terrorist attack on the Indian Parliament, the United States took a neutral stance and urged both states to back down. High-level visits from both the State and Defense departments showed the level of U.S. concern.

Per our discussion above, after 9/11 the United States was anxious to keep on good terms with both India and Pakistan, so the Kashmir dispute was a dangerous annoyance to Washington. Fortunately, Indian Prime Minister Vajpayee was willing to make an overture to Pakistan, which led to his visit to Islamabad in January 2004.[94] The Vajpayee-Musharraf meeting created a major improvement in relations and was followed up since with talks by specialists who were able to agree on putting confidence-building measures in place. As a result, Pakistan pledged not to allow terrorists to operate from its soil, committed to mutual increases in diplomatic representation, and expanded trade and tourist travel. After governments changed in India in 2004, the new prime minister, Manmohan Singh, from the Congress Party, continued the nonconfrontational approach by offering aid to all groups in Kashmir that eschewed violence.

In sum, in early 2007, two of the three leading trouble spots in Asia were calm. The principal immediate flash point is North Korea. In our discussion of the strategic concerns raised, we will link these specific disputes to potential realignments covered in Chapter 5.

Crises in the Making

Discussing future, potential crises is inherently a speculative enterprise, so we will be brief, but it is worth seeing the connection between these nascent problems and the broader adjustments taking place in Asia.

Militant Islam has to be seen as one of the most difficult problems ahead. At present, most Muslims in Asia are law abiding and anxious to participate in its economic growth and modernization. However, there is a small percentage who reject modernization and who are willing to organize to fight mainstream governments and economic activities.[95] The funding for these radical groups is sufficient, so that they can maintain themselves, on a clandestine basis, for long periods or use charitable organizations as fronts.[96] It is, thus, extremely difficult for governments to trace their activities. Even if economic growth rates in Southeast Asia pick up and even if governments adopt more skillful policies toward militant Islamic groups, it seems highly probable that the Philippines, Malaysia, Indonesia, and Thailand will all face this problem for years to come.

Myanmar (*Burma*) is a different type of problem: a brutish, repressive government that has clung to power even after losing a nationwide election in 1990. The United

States has tried to pressure the government into a better human rights policy by using economic sanctions and diplomatic isolation.[97] However, the ASEAN states chose to admit Myanmar in 1997 and have, instead, decided to "engage" Myanmar's population rather than spurn them. More importantly, though, the Chinese have decided that Myanmar's southern islands are ideal listening posts for intelligence operations and tracking ships as they approach the Malacca Strait. Therefore, Myanmar can count on its ASEAN neighbors and China to undercut sanction efforts. This standoff could continue for a long time, but it creates difficulties between the United States and ASEAN and allows the Chinese to expand their influence southward.

The issue of the *Spratly Islands and the South China Sea* involves overlapping claims on islands and economic zones around them. Because the Chinese have been willing to use force, in 1974 in the Paracel Islands and in 1988 on Fiery Reef, to establish their claims, the ASEAN states have been divided on how to respond. The ASEAN states could not agree on a unified response, so they settled for a non-binging resolution in 2002 on how they would avoid conflict over the islands. This *Declaration on the Conduct of Parties in the South China Sea* called for mutually respecting one another's claims and for restraint on trying to establish new claims.[98] However, China, Taiwan, Vietnam, and the Philippines have all taken various actions to undermine the declaration, and there is no enforcement mechanism. While this is not an immediate crisis, if the ASEAN states do not stick together as a group, the United States may have to give up its current stance of taking "no position" on the territorial claims because otherwise China may end up with a vastly increased domain in the South China Sea. As long as the U.S. 7th Fleet is dominant in the area, this is only a hypothetical problem. Yet, if China develops a capable navy, American political leaders will have to decide if this is an issue they want to take on or if they, as in Myanmar, will accede to a further expansion of Chinese power.

Long-Term Strategic Concerns

In the section "Immediate Issues," we evaluated the Asian policy problems that are the most volatile and where the United States is intricately involved and has some tangible ability to shape the outcome. In the section "Crises in the Making," we speculated about nascent problems that appear to be getting less tractable and that, because they affect sufficiently large parts of Asia, warrant attention. However, militant Islam, Myanmar, and the South China Sea are not issues that the United States can control itself. The United States can be a participant, but Asian states have a more direct stake in and influence on the outcome.

In this section, we will turn to "long-term strategic dilemmas" that grow out of the potential realignments discussed in Chapter 5. To make this discussion manageable, we will focus on the four most critical realignments which could affect the strategic balance in Asia: (1) shifts within Northeast Asia, (2) interaction between China and Japan, (3) cooperation or conflict between India and China, and (4) allegiances within Central Asia. Although the United States will have some impact on these long-term dilemmas through inducements (trade, aid, and technology) or penalties (sanctions or force), this discussion will concentrate on the underlying structural changes over which American policy can have only a limited impact.

Northeast Asia is the current fulcrum of the region because of its wealth, manufacturing capacity, military power and population. Here, the two principal, independent actors are China and Japan. Figures 6.3, 6.4, and 6.5 show the stark realities. Modern societies need substantial populations and the ability to manufacture or acquire high performance weapons to project their power. Although China's

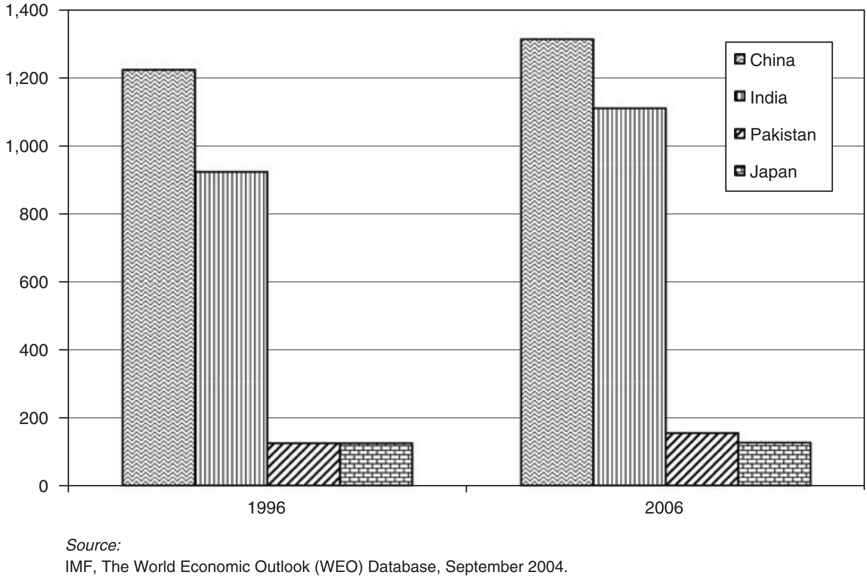


Figure 6.3 Population.

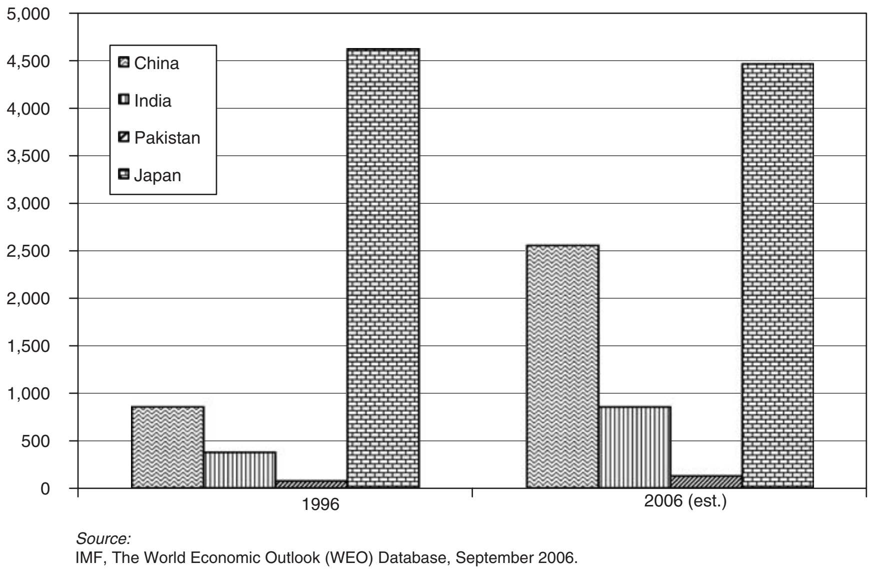
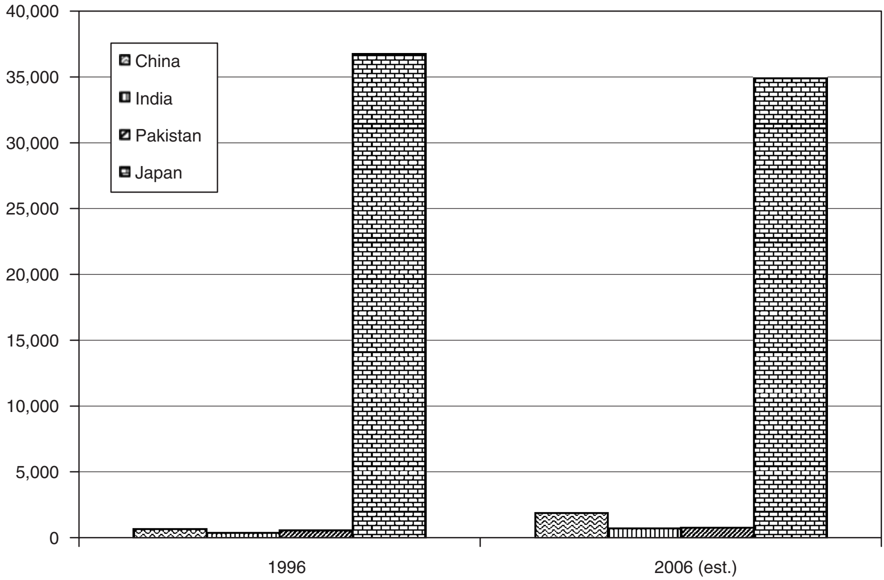


Figure 6.4 Total GDP.



Source:
IMF, The World Economic Outlook (WEO) Database, September 2006.

Figure 6.5 Per capita GDP.

per capita income is much lower than Japan's, its total GDP is quite adequate to field and sustain a modern military.[99] Figure 6.5 specifically illustrates that, if the Japanese feel threatened, they are quite capable of buying a first-rate military.

If China and Japan enter into a major rivalry, the United States is likely to side with Japan. However, if these two states choose to cooperate, then the United States will lose its forward position in Asia and will, presumably, have to reduce its presence because trying to keep up an alliance with South Korea alone would be extremely difficult.

The swing state would be Russia. If Japan proves willing to balance China, then leaders in Moscow would have to decide whether to lean toward Washington and Tokyo or toward Beijing. The United States could offer various inducements to slow these changes, but if China can sustain its growth for another two decades, it will not need to constrain its foreign policy to continue to attract capital and technology (as it does now).

Even if China and Japan do not trigger strategic realignments soon, there is some likelihood that South Korea will. The growing dissatisfaction with the American presence and the fear that the United States will draw South Korea into a conflict with the North makes current arrangements tense. The United States has already announced to the South Koreans that it will move its troops away from the Demilitarized Zone to spots farther south in the country and that the total number of soldiers will be cut by about a third.[100]

If South Korean sentiment does not change and the American reductions in forces continue, the United States might, ultimately, withdraw its troops entirely. The mutual security treaty might continue, as it has with the Philippines and Thailand, but the character of the relationship would change fundamentally.[101] As noted in Chapter 5, the two questions then become: Would South Korea proceed with reunification?

And, would a reunified Korea be neutral or even pro-China? All of this is speculative, but it is obvious that planners in both Seoul and Washington are anticipating changes of this magnitude, and if they occur, they would have a major impact on Northeast Asia. If a unified Korea became pro-Chinese, the strategic landscape in Asia would be dramatically different.

The India-China relationship is the next big unknown. Since 2003 there has been a growing courtship between Beijing and New Delhi. High-level political visits have occurred and, in November 2003, there were joint naval exercises.[102] This is a far cry from the border war of 1962. Three different interpretations of how Indian-Chinese relations may develop are worth considering: (1) interests converge, (2) strategic competition develops, or (3) the relationship remains complex, with a mixture of both rivalry and cooperation.[103]

Beijing and New Delhi have put in countless hours attempting to resolve their differences over their borders; and it appears that the visit of Chinese Premier Wen Jia-bao to New Delhi in 2005 succeeded at getting a preliminary resolution.[104] More broadly, however, truly close Indo-Chinese cooperation would be hard to maintain because both states want influence in the same buffer areas (Pakistan, the Himalayan states, Bangladesh, and Myanmar).[105] Both China and India are in intense competition to locate future supplies of energy. This puts New Delhi and Beijing in a competitive position, for example, in Central Asia and Iran.

Obviously, we cannot know today which path the two Asian giants will take but convergence seems very unlikely. Both states are continental powers, both have great power aspirations, and there are enough cultural differences to make cooperation complicated. Also, unless China's economic growth rate slows significantly or India's accelerates even above current levels, India would be in an ongoing "junior partner" position, which would have limited appeal to most Indians. It would be more plausible to assume that India would prefer to: strengthen its ties with the United States, reinvigorate its relationship with Russia, and court Southeast Asia (which may want a balancer against China). Given the scale and importance of these two states, the India-China relationship will be the second pivot for Asia's future alignments.

In assessing the import of the Northeast Asian and Indian-Chinese developments we have been discussing, it is useful to try to identify how likely it is that Japan, China, and India will each rise to great-power status. Table 6.3 sets out this comparison in summary form.

All three of these states have an economic and technical base sufficient to become great powers.[106] Though Japan does not now have nuclear weapons, it could develop them quickly given all of its engineers and nuclear reactors. All three states have space-launch missile programs, and all have sufficiently stable political systems that they could sustain a move to great power status if desired. The key difference is on aspirations: there is little doubt that the Chinese and Indian elite want global influence and that they have made the initial military investments necessary to eventually have a power projection capability, while much of the Japanese public is either negative or deeply ambivalent about it.[107] The current Japanese hesitancy to exert its power is a clear outgrowth of its experience in World War II, but this does not mean that the Japanese would refuse to react if directly challenged.

Table 6.3 Ability to sustain rise to great-power status

	Japan	**China**	**India**
Desire among Political Leaders	Mixed	Yes	Yes
Stable Political System	Yes	Uncertain	Yes
Size of Economy	Yes	Yes	If high growth continues
Technical Capability	Yes	Depends on foreign purchases	Yes
Nuclear Weapons	Could quickly develop	Yes	Yes
Missile Technology	Yes	Yes	Yes
Power Projection	Has ability, but self-restrained	Yes via land; no By air or sea	Sustained air and sea effort
Key Limitations	Historical Legacy: pacifist public	None	Pakistan

In fact, since 1998 when the North Koreans fired their Taepo-dong 2 missile across Japanese airspace into the Pacific, Japanese public opinion has become more attentive to national security issues. This has facilitated some critical changes in defense policy: (1) pacifism is still important in Japan but it no longer dominates Japanese public views,[108] (2) Prime Minister Koizumi got public support for developing a comprehensive ballistic missile defense system,[109] and (3) the director general of the Japan Defense Agency (JDA) has testified in front of the Diet (parliament) on the circumstances under which it would be permissible for Japan to launch either a preemptive or second-strike missile attack on a hostile state.[110] These changes, in combination with the decision at the February 19, 2005, the "2 + 2 Meeting" (where the U.S. secretaries of state and defense meet their Japanese counterparts) to include the Taiwan Strait issues as a part of U.S.-Japan security concerns, represent a major turn from past positions.[111] Also, as previously discussed, Prime Minister Abe has allowed members of his inner circle to state publicly that they think Japan should consider rewriting its constitution and developing nuclear weapons if North Korea proceeds with an expanded nuclear weapons program.

As we turn to the strategic options at the end of this chapter, Japan, China, and India will be the key to Asia's future alignments.

One remaining element of the Asian strategic landscape that warrants attention is the changes in Central Asia after 9/11.[112] Although Central Asia might be defined to include the Caucuses, Xinjiang, and Tibet, for our purposes here we will concentrate on the former Soviet republics of Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan. Although there is a tendency of some observers to lump them together, their ethnic and political orientations are quite distinct and make caution advisable when generalizing about the group. Nevertheless, all five of the states have gotten more international attention in the past fours years than in the previous fifty.[113]

American interest in Central Asia in the 1990s shifted from concerns about demobilizing nuclear weapons to major finds of oil near the Caspian Sea.[114] U.S. efforts to build pipelines out of Central Asia that avoid Russia have angered President Putin. Yet, like most of the recent American activities in Central Asia, Russians have found little leverage to stop them and, on balance, have probably concluded that the United States is reducing Chinese influence more than their own.

Because it needed secure supply lines for the war in Afghanistan, the United States approached Kyrgyzstan, Tajikistan, and Uzbekistan about using bases on their soil and Turkmenistan about overflight rights. All were granted. If we look at the aid figures in Appendix 6.1, we note that security assistance and direct U.S. Department of Defense payments for basing facilities after 9/11 far outweighed the other programs.

In 2006, the preponderance of the U.S. effort in Central Asia is still concentrated on access to oil and gas and counterterrorism activities. Few Americans know about these activities, and it will be difficult to maintain strong U.S. ties with the region unless the American public and Congress see this as a necessary long-term commitment. So, the United States has temporarily displaced Russia and China as the principal foreign powers in Central Asia. If the United States remains committed to its role in Afghanistan and a close relationship with Pakistan, the American presence in Central Asia will be essential (to prevent infiltration of insurgents from the north). However, the 2005 declaration by the Shanghai Cooperation Organization (SCO) that the United States should withdraw from the region is certainly a sign of difficulties ahead for the American presence in Central Asia.

Plausible Directions for Asian Players

We now turn to a synthesis of the trends identified earlier in this book and will draw on a combination of the economic and strategic analysis already covered. Although there are a wide variety of strategic combinations that could potentially develop in Asia, for our discussion here it seems useful to concentrate on the four main directions that seem most plausible: (1) continued American dominance, (2) U.S.-Japanese-Indian leadership, (3) Chinese preeminence, and (4) an Asian concert of powers.

Table 6.4 sets out these strategic options and attempts to summarize the likely reaction of the principal Asian states to the different directions. We will not cover every state's potential response, but, instead, focus on the key issues that each option raises.

U.S. dominance is certainly the most likely near-term option and the one favored by the George W. Bush administration. However, it is by no means the most likely long-term development. Not only could the American public grow skeptical of the need to project power in all corners of Asia, but also it may prove too expensive.[115] If U.S. fiscal and trade deficits continue, the dollar may decline and the Americans may find themselves needing to increase savings rates and reduce spending.[116] Moreover, the nationalistic, anti-American sentiment in evidence in South Korea is likely to spread if the United States tries to maintain its dominance as a permanent strategy.

Many Japanese and Taiwanese may be willing to remain indefinitely under the U.S. security umbrella, but the Chinese clearly see this as a temporary necessity and the Muslim states in Southeast Asia are already chafing. Thus, it seems more plausible for some Asian powers themselves to take the lead as their power projection and diplomatic influence grows.

Table 6.4 Current strategic options

		U.S. Dominance	**U.S.-Japanese-Indian Leadership**	**Chinese Informal Preeminence**	**Asian Concert of Powers**
Northeast Asia	Russia	Subtly resist	Prefer to Chinese lead	Resist	Legitimize role in Asia
	North Korea	Implacably resist	Resist	Accept	Support, if included
	South Korea	Continued ambivalence	Threaten Defection	Preferable to Japanese influence	Public support, elite skepticism
	Japan	Easiest choice	Requires Exertion	Regret But Prefer To Arms Race	Prefer U.S. ties plus guarantee
	China	Subtle resistance	Open Resistance	Preferred Result	See as step to China's preeminence
Southeast Asia	Vietnam	Ambivalence	Increases future options	Accept if necessary	Prefer ties to U.S. or Russia to balance China
	Philippines	Ideal outcome	Second choice	Resist	Accept but continue treaty with U.S.
	Malaysia	Resist	Resist	Acquiesce	Mahathir redux, would support
	Cambodia/Laos/ Myanmar	Resist	Resist	Already established	Accept, follow China's lead
	Thailand	Ended after 1975	Risks antagonizing China	Already established	Accept but maintain links to U.S.
	Singapore	Preferred	Second choice	Accept if inevitable	See as means to elevate status
	Indonesia	Ambivalence	Might join if included as a principal	Resist	Would want a special role for ASEAN

A *U.S.-Japanese-Indian* coalition would have a number of advantages. As democracies, the three countries could agree on what values they were trying to preserve, and the principals in the coalition could count on stable governments among their allies.[117] Between them, there would also be the world's leading technical combine, which should have no trouble in staying ahead of any potential adversary in the newer forms of high-tech weaponry. This could be important if other states of the world began to grow faster and had the resources to buy themselves entry into the great-power status.

The former Singaporean prime minister Lee Kuan Yew said in 2002, "China cannot be balanced by the rest of Southeast Asia."[118] This quote highlights one of the key advantages of a U.S.-Japanese-Indian coalition: it would have sufficient economic, military, and technical strength to last for a period of several decades, presumably the time when China's economy and military might will expand at its most rapid pace.

Nevertheless, there would be a number of problems: the Japanese have still not made a real commitment to coalition formation and collective security, that is, having allies other than the United States. The Indians have no post-1947 experience with this sort of active alliance either.[119] Many in India are also hesitant to be drawn into a coalition that pits them against their most formidable neighbor. Most Indians would also resent being a junior partner in an alliance. The United States would probably have major adjustment problems as well, since it has loosened its ties with NATO after 2001 and would need to accept that consultative procedures are necessary.

The strongest opposition to a U.S.-Japanese-Indian coalition, however, would come from Beijing, which would see this, correctly, as a coalition to balance China's power. The Southeast Asian states would not need to join formally with this coalition but could cooperate informally with it if they chose. Yet, like the period of the Cold War, the mere formation of this coalition would give China a legitimate reason to form alliances with states that did not want to join the U.S.-Japanese-Indian leadership. Asia may not be ready for this coalition, but it is a prospect that is worth exploring.

Chinese informal preeminence is the likely result in Asia if the United States reduces its presence and Washington does not participate in some new alliance.[120] Some would argue that this has already occurred with Cambodia, Laos, and Myanmar being strongly influenced by China and with Thailand being ever sensitive to its northern neighbor. The failure of the ASEAN states to take a strong, cohesive position on the Spratly Islands question is also clear evidence of Southeast Asian states being unwilling to antagonize China. However, China seems to be pursuing skillful diplomacy and is biding its time, now not asking for formal commitments from its neighbors.

Also, as discussed in Chapter 5, China is actively courting the Europeans, hoping to use the inducements of its market to get the European Union to lift the arms embargo (which was imposed after the Tiananmen Square crisis in 1989). Although the Bush administration has openly urged the Europeans not to accede to China's request, there are major differences between European and American views on this subject.[121] Most Europeans are focused on the commercial benefits of lifting the embargo, while the United States is concentrating on the security implications. Western European leaders have said that they do not have plans to sell high-tech weapons. Yet, if China succeeds at getting the embargo lifted and Europe, ultimately, does become a supplier of high-performance weaponry, it could have a significant effect on the Asian military balance. That is why Japan has taken the step of explicitly asking the Europeans not to lift the arms embargo. This issue will be an important test of transatlantic relations. In addition, it will have important symbolic value: if the Chinese succeed, it will strengthen Beijing's hand both diplomatically and militarily with states in the region.

An *Asian concert of powers* would be another direction that events may take if neither the U.S.-Japanese-Indian coalition nor Chinese preeminence could gains wide acceptance.[122] The advantage of this approach is that it would, presumably, be open to all and Asians could take responsibility for their own defense.[123] The disadvantage is that few think it would provide effective security guarantees. How would it actually function? If a consensus were needed, it would face the same paralysis as ASEAN has experienced when dealing with difficult problems. If it were modeled after the UN Security Council and led by the major Asian powers, then China, Japan, and India would have to agree on spheres of influence or some other means of dividing responsibilities.

Since none of the alternatives to U.S. dominance is likely to win immediate acceptance, American leadership will continue in the short run. Nevertheless, American leadership does not need to be in the form that the George W. Bush administration has practiced to date.

Impact of the 2006 Congressional Elections

The dramatic repudiation of the Republican Party and its candidates by the American electorate on November 7, 2006, led to Democratic Party control of both the House of Representatives and the Senate. At the time that this manuscript has gone to press, it is too soon to know, with certainty, what the impact of the shift in power will entail. Nevertheless, there appear to be a number of important implications for U.S. policy in Asia.

The American public sent a clear signal that it would not support an ongoing, long-term war in Iraq. If a withdrawal from Iraq follows, that might, in fact, free up resources and workforce for use in potential military contingencies on the Korean Peninsula. Yet, in the last two years of the George W. Bush administration and, probably, in the first few years of the next administration, there is likely to be considerable caution about new military interventions abroad.

Because both the House and Senate are under Democratic control, the Bush administration will need to seek Democratic support for its appointees and will, doubtless, have to spend considerable effort defending itself during investigations of its actions in the 2001–2006 period. This "domestic" focus will also limit the likelihood of major new commitments abroad.

The sweeping nature of their electoral defeat will force the Republicans to regroup in many regards. The neoconservatives are in retreat and it is uncertain if any systematic alternative "worldview" will emerge as a guide for policy in the last two Bush years. Lacking a focus, U.S. foreign policy could be driven by assorted interest groups and narrow concerns. This, too, makes major policy initiatives low-probability events.

Allies of the United States are also likely to be cautious and even more sparing in their commitments to cooperate with American ventures. This means that opponents of the United States and countries whose interests diverge from those of Washington will have more room for maneuver in the last two years of the Bush administration.

Thus, overall, the change of power in the U.S. Congress in 2006 will make American foreign policy more restrained in its overseas actions. It is also likely to accelerate an already developing trend in Asia of moves to resolve issues within the region, without Washington's intervention.

Conclusion

At a time when the United States is so dominant in every aspect of foreign affairs, it is difficult to see new strategic realignments in the making. Yet, by starting with the Asian financial crisis of 1997 and examining how that turbulence led to significant changes within Asia, we can now see that adjustments of global importance are underway.

The surge of economic activity and modernization that spread through the Pacific Rim countries in the three decades after 1970 was halted in 1997. Although the Pacific Rim countries are now growing again, there are basic structural reasons to expect them to grow at a slower pace than before the crisis. Because India and China now appear able to sustain rapid growth for at least another decade or more, the attention of bankers, exporters, and foreign investors has turned to them.

This book has been able to document and explain these basic shifts in Asian economic activity and then suggested that there are important strategic implications occurring as India and China, the continental powers, eclipse the smaller Pacific Rim states. Because of 9/11 and the current preeminence of the United States, insufficient attention has been devoted to understanding how the states in Asia are preparing for new alignments.

This book is not predicting that China and India will develop a hostile relationship. Nor is it predicting that the United States and China will necessarily become adversaries. Yet, we are assuming that both China and India will have the economic capacity to become major powers and that the governing elite in both capitals will have major power aspirations. Since the recent changes in trade and investment patterns *within Asia* (discussed in Chapters 1, 2, and 3) have already begun to shift political and diplomatic ties toward Beijing, it is not unreasonable to expect even more fundamental changes in alignments as the power of China and India grows and becomes more evident.

Appendix 6.1 U.S. Assistance to Central Asia

	U.S. Assistance (FY 2002 budgets, $m and %)						
	Total	**Kazak.**	**Kyrgyz.**	**Tajik.**	**Turk.**	**Uzbek.**	**Region**
Democratization	92.4	13.7	22.7	17.4	5.6	30.6	2.5
	(16%)	(16%)	(24%)	(11%)	(29%)	(14%)	(15%)
Market Reform	55.3	15.0	18.0	9.4	0.9	11.0	1.0
	(9%)	(17%)	(19%)	(6%)	(5%)	(5%)	(6%)
Security and Law	187.2	40.4	37.5	21.6	7.8	79.9	–
	(32%)	(47%)	(40%)	(14%)	(41%)	(37%)	–
Humanitarian Aid	142.4	0.7	4.8	87.2	0.6	48.6	0.6
	(24%)	(1%)	(5%)	(57%)	(3%)	(22%)	(4%)
Cross-sectoral	108.2	16.9	10.7	18.0	4.1	46.5	12.1
	(18%)	(19%)	(15%)	(12%)	(22%)	(21%)	(75%)
Total (FSA/Other)	585.6	86.7	93.5	153.5	19.0	216.7	16.2
DoD Assistance	137.9	7.2	21.2	29.1	2.2	78.2	–
Total Assistance	723.5	93.9	114.7	182.7	21.1	294.9	16.2

Source: K. Collins and W. Wohlforth, "Defying Great Game Expectations," in *Strategic Asia, 2003–2004: Fragility and Crisis,* ed. R. J. Ellings and A. L. Friedberg, with Michael Wills (Seattle, WA: National Bureau of Asian Research, 2004, pp. 291–317.

Notes

Chapter 1

1. *The Economist,* "Chinese Companies Abroad: The Dragon Tucks In," July 2, 2005, pp. 53–56.
2. Wayne, L., and D. Barboza, "Unocal Deal: A Lot More Than Money Is at Issue," *New York Times,* June 24, 2005, p. C4.
3. The SCO has six members: China, Russia, Kazakhstan, Kyrgyzstan, Turkmenistan, and Uzbekistan. Neither China nor the SCO openly complained in the fall of 2001, when the United States began using bases in Kyrgyzstan and Uzbekistan to support its operations in Afghanistan.
4. The understatement of the Chinese GDP will be discussed later in this chapter and in Chapter 3.
5. Kranhold, K., H. Sender, and E. Bellman, "GE Plans to Sell Call-Center Unit Based in India," *Wall Street Journal,* September 17, 2004, p. C1.
6. International Institute for Strategic Studies, *The Military Balance, 2004–2005* (London: IISS, 2004), pp. 151–154.
7. Vietnam, Cambodia, Laos, and Burma (Myanmar) have not reached the "newly-industrialized country" stage that their Pacific Rim neighbors went through in the 1970s and 1980s. Thus, they are marginal players in terms of GDP but are important for strategic reasons, to be discussed in Chapter 6.
8. Hofheinz, R., and K. Calder, *The East Asian Edge* (New York: Basic Books, 1982); Haggard, S., *Pathways From the Periphery* (Ithaca, NY: Cornell University Press, 1990).
9. There has long been Islamic separatism in the southern Philippines. Also, there was a violent Islamic movement in Indonesia, Darul Islam, in the 1950s, but it was suppressed and lost public support as the concept of a multiethnic, multireligious, secular state took hold. Islamic disaffection in southern Thailand led to low levels of violence in the 1960s and 1970s, but not a full-scale insurgency until 2003–2004.
10. For an overview of current Islamic radicalism in Southeast Asia, see International Crisis Group, "Al-Qaeda in Southeast Asia: The Case of the 'Ngruki Network' in Indonesia," MS, Brussels/Jakarta, August 8, 2002.
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12. The Pacific Rim states are usually defined as the Korean Peninsula, Japan, Taiwan, and Southeast Asia. Our discussion will include Russia on those limited economic and security topics where it is currently an active participant.
13. An exception is the book by F. Frankel and H. Harding, eds., *The India-China Relationship: What the United States Needs to Know* (New York: Columbia University Press and Washington, DC: Woodrow Wilson Center Press, 2004).

14. Ganguly, S., ed., *India as an Emerging Power* (London: Frank Cass, 2003).
15. Denoon, D., "Cycles in Indian Economic Liberalization, 1966–1996," *Comparative Politics* 31, no. 1, October 1999, pp. 43–60.
16. International Monetary Fund, *World Economic Outlook, 1997* (Washington, DC: IMF, May 1997), p. 36.
17. In this book, we will concentrate the economic analysis on the countries in North and Southeast Asia (essentially the arc from Russia around to Burma); then, in assessing the role of regional institutions and strategic questions, we will further broaden the scope and include South Asia (the Indian Subcontinent) as well.
18. For an overview of the Japanese strategy in the 1960s and 1970s, see H. Patrick and H. Rosovsky, eds., *Asia's New Giant: How the Japanese Economy Works* (Washington, DC: Brookings, 1976).
19. Brooke, J., and K. Belson, "Japanese Plan to Overhaul Banks Hits a Stone Wall," *New York Times,* October 23, 2002, p. C1.
20. French, H., and K. Belson, "Showdown Over Japanese Banking Reform," *New York Times,* October 28, 2002, p. A7.
21. Mano, T., "Decline in Savings Rate a Warning to Reform-Resistant Politicians, *Japan Times Online,* June 28, 2004.
22. Lague, D., "On the Road to Ruin: Chinese Banks on Fire," *Far Eastern Economic Review,* November 14, 2002, pp. 32–35; K. Bradsher, "China Announces New Bailout of Big Banks, " *New York Times,* January 7, 2004, p. C–1.
23. Crispin, S., "Thailand: Giddy Growth," *Far Eastern Economic Review,* January 29, 2004, p. 44; W. Arnold, "Cleaning Up Malaysia's Bad Debts," *New York Times,* December 12, 2002, p. W–1.
24. Mydans, S., "Thailand Reinterprets the Rules of Democracy, Again," *New York Times,* September 21, 2006, p. A3.
25. The best bibliography on the crisis is maintained and updated by Nouriel Roubini at New York University's Stern School and is accessible through his website, www.stern.nyu/globalmacro.
26. *Business Week,* "A Bad Situation Is Set to Get Worse," December 6, 2004, p. 34.
27. FDI in the first half of 2004 increased to about $5 billion, but final figures for 2004 were not available at the time this book went to press. See C. Brown, "Trade Sector Leads Korea's Growth in the 1st Half of 2004," *Korea Insight* 6, no. 8, August 2004, pp. 1–2.
28. Dean, J., "Resignation over Reform," *Far Eastern Economic Review,* December 5, 2002, pp. 44–45.
29. This drop in income may be somewhat exaggerated by doing the comparison in U.S. dollars, as the nontraded goods sectors in Thailand and Indonesia are large. The same criticism applies to using dollars for Table 1.1, as China has a large nontraded goods sector.
30. Arnold, W., "Exxon and Indonesia Reach Accord on a New Oil Field," *New York Times,* March 14, 2006, p. C–7.
31. Nguyen, T., "Opinion," *Business Times* (Singapore), January 24, 2006.
32. Krueger, A., *Political Economy of Policy Reform in Developing Countries* (Cambridge, MA: MIT Press, 1993).
33. Fingleton, E., *Blindside: Why Japan Is Still on Track to Overtake the U.S. by the Year 2000* (New York: Simon & Schuster, 1995).
34. See, for example, R. Muscat, *The Fifth Tiger: A Study of Thai Development Policy* (Armonk, NY: M.E. Sharpe, 1994); D. Cole and B. Slade, *Building a Modern Financial System: The Indonesian Experience* (Cambridge: Cambridge University Press, 1996).

35. For views on the debate, see S. Haggard, C. H. Lee, and S. Maxfield, eds., *The Politics of Finance in Developing Countries* (Ithaca, NY: Cornell University Press, 1993).
36. World Bank, *The East Asian Miracle* (Oxford and New York: Oxford University Press, 1993).
37. Siamwalla, A., "Can a Developing Democracy Manage Its Macroeconomy? The Case of Thailand," in *Thailand's Boom and Bust* (Bangkok: Thailand Development Research Institute, 1997).
38. Krugman, P., "The Myth of Asia's Miracle," *Foreign Affairs* 73, no. 6, November/December 1994, pp. 62–78.
39. Sachs, J., "International Economics: Unlocking the Mysteries of Globalization," *Foreign Policy,* no. 110, Spring 1998, pp. 97–111.
40. Rogoff, K., "Reflections on the Global Economy," *IMF Survey* 30, no. 22, pp. 357–359.
41. Bhagwati, J., "The Capital Myth," *Foreign Affairs* 77, no. 6, May/June 1998, pp. 7–12.
42. For a detailed, country-by-country description of corrupt practices and faulty investment decisions, see M. Backman, *Asian Eclipse: Exposing the Dark Side of Business in Asia* (New York: Wiley, 1999).
43. For a historical discussion of corruption in Southeast Asia, see D. G. E. Hall, *A History of Southeast Asia,* 3rd ed. (London: Macmillan/St. Martin's Press, 1968), p. 477.
44. Schwarz, A., *A Nation in Waiting: Indonesia in the 1990s* (New York: Allen & Unwin, 1994).
45. The South Korean case was different, because the country was not receptive to FDI and did not encourage short-term capital inflows. However, the South Korean government did borrow extensively and supervised banks while they borrowed overseas as well. It was these large external borrowings that caused Seoul's financial crisis in December 1997.
46. Joseph Stiglitz's *Globalization and Its Discontents* (New York: W. W. Norton, 2002) provides a broad-ranging critique of the IMF and an alternative set of policies for developing countries to pursue.
47. Chile and Malaysia provide interesting examples of partially liberalized capital markets, while maintaining controls over short-term funds; China and India practice much more pervasive controls.
48. For a recent book developing related themes, see Z. Brzezinski, *The Grand Chessboard: American Primacy and Its Geo-Strategic Imperatives* (New York: Basic Books, 1997).
49. Overholt, W., *The Rise of China: How Economic Reform Is Creating a New Superpower* (New York: W. W. Norton, 1993).
50. For an analysis of those situations where China has used force, see A. Scobell, *China's Use of Military Force: Beyond the Great Wall and the Long March* (New York: Cambridge University Press, 2003).
51. See, for example, S. Cohen and R. Park, *India: Emergent Power?* (New York: Crane Russack, 1978); G. Choudhury, *India, Pakistan, Bangladesh and the Major Powers* (New York: Free Press, 1978).
52. Mohan, C. R., *Crossing the Rubicon: The Shaping of India's New Foreign Policy* (New York: Palgrave Macmillan, 2004).
53. Perkovich, G., "Is India a Major Power?" *Washington Quarterly* 27, no.1, Winter 2003–2004, p. 137.
54. Talbot, S., *Engaging India* (Washington, DC: Brookings Institution, 2004), pp. 23–51.
55. Haniffa, A., "Clinton May Personally Push Pakistan Arms Sale Amendment," *Statesman,* August 11, 1995, p. 1.

56. In addition to India's further tests of fission weapons, it appears that its 1998 efforts included a failed test of a hydrogen bomb. See G. Perkovich, *India's Nuclear Bomb* (Berkeley: University of California Press, 1999), p. 433.
57. Tellis, A., "Seeking Breakthroughs: The Meandering U.S.-India Relationship Needs a Fresh Impetus," *Force,* October 2004, pp. 8–9.
58. For background on the Afghan-Pakistani tension, see C. Gall, "Musharraf Vows to Aid Afghanistan in Fighting Taliban," *New York Times,* September 7, 2006, p. A8.
59. For a discussion of this kind of leverage, see D. Denoon, *Devaluation Under Pressure: India, Indonesia, and Ghana* (Cambridge, MA: MIT Press, 1986), pp. 9–16. In the IMF's case, these would usually entail specific targets for each major macroeconomic indicator (such as budget deficit, trade deficit or surplus, and inflation). In the World Bank's case, the most influence came from "structural adjustment loans," which specified how an entire sector or industry should be reorganized.
60. These issues will be covered in depth in Chapter 2.
61. Data on FDI flows are presented in Figure 1.6. This topic will be discussed extensively in Chapter 3.
62. The net outflows from Indonesia averaged $2 billion per year between 2000 and 2003.
63. For a summary of the proposals and the IMF's objectives, see the interview with the IMF deputy director Anne Krueger, "Krueger Welcomes IMFC Green Light to Continue Sovereign Debt Proposal," *IMF Survey* 31, no. 9, May 13, 2002, pp. 145–147.
64. Farrel, D., "Mapping the Global Capital Markets," McKinsey Global Institute, January 2006, p. 4.
65. The original members were Thailand, Malaysia, Singapore, Indonesia, and the Philippines. For an assessment of ASEAN's performance, see D. Denoon and E. Colbert, "Challenges for ASEAN," *Pacific Affairs* 71, no. 4, Winter 1988–1989, pp. 505–523.
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67. For an overview of the original objectives of the ASEAN Regional Forum, see M. Leifer, *The ASEAN Regional Forum,* Adelphi Paper No. 302 (London: International Institute of Strategic Studies, 1996).
68. Chinese agriculture would be a threat to both the South Korean and Japanese farming sectors, so complete free trade in Northeast Asia, or throughout East Asia, is not likely soon.
69. Trenin, D., *The End of Eurasia: Russia on the Border between Geopolitics and Globalization* (Washington, DC, and Moscow: Carnegie Endowment, 2002), pp. 203–220.
70. Shanker, T., and N. Onishi, "Japan Assures Rice That It Has No Nuclear Intentions," *New York Times,* October 19, 2006, p. A14.
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72. On Japan's ambivalence about great power politics, see T. Inoguchi, *Japan's Foreign Policy in an Era of Global Change* (London: Pinter, 1993), pp. 117–138.
73. Brasher, K., "China Passes Japan in Foreign Exchange Reserves," *New York Times,* March 29, 2006, p. C6.
74. Bradsher, K., "Alert to Gains by China, India Is Making Energy Deals," *New York Times,* January 17, 2005, p. C2.
75. Vogel, E., "Pax Nipponica," *Foreign Affairs* 64, no. 1, Spring 1986, pp. 752–767.

76. Schlossstein, S., *Asia's New Little Dragons: The Dynamic Emergence of Indonesia, Thailand, and Malaysia* (San Francisco: Contemporary, 1991).
77. For an argument in favor of theoretical eclecticism, see P. Katzenstein and N. Okawara, "Japan, Asian Pacific Security, and the Case for Analytical Eclecticism," *International Security* 26, no. 3, Winter 2001–2002, p. 154.
78. Hagen, E., *The Economics of Development* (Homewood, IL: Irwin, 1968; rev. ed., 1975).
79. Vietnam, Cambodia, Laos, and Burma did not follow the Washington Consensus.
80. For a summary of the orthodox IMF view, see IMF, *International Capital Markets: Developments, Prospects and Policy Issues* (Washington, DC: IMF, 1995).
81. Jones, R., "Comparative Advantage and the Theory of Tariffs: A Multi-country, Multi-commodity Model," *Review of Economic Studies,* no. 28, June 1961, pp. 161–175.
82. For a detailed description of how this supply-chain production works in Asia, see J. Naughton, "China's Economic Growth and Technology Development: International Linkages and Implications for the U.S.," *Hearing before the U.S.-China Economic and Security Review Commission,* San Diego, February 12, 2004.
83. FDI in China is growing so rapidly that it is putting upward pressure on wages. See D. Roberts, "How Rising Wages Are Changing the Game in China," *Business Week,* March 27, 2006, pp. 32–35.
84. Fackler, M., "In Korea, Bureaucrats Lead the Technology Change," *New York Times,* March 16, 2006, p. C1.
85. For an overview of these schools and an assessment of optimistic and pessimistic variants of each in their judgments about Sino-American relations, see A. Friedberg, "The Future of U.S.-China Relations," *International Security* 30, no. 2, Fall 2005, pp. 7–45.
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87. Wendt, A., "Collective Identity Formation and the International State," *American Political Science Review* 88, no. 2, June 1994, pp. 384–396.
88. For examples of a realist perspective over a sixty-year period, see E. H. Carr, *The Twenty Years Crisis* (London: Macmillan, 1939); H. Morgenthau, *Politics among Nations* (New York: Knopf, 1948); K. Waltz, *Theory of International Relations* (Reading, MA: Addison-Wesley, 1979); J. Mearsheimer, *The Tragedy of Great Power Politics* (New York: W. W. Norton, 2001).
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91. Christensen, T., "Chinese Realpolitik," *Foreign Affairs* 75, no. 5, September–October 1996, pp. 37–52.
92. McDevitt, M., "Taiwan: The Tail That Wags the Dog," *Asia Policy* 1, no. 1, p. 82.
93. For a blunt statement of this new, assertive stance in Indian policy, see P. Khanna and C. R. Mohan, "Getting India Right," *Policy Review,* no. 135, February–March 2006.
94. Calder, K., "Japan and China as Rivals," *Foreign Affairs* 85, no. 2, March–April 2006, pp. 129–140.
95. Sridharan, E., "Improving Indo-Pakistani Relations: IR Theory, Nuclear Deterrence, and Possibilities for Nuclear Cooperation," *Contemporary South Asia* 14, no. 3, September 2005, pp. 321–339. The Indian government has not released figures on the number of its nuclear weapons, but they are estimated to be between 50 and 100.

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97. Gong, G., ed., *Remembering and Forgetting: The Legacy of War and Peace in East Asia* (Washington, DC: Center for Strategic and International Studies, 1996).
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CHAPTER 2

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Chapter 3

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7. Indonesia is still a labor-surplus country, but its political turmoil and the growing militancy of its unions have made it less attractive for foreign investors.
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10. U.S. Bureau of Labor Statistics, as reported in *Business Week,* June 21, 2004, p. 37.
11. For a background on the Asian Central Bank purchase of U.S. government securities, see I. Douglas, "Global Capital Flows and the United States' Growing Dependence on Asia for Capital," ms., presented at the Asia Society, New York, June 5, 2003.
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world's largest debtor and pays a massive amount of interest to foreigners, the United States runs a deficit on *both* the trade and the current accounts.

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25. Tao Weng, "China: Economic Performance and Policy Challenges," presented at the IMF Conference on India and China, New Delhi, November 2003.
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CHAPTER 4

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17. Ishihara, S., *The Japan That Can Say No: Why Japan Will Be First among Equals* (New York: Simon and Schuster, 1991), pp. 17–41.
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20. Some argue that Hun Sen in Cambodia has given up allegiance to Marxist principles, but his government is still led by many formerly Marxist individuals.
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25. Using the yuan-dollar exchange rate to compute China's national income, Japan's GDP is ten times larger than China's; however, using purchasing power parity measures, Japan is only about four times larger. Moreover, if China and Japan continue with their current economic growth rates, China's GDP will equal Japan's within two decades.
26. Caballero-Anthony, M., "ASEAN-China Relations Turn the Corner," *PacNet* 52, December 12, 2002, pp. 1–3.
27. Evans, P., *Embedded Autonomy: States and Industrial Transformation* (Princeton, NJ: Princeton University Press, 1995). The more open economies of Hong Kong, Thailand, and Singapore were the exception.
28. Belassa, B., *Development Strategies in Semi-Industrializing Economies* (Baltimore, MD: Johns Hopkins University Press, 1982).
29. Westphal, L., "The Republic of Korea's Experience with Export Led Development," *World Development,* no. 6, 1978, pp. 347–382.
30. Denoon, D., *Real Reciprocity: Balancing U.S. Economic and Security Policy in the Pacific Basin* (New York: Council on Foreign Relations, 1993), pp. 45–68.
31. Johnson, C., *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925–1975* (Stanford: Stanford University Press, 1975).
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33. Heng, T. M., and L. Low, "Is the ASEAN Free Trade Area a Second Best Option?" *Asian Economic Journal* 7, no. 3, 1993, pp. 275–298.
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39. Henderson, J., *Reassessing ASEAN,* Adelphi Paper no. 328 (London: International Institute for Strategic Studies, 1999), pp. 15–20.
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43. Japan has a multibillion-dollar aid program in China, which is, in essence, in lieu of reparations. In 2000, it appeared to the Japanese that Zhang Zemin was raising the issue of Japanese wartime behavior and the Chinese desire for further apologies to get more aid.
44. Glosserman, B., "Japan-ASEAN Summit: Playing Catch-Up with China?" *PacNet no. 52,* Pacific Forum, Center for Strategic and International Studies, December 19, 2003, pp. 1–3.
45. Benoit, E., *Europe and Sixes and Sevens* (New York: Columbia University Press, 1961); I. Frank, *The European Common Market* (New York: Praeger, 1961).
46. See, for example, Lee Kuan Yew's own description of his early efforts to develop ASEAN in Lee, K. Y, *From Third World to First: The Singapore Story, 1965–2000* (New York: Harper Collins, 2000), pp. 329–342.
47. APEC has very diverse membership: the ASEAN states (except Cambodia, Laos, and Myanmar), Australia, Canada, Chile, China, Hong Kong, Japan, Mexico, New Zealand, Papua New Guinea, Peru, Russia, South Korea, Taiwan, and the United States. It is at least as much a Pacific Basin institution as an Asian one.
48. The APEC summit is usually held in the late fall of the year with different states rotating as the host country. The annual picture of all those present, wearing a shirt in the host country's style, has become the symbol of APEC cooperation.
49. For a detailed analysis of this situation, see R. Garnaut and L. Song, "Truncated Globalization: The Fate of the Asia Pacific Economies," *mimeo,* Australian National University, February 24, 2004.
50. Skanderup, J., "The APEC Santiago Declaration: Steady Progress, New Challenges," *PacNet,* no. 51, December 6, 2004.
51. *Far Eastern Economic Review,* "APEC Forum Mulls and Upgrade," June 10, 2004, p. 8.
52. For a detailed discussion of these agreements, see C. R. Henning, *East Asian Financial Cooperation* (Washington, DC: Institute for International Economics, 2002).
53. In 2006, both Japan and China had approximately $1trillion in foreign exchange reserves, and the smaller states in the region significantly increased their reserves as well.
54. Holland, T, "Currency Calls: Bank Customers Can Manage Their Forex Needs and Enhance Yields at the Same Time," *Far Eastern Economic Review,* April 29, 2004, p. 50.
55. For an overview of the ASEAN Cooperation Plan, see J. Andre, "ASEAN Cooperation Plan, U.S. Department of State, November 2004. For details of the projects, see "Status of Projects under the ASEAN Cooperation Plan (as of September 16, 2004)," U.S. Department of State, Washington, DC.
56. The "six-party-talks" is not a formal organization; it is a diplomatic forum.
57. Anwar, D. F, *Indonesia in ASEAN* (Singapore: Institute of Southeast Asian Studies, 1994), p. 222.
58. Wain, B, "Jakarta Jilted: Indonesia's Neighbors Are Not Very Supportive of Its Vision of a Regional Security Community," *Far Eastern Economic Review,* June 10, 2004, p. 20.

59. ARF's membership includes the ASEAN states, Australia, Canada, China, the EU, India, Japan, Mongolia, New Zealand, Papua New Guinea, South Korea, and the United States.
60. For additional background, see H. Maull, G. Segal, and J. Wanandi, eds., *Europe and the Asia Pacific* (London: Routledge, 1998).
61. During the Sino-Soviet split and up to the end of the Cold War, the Soviet Union was China's principal nemesis, and though most Japanese still want U.S. security guarantees, they would like greater autonomy for their role in Asia.
62. For a summary of ASEAN + 3 developments, see B. Glosserman, "ASEAN Plus Three Leads the Way," *PacNet,* 51A, December 7, 2004, p. 2.
63. Taiwan is an important export market for Southeast Asia and a key supplier as well. Although Taiwan is not included in ASEAN + 3, China has made no effort to block Southeast Asian commerce with Taiwan.
64. Weatherbee, D., "Strategic Dimensions of Economic Interdependence in Southeast Asia," chapter in M. Wills, ed., *Strategic Asia 2006–2007* (Seattle: National Bureau of Asian Research, 2006).
65. Fairbank, J., *The U.S. and China* (New York: Viking, 1958), pp. 303–323.
66. Hinton, H., "China as an Asian Power," in T. Robinson and D. Shambaugh, eds., *Chinese Foreign Policy: Theory and Practice* (Oxford: Clarendon Press, 1994), p. 353.
67. Kenny, H., *An Analysis of Possible Threats to Shipping in Key Southeast Asian Sea Lanes* (Washington, DC: Center for Naval Analyses, 1996).

Chapter 5

1. For an overview of the security situation on the Korean Peninsula and in East Asia in 1953, see D. Oberdorfer, *The Two Koreas: A Contemporary History* (Reading, MA: Addison-Wesley, 1997), pp. 3–16.
2. The Southeast Asia Treaty Organization (SEATO); Australia, New Zealand, United States (ANZUS) Treaty.
3. From the 1950s to 1975 there were numerous agreements with South Vietnam, and, in the 1980s and 1990s, various agreements for defense cooperation with Singapore, Malaysia, and Indonesia. However, the Association of Southeast Asian Nations (ASEAN) remained officially nonaligned.
4. For the original conception of the "Containment Strategy," see the "X Article" by George Kennan, "The Sources of Soviet Conduct," *Foreign Affairs* 25, no. 4, July 1947.
5. For a perspective on how America's Asian allies viewed the U.S. cooperation with China, see T. Inoguchi, *Japan's Foreign Policy in an Era of Global Change* (London: Pinter, 1993), pp. 159–178.
6. The Soviet Union did, briefly, expand its influence in Vietnam until relations between Hanoi and Moscow soured in the 1980s. The one Asian area where Soviet influence grew in the 1970s and 1980s was in the subcontinent, due to the close relations with India.
7. For Taiwan, the original treaty was with the Republic of China, under Chiang Kai-shek. When the United States dropped recognition of the ROC in 1979, the Congress then passed the Taiwan Relations Act (TRA), which provided security guarantees to Taiwan. The TRA is still in effect and is the basis for American arms sales to the Chen Shui-bian government and for ongoing security protection.
8. Kurth, J., "The Pacific Basin vs. the Atlantic Alliance: Two Paradigms of International Relations," *Annals* 505, September 1989, pp. 34–45.

9. The most extensive effort in this regard came under President Clinton who oversaw multiyear negotiations on the "Defense Guidelines," which spell out those circumstances in which the Japanese must actually come to U.S. aid. Prime Minister Hashimoto and President Clinton signed the revised guidelines, with expanded Japanese commitments, in 1996.
10. Both the South Koreans and the Taiwanese spend a higher percentage of their gross domestic product (GDP) on defense than the Japanese do.
11. For a summary of this debate, see C. Hughes, *Japan's Re-emergence as a "Normal" Power* (London: Adelphi paper no. 368–369, International Institute of Strategic Studies, 2004).
12. Since China is the only plausible country that might attack Taiwan, this was a clear signal to Beijing. See J. Brinkley, "Japan Said to Support U.S. on Security of Taiwan," *New York Times,* February 19, 2005, p. A–6.
13. Sigur, C., and B. Glosserman, "New Challenges, New Opportunities for the U.S. and Japan," *PacNet* 14, March 30, 2006.
14. Glosserman, B., "Straight Talk About Japan's Nuclear Option," *PacNet* 50A, October 11, 2006.
15. For a fuller elaboration of these issues, see D. Denoon, *Real Reciprocity: Balancing U.S. Economic and Security Policies in the Pacific Basin* (New York: Council on Foreign Relations, 1993), pp. 10–44.
16. Curtis, G., *The Logic of Japanese Politics* (New York: Columbia University Press, 1999), pp. 7–22.
17. Katzenstein, P. *Cultural Norms and National Security: Police and Military in Postwar Japan* (Ithaca, NY: Cornell University Press, 1996); and T. Christensen, "Posing Problems without Catching Up: China's Rise and Challenges for U.S. Security Policy," *International Security* 25, no. 4, Spring 2001, pp. 5–40.
18. Goldstein, A., "The Diplomatic Face of China's Grand Strategy: A Rising Power's Emerging Choice," *China Quarterly* 168, December 2001, p. 862.
19. Denoon, D., and S. Brams, "Fair Division: A New Approach to the Spratly Islands Controversy," *International Negotiation* 1, no. 2, 1997, pp. 303–329.
20. ASEAN + 3 is an all-Asian forum with the ASEAN states plus China, Japan, and South Korea.
21. For a statistical review of the growth performance and a discussion of changes in policy that led to the region-wide surge in growth, see the World Bank's report, *The East Asian Miracle* (New York: Oxford University Press, 1993).
22. Patrick, H., and H. Rosovsky, eds., *Asia's New Giant* (Washington, DC: Brookings Institution, 1976).
23. Okita, S., "Pacific Development and Its Implications for the World Economy," in J. Morley, ed., *The Pacific Basin: New Challenges for the United States* (New York: Academy of Political Science, 1986), pp. 11–22.
24. For example, the Pacific Economic Cooperation Council's *Pacific Economic Outlook* (Washington, DC: PECC, 1993).
25. See, Australia National University, "East Asia and the Doha Round," *APEC Economies* 7, no. 4, April 2003.
26. For an early assessment of how this would affect the rest of Asia, see W. Overholt, *The Rise of China: How Economic Reform Is Creating a New Superpower* (New York, Norton, 1993).
27. Bracken, P., *Fire in the East: The Rise of Asian Military Power and the Second Nuclear Age* (New York: Harper Collins, 1999).
28. Rosecrance, R., and A. Stein, eds., *The Domestic Bases of Grand Strategy* (Ithaca, NY: Cornell University Press, 1993).

29. North Korea, of course, is single-handedly trying to create a "middle power" role for itself.
30. For a comprehensive summary of this debate, see A. I. Johnston, "Is China a Status Quo Power?" *International Security* 27, no. 4, Spring 2003, pp. 5–56.
31. The leading theorist of the strategic rivalry in Asia is Aaron Friedberg. See A. Friedberg, "The Struggle for Mastery in Asia," *Commentary,* November 2000, pp. 17–26; and "Ripe for Rivalry: Prospects for Peace in a Multi-polar Asia," *International Security* 18, no. 3, Winter 1993, pp. 5–33.
32. Gong, G., ed., *Remembering and Forgetting: The Legacy of War and Peace in East Asia* (Washington, DC: Center for Strategic and International Studies, 1996).
33. Tamamoto, M., "Japanese Discovery of Democracy," Japan Institute for International Affairs, *Commentary,* April 26, 2006, pp. 1–4.
34. Shambaugh, D., *Modernizing China's Military: Progress, Problems, Prospects* (Berkeley: University of California Press, 2002), pp. 284–327.
35. Ayres, A., "Introduction," in A. Ayres and P. Oldenburg, eds., *India Briefing: Quickening the Pace of Change* (Armonk, NY: M. E. Sharpe, 2002), pp. 12–15.
36. For an overview of the changed working relationships, see R. Ellings and A. Friedberg, "Introduction," in R. Ellings and A. Frieberg, eds., *Asian Aftershocks: Strategic Asia 2002–2003* (Seattle, WA: National Bureau of Asian Research, 2002), pp. 9–15.
37. In the 1990s American military commitments in Asia were designed to convince allies and cooperating states that the United States was not leaving the region, despite the end of the Cold War. The Nye Initiative, launched by Joseph Nye when he was assistant secretary of defense, explicitly committed the United States to keeping 100,000 troops in the Asian theater. For background, see J. Nye *The Paradox of American Power: Why the World's Only Superpower Can't Go It Alone* (New York: Oxford University Press, 2002), pp. 17–35.
38. Indonesia has a small radical Islamist following, and they have been vehemently opposed to U.S.–Middle East policy; however, the broader population has also turned critical of American intentions. Since the U.S. intervention to help the independence of East Timor, there have been frequent demonstrations in Jakarta against U.S. policies.
39. Bonner, R., "Thailand Tiptoes in Step with the American Anti-terror Effort," *New York Times,* June 8, 2002, p. A–30.
40. Smaller states such as Singapore also saw this as an opening to reinforce ties with Washington, while sending a signal to its Muslim neighbors (Malaysia and Indonesia) that it would be tough on terrorists.
41. For a discussion of whether Asian states are likely to "bandwagon" or "balance," see R. Betts, "Wealth, Power, and Instability: East Asia after the Cold War," *International Security* 18, no. 3, Winter 1993/1994, p. 60.
42. The EP-3 reconnaissance plane incident of May 2001 got U.S.-China relations in the G. W. Bush administration off to a rough start, and Beijing was able to use counterterrorism cooperation as a means to reorient relations on a less confrontational basis.
43. Brooks, S. and W. Wohlforth, "Power, Globalization and the End of the Cold War: Reevaluating a Landmark Case for Ideas," *International Security* 25, no. 3, Winter 2000/2001, pp. 5–53.
44. Myers, S., "Strong Rebuke for the Kremlin from Cheney," *New York Times,* May 5, 2006, p. A–1.
45. Krauthammer, C., "The Unipolar Moment Revisited," *National Interest,* no. 70, Winter 2002/2003, pp. 5–20.
46. Not only did the Pakistani ISI support the Taliban financially, but it also recruited Pathan guerilla fighters in Afghanistan and Northwest Frontier Province to carry out

attacks in Kashmir. See J. Stern, "Pakistan's Jihad Culture," *Foreign Affairs* 79, no. 6, November/December 2000, pp. 115–126.

47. The Karzai government was installed by a caucus of local leaders, with U.S. encouragement, as an interim one until a new constitution could be drafted and country-wide elections take place in 2004.
48. For background, see O. B. Jones, *Pakistan: Eye of the Storm* (New Haven: Yale University Press, 2002).
49. For an assessment of the cross-pressures inside Pakistan, see S. P. Cohen, "The Nation and the State of Pakistan," *Washington Quarterly* 25, no. 3, Summer 2002, pp. 109–122.
50. This skepticism about American plans was by no means limited to Asia. In the Western Hemisphere, two of the United States' closest allies, Mexico and Chile, refused to support the war until more inspections had been completed inside Iraq.
51. Risen, J., *State of War: The Secret History of the CIA and the Bush Administration* (New York: Free Press, 2006) pp. 61–84.
52. The Agreed Framework, directly negotiated between the United States and North Korea, was essentially a bargain in which Pyongyang agreed to end its efforts to use plutonium rods in a power reactor to develop weapons-grade fissile material in exchange for fuel oil, food aid, and the construction of heavy-water reactors (that would not produce weapons material). The enriched uranium program was separate from the plutonium reprocessing but clearly violated the intent of the Agreed Framework.
53. For information on how the evidence was obtained, see J. Risen, "Russia Helped U.S. on Nuclear Spying Inside North Korea," *New York Times,* January 20, 2003, p. A1.
54. Solomon, J., and D. Cloud, "A Split with Seoul Complicates Crisis over North Korea," *Wall Street Journal,* January 2, 2003, p. A1.
55. To make clear that it could cause further tension in the region, North Korea continued its provocative actions by withdrawing from the 1992 Denuclearization Agreement with South Korea and by intercepting and trying to force down a U.S. reconnaissance plane flying over international waters.
56. Weisman, S., "Plan to Block North Korean Nuclear Shipments Gains Support," *New York Times,* June 18, 2003, p. A9.
57. North Korea has long been involved in smuggling drugs and arms, but other Asian states have not, previously, been willing to intervene.
58. Brooke, J., "Japanese Official Warns of Fissures in North Korea," *New York Times,* November 22, 2004, p. A3.
59. Sanger, D., and W. Broad, "Tests Said to Tie Deal on Uranium to North Korea," *New York Times,* February 2, 2005, p. A1.
60. Sanger, D., "U.S. Said to Weigh a New Approach on North Korea: Bush Approval Expected," *New York Times,* May 18, 2006, p. A1.
61. It is unclear how many people died of SARS before it was diagnosed as a distinct disease and how many people were misdiagnosed with another ailment.
62. Many epidemiologists speculated that the disease was not extinguished but is just dormant and that new cases will reappear in the winter of 2003–2004 and later.
63. For a summary of the quarantine and health-check measures and the debate about information in China, see B. Dolven and D. Murphy, "Building New Chinese Walls," *Far Eastern Economic Review,* May 22, 2003, pp. 24–27.
64. Waldron, A., "The Chinese Sickness," *Commentary,* July–August 2003, pp. 36–42.
65. The WHO requires that its members be states, and China has effectively thwarted Taiwan's effort to be accepted into WHO membership.
66. The only known cases of SARS in Southeast Asia were in Singapore and came from individuals who had recently been in southern China.

67. Jha, P.S., *Kashmir, 1947: Rival Versions of History* (New Delhi: Oxford University Press, 1996). There are three definitions of Kashmir: (1) the Kashmir Valley, (2) the current Indian state of Jammu and Kashmir, and (3) the former princely state of Kashmir.
68. For an overview of the entire period, see S. Ganguly, *Conflict Unending: India-Pakistan Tensions since 1947* (New York: Columbia University Press, 2001).
69. As the "Kargil Offensive" was proceeding, the Clinton administration was unequivocal in its criticism of Pakistan and of its demand for the Pakistani forces to return to the previously set Line of Control. In the spring of 2002, the Bush administration urged both sides to reduce forces in Kashmir and put pressure on Pakistan to stop infiltration of guerillas across the Line of Control.
70. Sanger, D., "Bush Offers Pakistan Aid but No F–16s," *New York Times,* June 25, 2003, p. A10.
71. Sengupta, S., "India and China Agree to Resolve Decades of Border Disputes," *New York Times,* April 12, 2005, p. A9.
72. For an overview of U.S.-Pakistani relations, see D. Kux, *Disenchanted Allies: The United States and Pakistan, 1945–2000* (Baltimore: Johns Hopkins University Press, 2001).
73. For the best summary of the foreign policy thinking behind George W. Bush's electoral campaign, see C. Rice, "Promoting the National Interest," *Foreign Affairs* 79, no. 1, January/February 2000, pp. 45–62.
74. The three speeches were to (1) a joint session of Congress on September 20, 2001, where he stressed that the counterterrorism effort would be global and indefinite in duration; (2) the State of the Union on January 29, 2002, where he identified the "Axis of Evil" (Iraq, Iran, and North Korea); and (3) the West Point cadets on June 1, 2002, where he spoke about the changes in the nature of twenty-first century warfare.
    The publications were as follows: Office of the President, *National Security Strategy of the United States* (Washington, DC: September 2002), and Office of the President, *National Strategy to Combat Weapons of Mass Destruction* (Washington, DC: December 2002). The National Security Strategy was updated in 2006, but the focus was kept on counterterrorism and limiting the spread of WMDs.
75. Wolfowitz was the undersecretary of defense for policy at the time (the third-ranking position in the Department of Defense).
76. Huntington, S., "Why International Primacy Matters" *International Security* 17, no. 4, Spring 1993, p. 70.
77. For coverage on this initial draft of the 1992 DPG, see P. Tyler, "U.S. Strategy Calls for Ensuring that No Rivals Develop," *New York Times,* March 8, 1992, p. A1.
78. Bacevich, A., *American Empire: The Realities and Consequences of U.S. Diplomacy* (Cambridge: Harvard University Press, 2002), pp. 43–54.
79. Snyder, J., "Imperial Temptations," *National Interest* 71, Spring 2003, pp. 29–40.
80. Jehl, D., "Digital Links Are Giving Old Weapons New Power," *New York Times,* April 7, 2003, p. B2.
81. This was a major policy change for New Delhi, which had formerly been "non-aligned" and had only allowed U.S. military aircraft to use Indian bases during its 1962 war with China.
82. One of the strongest supporters of President George W. Bush has been Prime Minister John Howard of Australia. As a treaty ally and as a state anxious to avoid isolation, Australia has supported U.S. policy on antiterrorism and was the only country in the Asian region to send troops to Iraq for the 2003 war.
83. For an early critique of the global preeminence strategy, see C. Layne, "The Unipolar Illusion: Why New Great Powers Will Arise," *International Security* 17, no. 4, Spring 1993, pp. 5–51.

84. Kupchan, C., *The Vulnerability of Empire* (Ithaca, NY: Cornell University Press, 1994).
85. Cooper, J. and K. Madigan, "Lest We Forget: No Economy Is An Island," *Business Week,* April 7, 2003, p. 27.
86. Shanker, T., "U.S. Awaits South Korean Plan on Troop Numbers in Seoul," *New York Times,* November 12, 2003, p. A10.
87. For a discussion of these goals, see T. Christensen, "China," in R. Ellings and A. Friedberg, eds., *Strategic Asia: Power and Purpose, 2001–2002* (Seattle, WA: National Bureau of Asian Research, 2001), pp. 30–33. "Territorial integrity" means keeping control of Tibet and Xinjiang, and ensuring that Taiwan does not declare independence.
88. In extensive interviews by the author in Beijing and Shanghai during the 2000–2003 period, most members of China's strategic elite (government officials, ex-government officials, and think tank scholars) describe themselves as realist and are quite open about wanting to expand China's power, prestige, and influence.
89. The members were: China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan.
90. Kahn, J., "Hands across the Pacific: U.S.-China Ties Grow," *New York Times,* November 15, 2002, p. A12.
91. See, for example, M. Swaine and A. Tellis, *Interpreting China's Grand Strategy: Past, Present, and Future* (Santa Monica, CA: RAND, 2000), L. Wortzel, ed., *The Chinese Armed Forces in the 21st Century* (Carlisle Barracks, PA: U.S. Army War College, 1999), and M. Pillsbury, ed., *China Debates the Future International Security Environment* (Washington, DC: National Defense University Press, 2000).
92. Shambaugh, D., "Sino-American Strategic Relations: From Partners to Competitors," *Survival* 42, no. 1, Spring 2000, pp. 97–115.
93. Ross, R., "The Geography of the Peace: East Asia in the 21st Century," *International Security* 23, no. 4, Spring 1999, pp. 81–118.
94. For an overview of the backgrounds of the new politburo, see A. Nathan and B. Gilley, *China's New Rulers: The Secret Files* (New York: New York Review Press, 2002).
95. Cohen, S. P., *India: Emerging Power* (Washington, DC: Brookings, 2001).
96. For an overview of differences among Indian strategists, see K. Bajpai, "India's Strategic Culture," ms. (New Delhi: Jawaharlal Nehru University, June 2002).
97. Mukherjee, J., "India's Long March to Capitalism," *India Review* 1, no. 2, April 2002, pp. 29–60.
98. Srivastava, A., "India's Growing Missile Ambitions: Assessing the Technical and Strategic Dimensions," *Asian Survey* 40, no. 2, March/April 2000, pp. 311–341.
99. For an overview about Indian strategy and the role of its military, see S. P. Cohen and R. Park, *India: Emergent Power* (New York: Crane Russak, 1978). For developments in the 1990s, see A. Tellis, *Stability in South Asia* (Santa Monica, CA: RAND, 1997).
100. Rashid, A., "Pakistan: Trouble Every Day," *Far Eastern Economic Review,* July 1, 2004, pp. 14–15.
101. For examples of the earlier enthusiasm, see E. Vogel, *Japan as Number One: Lessons for America* (Cambridge, MA: Harvard University Press, 1979), and C. Prestowitz, *Trading Places: How We Allowed Japan to Take the Lead* (New York: Basic Books, 1989).
102. Fackler, M., "New Optimism about the Japanese Economy After a Bleak Decade," *New York Times,* December 7, 2005, p. C1.
103. Muhleisen, M., and H. Faruqee, "Japan: Population Aging and Fiscal Challenge," *Finance and Development* 38, no. 1, March 2001.
104. Johnson, C., "Japan in Search of a 'Normal' Role," *Daedalus* 121, Fall 1992, pp. 1–33.

105. Denoon, D., "Japan and the United States: The Security Agenda," *Current History* 82, no. 487, November 1983, pp. 353–394.
106. International institute for Strategic Studies, *Strategic Survey 2002/2003* (London: IISS, 2003), pp. 253–262.
107. *The World Almanac* (New York: World Almanac Books, 2001), pp. 775–805.
108. Brooke, J., "Russia's Economy Building on Three Years of Solid Growth," *New York Times,* June 25, 2003, p. W1.
109. In March 2005, Russia went ahead, despite U.S. objections, with an agreement to supply Iran with nuclear reactor fuel.
110. For a debate on these issues, see P. Desai, "Russian Retrospectives on Reforms from Yeltsin to Putin," *Journal of Economic Perspectives* 19, no. 1, Winter 2005, pp. 87–196, and A. Shleifer and D. Treisman, "A Normal Country: Russia after Communism," *Journal of Economic Perspectives* 19, no. 1, Winter 2005, pp. 151–174.
111. Russia overplayed its hand in midwinter 2005–2006 when it cut gas supplies to Ukraine (in a dispute over terms) and Ukraine then promptly cut supplies into Western Europe. Russia did an about-face after bitter protests from Western Europe but ended up hurting its credibility as a reliable energy supplier.
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CHAPTER 6

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