



Asia-Pacific: A new Agenda for the Times Ahead

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Abstract

The rapid growth of the populous Asian economies provokes profound economic changes and a shift in the balance of power. On the economic front, Asian leaders are confronted with the need to preserve the stability that has underpinned their prosperity, maintain an environment conducive to trade and investments and encourage domestic consumption while avoiding ecological disasters. Internationally, business competition will intensify with the strong presence of Asian manufacturers in global supply chains, growing price competition from Asian firms in domestic markets and global competition for energy, food, minerals and other commodities. Geopolitical concerns stem, in part, from Asia's global quest for critical resources, conflicting territorial and maritime disputes and increasing military expenditures which affect security dynamics. China's assertiveness over its periphery prompts an arm's race in the region and concerns about Sino-American relations even though U.S.-Chinese relations may be less risky than China's relations with its neighbours. The United States remains a key player in the Asia-Pacific region, with the capacity to alter balances and affect outcomes. Globally, the United States capacity to lead is now diminished and will continue to be so for the foreseeable future. Since no rising power is capable of exercising global leadership, a return to the "old normal" where no one power in geopolitical or economic terms dominates the world is to be expected.

Résumé

La croissance rapide des peuplées économies asiatiques crée des défis économiques d'envergure et un déplacement de l'équilibre du pouvoir. Au plan économique, les dirigeants asiatiques devront préserver la stabilité qui a soutenu leur prospérité, maintenir un environnement propice au commerce et aux investissements et encourager la consommation intérieure, tout en évitant les désastres écologiques. Au niveau international, la concurrence s'intensifiera du fait de la forte présence des fabricants asiatiques dans les chaînes d'approvisionnement, la compétitivité croissante des entreprises asiatiques dans tous les marchés et la concurrence mondiale pour l'énergie, la nourriture, les minéraux et autres denrées. Les préoccupations géopolitiques sont alimentées, en partie, par la quête mondiale des pays asiatiques pour les ressources, les différends territoriaux et maritimes et

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l'augmentation des dépenses militaires qui affectent la sécurité régionale. L'influence croissante de la Chine sur sa périphérie donne lieu à une course aux armements et soulève des craintes quant aux relations du couple sino-américain même si les relations entre la Chine et les États-Unis comportent probablement moins de risques que ceux avec ses voisins immédiats. Les États-Unis demeurent un joueur incontournable dans la région Asie-Pacifique capable de balancer les équilibres de pouvoir et de tempérer les comportements. Globalement, la capacité des États-Unis à exercer un leadership mondial est diminué et continuera de l'être pour l'avenir prévisible. Comme aucune nouvelle puissance n'est capable d'exercer ce rôle, un retour à l'« ancienne normalité » où aucun pays ne domine le monde en terme géopolitique ou économique est à prévoir.

Citation

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Introduction

For over two centuries the West has dominated the world. At the dawn of the 21st Century, we are witness to an historic realignment where the nations of Asia, home to over half of the world's population, are playing an increasing leading role. Today, the region is the world's most dynamic economically. Three Asian countries are amongst the ten largest national economies. The unprecedented level of economic growth experienced by China and India – two very populous and continental-sized states – underpins the resurgence of Asia on the global scene. Consonant with this secular shift in the center of gravity of economic might and the higher levels of economic interdependence and competition globalisation entails, a realignment of geopolitical power is occurring giving rise to tensions and concomitant security challenges.

Looking ahead, the main economic policy challenges that will confront Asian leaders will be to preserve the stability that has underpinned regional prosperity, to maintain an environment conducive to trade and investments and to encourage domestic consumption and the development of the services sector. In this regard, we can take comfort from the resilience demonstrated by Asian countries during the 2008 global financial crisis. Although the external shocks stemming from the global financial crisis hit the region hard, the decline in output was shallower, the recovery was more rapid, and the cumulative output loss was smaller in comparison to other regions. Moreover, appropriate prudential policies ensured Asia's financial sector remained stable throughout this crisis.

Sustained fast economic growth is not manifest destiny. Already, we see China's growth slowing from two digits to 7 percent or less; India is on a similar growth path and the relative stagnation of the Japanese economy continues to run its long course. The broad domestic consequences stemming from these tamed growth prospects defy definition and will reverberate worldwide because of the globalized

and hyper connected world that prevails. Nonetheless, given the sheer size of its economy, slower growth is unlikely to affect China's rising power in world affairs.

A powerful indication of China's rising economic dominance is that its currency, the Yuan (CNY), is fast becoming a reference currency. In East Asia, the high degree of co-movement between the CNY and other currencies indicates that the CNY has replaced the US dollar as the dominant reference currency.² In terms of use in global payments, the CNY is in the fifth position, a rank which suggests that the International Monetary Fund ("IMF") will soon endorse the CNY as one of the world's five reserve currencies. The recent agreement to establish the first CNY trading hub in the Americas in Toronto is a key step for the commercial internationalization of the CNY and its development as a global reference currency.³

The global quest for critical resources, conflicting territorial and maritime disputes and increasing military expenditures are affecting regional security dynamics. In contrast to the extensive networks of economic arrangements that have been instrumental in facilitating regional trade, political institutions and stability-enhancing mechanisms to mitigate and manage conflicts within the region remain weak and inchoate, a legacy of the Cold War cleavages and the strong conviction of the 10 ASEAN members that institutional flexibility is necessary to avoid the dominance of regional organizations by China or the United States.⁴ China's growing assertiveness in establishing its dominion over a significant portion of its periphery raises geopolitical concerns. In this day and age, it cannot implement a Western Pacific version of the Monroe Doctrine without encountering stiff opposition. The

² Arving Subramanian and Martin Kessler, *The Renminbi Bloc Is Here: Asia Down, Rest of the World to Go?*, Peterson Institute for International Economics, WP 12-19, August 2013. In May 2014, only 3% of North American payments with China were executed in RMB whereas this ratio was 29% for the Euro Zone.

³ Aizenman, Joshua, *The Internationalization of the RMB, Capital Market Openness, and Financial Reforms in China*, NBER Working Paper No. 20943, February 2015.

⁴ The ASEAN members are Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam.

major challenges will therefore consist in defusing the destabilising security competition between China and major neighbouring countries, notably Japan, India and Vietnam, avoiding the “Finlandisation” of East and Central Asia and averting a lethal confrontation between China and the United States.

Globally, the United States capacity to lead is now diminished and will continue to be so over the medium term. The United States economic strength, a key factor for its global prestige and influence, was critically eroded by the last financial crisis and its massive budget deficits. Its moral standing was damaged by its military expeditions in Afghanistan and Iraq. And the gridlocked Washington is undermining the U.S. credibility as a reliable partner, the trenchant polarization of its polity leading to paralysis in decisions, unfulfilled international commitments and the inability to carry consistent strategies and their implementation across multiple political cycles. Although none of the rising powers is capable of exercising global leadership in the foreseeable future, China’s rising economic power and assertive foreign policies will irremediably spur the fraying of long standing Western and other institutional and informal alliances and a reconfiguration of spheres of influence.

With success come responsibilities

The rising share of East Asia economies in total world exports has been one of the defining features of the global economy in recent decades. Starting with Japan in the 1970s, it is undeniable that the substantial increases in economic growth and human welfare achieved by many Asian economies is tributary to the rule of law that governs the liberal investment, trade and monetary international regime implemented by Western countries under U.S. leadership. The accession of China to the World Trade Organization in 2001 not only facilitated access to the large European and North American markets but was used by Chinese leaders to legitimate many domestic reforms.

A major step in aligning the global governance architecture to the significant shift in the center of gravity of global economic power was taken in 2008 with the formation of the Group of Twenty (G20). Five Asian countries are member of the G20 which purports to be a “premier forum for our international economic cooperation.”⁵ At the outset, the G20 was instrumental in ensuring that the global financial crisis did not cause a second Great Depression. It injected unprecedented liquidity into the world economy through coordinated national actions, including some \$5 trillion in stimulus at the London Summit of April 2009. It reaffirmed the International Monetary Fund (IMF) bilateral and multilateral surveillance role and its function of international lender of last resort, created the Financial Stability Board with a mandate to develop new regulatory standards for systemically important financial institutions, and insisted on new bank capital account requirements under the Basel III agreement. Its members agreed to “standstill” provisions to avoid a recurrence of the ruinous beggar-thy-neighbor policies of the 1930s. The changes agreed in November 2010 at the Seoul Summit to double the IMF resources and better reflect in its governance structure and that of the World Bank the relative weight of members in the world economy aim at giving China and India, in particular, a more authoritative voice in the setting of policy directions.

China has to varying degrees upheld, accepted or adapted to prevailing structures and norms of the international system, except when they clash with its Westphalian conception of the world, or might create serious problems domestically. China has maintained a low profile in global governance and appears to have limited interest in assuming a leadership role. In international forums, it remains hesitant to join the club of "donors" and ambivalent in assuming responsibilities for the provision of international public goods. On balance however, China has deepened and expanded its formal commitments to many international norms, especially in areas such as trade, nuclear non-proliferation and the management of non-traditional security

⁵ Leaders’ declaration at the Pittsburgh G20 meeting, 2009.

threats such as pandemics. Its role in the Six Party Talks on the nuclear ambitions of North Korea, its participation in the P5+1, which led to the Joint Comprehensive Plan of Action framework agreement regarding Iran's nuclear program, and the engagement of the Chinese navy in joint anti-piracy operations with NATO navies in the Gulf of Aden and the coast of Africa shows that China is not allergic to collective action when congruent with its broad interests. Its substantial financial contribution and deployment of medical personnel in Western Africa to deal with the Ebola epidemic may portend a growing engagement in world affairs.

Since 2011, the momentum for significant reforms of major international financial institutions has evaporated. Sure, the G7 was an anachronism but the G20 is too large, victim of its heterogeneous composition and the unwillingness of established members to alter their standing within the governance structures. The reform of the IMF to which the U.S. Administration signed-off in 2010 remains stalled, victim of the U.S. Congress failure to adopt the enabling legislation. Changes to the "political" world governance institutions are prisoners of a similar status protective vise. Membership of the International Energy Agency (IEA) is limited to OECD members. The conspicuous absence of China, India and Indonesia, despite their huge imports of hydrocarbons, weakens the capacity of this multilateral institution to facilitate cooperation between energy-consuming countries. In its own backyard, Japan's voting share of the Asian Development Bank ("ADB") is more than twice that of China and the bank's president has always been Japanese. More broadly, it is accepted that institutions like the UN Security Council are in need of reform if they are to retain their credibility. Demands by India and Japan for a permanent membership on the UN Security Council have been actively opposed by China which is in a position to smother proposals to change the composition and workings of this premier organ of world governance by virtue of its status on the Council.

A polycentric geopolitical landscape

History teaches that polities seek power and status commensurate with their wealth. Increasing military expenditures, conflicting territorial and maritime disputes coupled to the fact that five of the eight declared nuclear states are in or border Asia are affecting regional security dynamics. The presence of three major Asian powers which actively compete with each other for influence and leadership in the region is fraught with risks, especially since their population still harbor resentment between each other. Whether the competition between China and the United States for regional influence can be managed peacefully will remain a source of concern. This general state of affairs renders the continued pursuit of a stable balance of power an absolute priority for Asian countries.

The rise of China as a global economic engine is bound to give rise to profound geopolitical consequences. In the region, China has become the largest trading partner for ASEAN, India, Japan and South Korea displacing the United States which, heretofore, enjoyed that position and the influence that attaches. Asians view the United States as the only power that can contain China, but no Asian country wants to be forced to choose side for fear of jeopardizing the benefits accruing from their close economic ties with China. The frangibility of the allegiances is not limited to Asian countries. In the Middle East, Saudi Arabia has initiated a pivot to Asia, an economically rational policy now that it sells more than two-thirds of its oil in South and East Asia markets and that North America is poised to become a net exporter.

The European Union is also vulnerable to deepening geostrategic cleavages. Germany's foreign policy has unmistakably edged towards a rapprochement with China. Since 2011, the two countries have held annual joint Cabinet meetings, a first for China. Given Germany's ascendancy within Continental Europe, particularly vis-à-vis central and eastern European members, this rapprochement is bound to imprint a tighter alignment between China and the European Union foreign policies which could pose problems. Henry Kissinger's warning, albeit in other circumstances, that

Germany will "avoid controversy outside of Europe, even when they affected fundamental security interests" with all the consequent reverberations on European unity and the undermining effects on U.S. leadership, remains apt. For instance, what attitude would Germany adopt should an Asian version of an occupation or annexation "à la Crimea" occur?

At the same time, the *Ostpolitik* between Germany and Russia (and similarly with Italy) is not shared by the countries on its periphery and is viewed with alarm by Poland and Baltic members. To be fair, Chancellor Merkel demonstrated outstanding leadership in her own country and at the European level in her response to Russia's annexation of Crimea despite significant opposition from influential Germans, including former Chancellor Gerhard Schroeder and former President Roman Herzog and the German business community. Notwithstanding the alignment of Germany with the United States in the Ukraine crisis, it remains that the *Westbindung* is now a choice that German leaders may not pursue with the same vigor in the future as they contend with a fragmented public opinion on the role of Germany in European and international political and security affairs. How will Germany, and it follows, the European Union, calibrate its foreign policy between Russia and China since the two countries compete fiercely in Central Asia to establish or maintain their sphere of influence?

At the APEC Summit in October 2014, President Xi Jinping's proposed the creation of the Asian Infrastructure Investment Bank (AIIB), a multilateral development bank with the mandate to provide infrastructure investment loans to its Asian partners, and invited countries to join, before March 31st, 2015, as "founding members".⁶

AIIB's stated mission to fund infrastructure has endeared the initiative with Asian countries which view it as a welcomed addition to the existing multilateral

⁶ In addition to China, the initial round of founding members is comprised of Bangladesh, Brunei, Cambodia, India, Kazakhstan, Kuwait, Laos, Malaysia, Mongolia, Myanmar, Nepal, Oman, Pakistan, Philippines, Qatar, Singapore, Sri Lanka, Thailand, Uzbekistan and Vietnam.

institutions which lack the resources to fill Asia's massive infrastructure funding gap estimated by the Asian Development Bank ("ADB") at some \$8 trillion between 2010 and 2020. The AIIB initiative has set off a heated diplomatic battle with the United States which has actively lobbied allies not to accept China's invitation to become founding members. Despite the overt efforts of the Obama Administration, Australia, India and South Korea and also two of China's recent antagonistic neighbours in the context of the South China Sea claims – Vietnam and the Philippines – signed up as founding members. The United Kingdom followed with its March 2015 announcement that it was joining as a founding member. This decision by an European ally was prompted, in part, by Britain's drive to establish the City of London as the world's largest international exchange center for the Yuan. The United Kingdom is also the largest recipient of Chinese investment in Europe. The British decision to join was quickly followed by that of France, Germany and Italy. Whether the AIIB, the World Bank and the ADB will be competing or partner institutions is a legitimate question but, underneath, lies the deeper concern of the United States and Japan that China will use the new bank to expand its influence at their expense. The whole episode is a diplomatic defeat for the United States which will be seen in many quarters as another manifestation of its waning power.⁷

The obvious conclusion is that the "degrees of freedom" enjoyed heretofore by the United States in global affairs are being significantly curtailed and the window may well be closing more rapidly than presently foreseen. The statecraft needed to navigate successfully through this uncharted geopolitical environment remains work in progress, a task incumbent not solely on China and the United States but also for all other major economies.

⁷ Canada missed the deadline of March 2015 to sign on as a founding member.

The changing nature of international business competition

The rapid growth of exports from Asia was accompanied by a structural shift in its composition, from primary commodities to manufacturing, a reflection of the success of these economies to integrate and structure the extensive global supply chains that account for more than 35% of total trade in manufactured goods. The competitiveness of the Asian manufacturing stems from its specialization in electronic, electrical goods and automotive industries and the tight fit of its supply chain networks between regional and global integration. Today, 5 of the top 15 manufacturers by share of global nominal manufacturing gross value added are Asian countries.⁸

Intra-Asia trade is skewed towards parts and intermediate products within supply chain networks. Its composition reflects a specialization across the region where Japan and South Korea provide the high technology components, other East Asian economies supply parts and components and China is the leading center for their final assembly. Hence, the nature of trade within Asia differs from its exports to Europe and North America which are dominated by final goods. Vertical trade involves the import of intermediate goods. When domestic firms engage in vertical trade, a certain volume of more complete or final goods will return to the home country. Tariffs on such imports act as impediments to their expansion abroad. Moreover, there exists a strong complementary relationship between vertical trade and foreign direct investments ("FDI"). Consequently, barriers to FDI between countries become as important as bilateral trade restrictions and, therefore, liberalization of both activities is needed to partake into vertical trade networks. A telling example – the Apple iPhone – is illustrated in Table 1.

⁸ These countries, and their ranking, are: China (2), Japan (3), South Korea (7), India (10), Indonesia (13). The United States is first and Canada holds the fifteen rank.

Table 1.
iPhone Production Costs

Components	Major suppliers		Amount of money per unit (U.S. dollars)
	Japanese firms	Non-Japanese firms	
NAND Flash Memory	Toshiba	Samsung (Korea), Hynix (Korea)	19.2
DRAM	Elpida	Samsung (Korea)	9.1
Display	Toshiba, Sharp	LG (Korea), Chimei (Taiwan)	23.0
Application Processor		Samsung (Korea)	15.0
Camera Module	Sony		17.6
Bluetooth/WLAN and other communication equipment	Murata	Qualcomm (U.S.), Avago (U.S.), Broadcom (U.S.), TriQuint (U.S.)	30.0
Battery	Sony, TDK	Samsung (Korea), LG (Korea)	5.9
Mechanical/Electro-Mechanical	Ibiden		33.0
Cost of other components			35.1
Total cost of all components			187.9
Manufacturing cost			8.0
Gross profit margin			453.1
Retail price			649.0

Note: The costs and prices are for the iPhone4S (16GB) in 2011. The retail price is SIM-free and without contracts.

Source: Shirakawa M., "Japan-US Economic Relations: What we can learn from each other", Bank of Japan, April 2012

The trade agenda

The remarkable success of East and Southeast Asia in global manufacturing was made possible by policies enticing foreign direct investments – notably by Japanese, South Korean, American and European corporations - which are drivers of vertical trade and the gradual knitting of a complex web of bilateral and regional free trade agreements (FTA) to ensure that the fragmentation of production across countries within an industry supply chain was not hindered. According to the ADB, there are close to 250 FTAs involving Asian countries that have been concluded or are under negotiation.⁹ ASEAN has emerged as the nexus of the network of FTAs that link Asia. About 55 percent of Asia's trade is conducted among Asian economies.

⁹ Asia Regional Integration Center (ARIC) website, <http://aric.abd.org/>

Paradoxically, the major casualty from the rise of emerging economies has been multilateral trade liberalization. The stance adopted by the major emerging market economies, notably Brazil, China and India, during the Doha Round of multilateral trade negotiations which started in November 2001, have not only played a part in the historic failure to reach an agreement but comforted many leaders in developed economies in the idea that the WTO multilateral approach was lopsided and that it no longer served their interests. And why should Western economies promote the economic interdependence that sustains overall growth but simultaneously produce geopolitical rivals? The response to this contemporary policy dilemma has been a systematic drive by major industrialized economies to eschew the WTO multilateral regime in favour of bilateral and regional free trade agreements. The United States has been particularly active on this front which, in turn, spurred a stampede by other countries to reach similar agreements in order to immunize their economies from the cost of trade diversion that was bound to ensue.

FTAs are not only instruments for economic integration but also a means to structure international relations. Launched in 2010, the U.S. led Trans Pacific Partnership ("TPP") is a case in point.¹⁰ It now encompasses twelve countries which, combined, produce 40 percent of global GDP.¹¹ The U.S. "partners" account for 45 percent of U.S. exports and 37 percent of U.S. imports. However, there is much less than meets the eye: 75 percent of this trade is already conducted within the confines of the FTAs six of the 11 other nations already have with the United States.

The defining aspect of the TPP is that China and Indonesia are absent from the table. The first is the largest trading partner of most Asia-Pacific countries whereas the second has been the leading force of ASEAN throughout its history. Their exclusion

¹⁰ Its antecedent is the Trans-Pacific Strategic Economic Partnership concluded in 2005 by Singapore, Brunei, Chile and New Zealand. The United States used this FTA as a building block for its TPP proposal.

¹¹ The twelve countries engaged in the TPP negotiations are: Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States, and Vietnam. Only 4 are members of ASEAN.

has painted the U.S. initiative as a means to contain Chinese influence in the region and a tool to exert additional leverage in its dealings with China, a suspicion reinforced when Japan joined the negotiations in 2013. U.S. Defence Secretary Ashton Carter's comment that TPP is the economic complement to the U.S. military rebalance to Asia and as important as "another aircraft carrier" does not suffer from a profusion of ambiguity. From Indonesia's perspective, TPP is seen as a clumsy attempt on the part of the United States to take the leadership of South East Asia trade and foreign investment agenda and, consequently, threaten the balance of power ASEAN as assiduously sought to achieve since its inception. There are also concerns that a successful conclusion of the TPP negotiations would give rise to centrifugal forces that would disrupt the current trade patterns within Asia. The response to the U.S. led TPP took the form of ASEAN's Regional Comprehensive Economic Partnership ("RCEP") which has gathered China's active support from the outset. The RCEP involves all ASEAN members and the six FTA partners, including Japan, South Korea and India, but excludes the United States.¹² While the RCEP and TPP are generally considered as competing schemes, both China and the United States have downplayed the rivalry.

The RCEP and the TPP represent two different models and approaches to regional economic integration in the Asia Pacific region.¹³ The dynamics within the RCEP and the TPP are also quite different. Led by the United States, the TPP is labelled as a group of "like-minded" countries seeking to achieve a high-standard and comprehensive FTA in order to correct the weaknesses in existing regional agreements. The approach is rules-based. In contrast, the China led RCEP "seeks harmony but not uniformity". The primary goal is to multilateralise the regional

¹² The countries participating in the RCEP negotiations are the ten ASEAN members (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Vietnam) and the six states with which ASEAN has existing FTAs (Australia, China, India, Japan, South Korea and New Zealand). RCEP negotiations were formally launched in November 2012 at the ASEAN Summit in Cambodia.

¹³ Wilson, Jeffery D., *Mega-Regional Trade Deals in the Asia-Pacific: Choosing between the TPP and the RCEP?* 45 (2) *Journal of Contemporary Asia* 345, 2015.

trade system by combining the overlapping ASEAN-plus FTAs into a single agreement. This objective is also in line with ASEAN's efforts to implement the ASEAN Economic Community ("AEC"). The pressure of non-ASEAN countries to conclude the RCEP may indeed quickened the pace of ASEAN's own economic and political integration, a favorable outcome, if any.

From a wealth creating point of view, the results of recent studies conclude that although the RCEP is a less ambitious trade architecture than the TPP, if successfully concluded, it would generate annual benefits of 0.6 percent of GDP in 2025, larger than the 0.2 percent of GDP TPP would yield. This is because the RCEP addresses larger pre-existing trade barriers, principally among China, India, Japan and South Korea.¹⁴ Notwithstanding these substantial recurring benefits, their successful conclusion is not a foregone conclusion. In the case of RCEP, significant development gaps among RCEP members, the lack of commonality across ASEAN plus one FTAs and varying domestic policies, the lack of domestic support, and concurrent regional integration agendas, constitute difficulties that may be hard to overcome.¹⁵ The TPP is confronted with the intractable roadblocks to the liberalisation of trade in agricultural products. Although the relevant U.S. House and Senate committees have passed the Trade Promotion Authority legislation in mid-April 2015, there remains strong opposition to "fast track" the TPP in the U.S. Congress. Should Congress fail to adopt this legislation, the negative consequences for the United States would be severe and long-lasting.¹⁶

China is not indifferent to the U.S. trade strategy. In April 2008, China signed a free trade agreement with New Zealand, the first with any developed country.¹⁷ In November 2014, it concluded a free trade agreement with Australia and announced

¹⁴ "State of the Region 2014-2015", Pacific Economic Cooperation Council, 2014.

¹⁵ Sanchita Basu Das, *Challenges in Negotiating the Regional Comprehensive Economic Partnership Agreement*, ISEAS Perspective No. 47, August 2013.

¹⁶ Altman, Roger C., Richard N. Hass, *Why the Asian Trade Deal Matters*, New York Times, 4 April 2015.

¹⁷ New Zealand's exports to China increased from \$ 4 billion in 2010 to \$11 billion in 2014.

that it had "effectively" reached a free trade agreement with South Korea. All three Asia-Pacific countries have a bilateral trade agreement with the United States. President Xi Jinping push at the November 2014 APEC Summit for the Free Trade Area of the Asia Pacific (FTAAP) is widely considered as a cunning initiative to relegate the U.S. led Trans Pacific Partnership (TPP) to a subsidiary platform. It should also be seen as a clever way to signal China's willingness to engage in discussions with the United States concerning a free trade agreement as well as a defensive move to counter the trade diversion cost that will accrue from the implementation of the EU-USA Transatlantic Trade and Investment Partnership. In the years following the 2003 conclusion of the Comprehensive Strategic Partnership between China and the EU, the EU has become China's largest trading partner. Hence, the potential for trade diversion at the expense of China stemming from a EU-US trade agreement is not inconsequential.

Industrial competition

On account of their size and rapid per capita GDP growth, China, India and Indonesia have become very large markets in a growing list of consumer and industrial goods. Taking advantage of these favorable circumstances, many Chinese and Indian firms have reached size and productivity levels comparable to that of the largest multinational companies that, heretofore, dominated their industry.¹⁸ They are also growing at a much faster pace, despite the fierce competition that generally prevails in these large markets. A comparison of the concentration ratios in the Chinese and American manufacturing industries found that China has sharply lower concentration ratios suggesting that "markets for Chinese manufactured products

¹⁸ In the mechanical engineering sector, Shanghai Electric Group (electrical equipment), Beijing Jingcheng Machinery (mechanical equipment), Gree Electric Appliances (HVAC equipment), Harbin Power Equipment (power systems) and Shanghai Zhenhua Heavy Industries (material handling), each have annual revenues exceeding \$20 billion.

are considerably more competitive than the U.S."¹⁹ The suggestion that Asian ITC companies will do far better outside their borders than their Western counterparts will do in their domestic market, not because of regulations but for cultural reasons, may prove accurate.²⁰ The huge success of Alibaba, an internet retailer, is a case in point. However, that may not be the case in other sectors since their global footprint and influence is shallow. The distinction between "made-in-China" where domestic and foreign-owned establishments supply or assembled products for the world's largest established brands and retailer's private labels and "made-by-China" reflects huge differences in industrial capabilities.

It is well established in the academic literature that home demand determines the pattern of specialization and the level of quality of export products.²¹ The large Asian emerging markets are dominated by high volume, low cost products. Consequently, the level of price competition in many industries will increase considerably with the business imperatives that ensue. Yingli solar panels and Xiami's "good enough", well-designed, reasonably priced "Mi" smart phones are harbingers of the nature of competition Western firms will increasingly encounter in their domestic markets. Investors will have to get used to corporate reports stating "our hardware products are increasingly subject to competition from existing and new entrants from emerging markets such as China, which compete aggressively on price at the lower priced end of the market."²² The response of Western firms to high-volume, low-cost Asian manufacturers needs to be high-skill innovation and development and highly customized designs. A recent study of the China effects on technology and jobs in Europe concludes that around 15 percent of technical change

¹⁹ Wang, Jun, John Whalley, *Are Chinese Markets for Manufactured Products More Competitive than in the US?: A Comparison of China – US Industrial Concentration Ratios*, NBER Working Paper No. 19898, February 2014.

²⁰ Michael Moritz's posting on LinkedIn on November 12, 2014. He is Chairman of Sequoia Capital.

²¹ Dingel, Jonathan, *The Determinants of Quality Specialization*, The University of Chicago Booth School of Business, November 2014.

²² Trimble Navigation Limited, 2014 Annual Report, p.12.

that occurred in the past decade can be attributed directly to competition from Chinese imports.²³ There will be no place for complacency.

To conquer markets in advanced economies, Asian firms (other than Japanese, South Korean and Taiwanese multinationals) will need to adjust to the new competitiveness paradigm taking hold in affluent markets and significantly raise their R&D expenditures to match the innovativeness, the design excellence and product quality levels attained by the global leaders in their industry. Whether or not Chinese, Indian and Indonesian companies will be as successful as Japanese and South Korean firms in establishing global brands in the manufacturing sector remains an open question. The few exceptions that confirm the rule, such as Haier in consumer appliances, Huawei in telecommunications equipment, Lenovo in personal computers, Sany in digging equipment, Aditya Birla Group, the world's largest aluminium rolling company and the world's largest producer of viscose stable fiber, and Tata Communications, the world's largest fibre-optic network, show that this is not out of reach.

The Third Plenary Session of the 18th Central Committee of the Chinese Communist Party in November 2012 initiated significant departures from China's habitual policies towards foreign direct investments. In August 2013, the State Council established a free trade zone ("FTZ") in Shanghai as a means to reduce the administrative burden and ease restrictions on investments. The FTZ territory was expanded at the end of 2014 to include Shanghai's commercial center where major multinational companies and Chinese banks are located. At the same time, similar FTZs were created in Guangdong, Fujian and Tianjin.²⁴ The adoption of the "negative

²³ Bloom, Nicholas, Mirko Draca, and John Van Reenen, 2011, *Trade Induced Technical Change? The Impact of Chinese Imports on Innovation, IT and Productivity*, CEP Discussion Paper No. 1000, London Centre for Economic Performance.

²⁴ The strategic positioning of these FTZ is worthy of note. Tianjing is well-connected to South Korea and Japan, Guangdong is close to Hong Kong and Macao and Fujian is linked to Taiwan and Southeast Asia.

list" approach to replace the traditional investment guidelines is a major step that conforms to the practice of developed countries in investment bilateral treaties.

The launch of negotiations of a China-EU Bilateral Investment Treaty ("BIT") in November 2013, which followed the resumption of the China-US BIT in July 2013, give a measure of China's ambitions. A major objective of China's policy of overture to inward and outward foreign direct investments is to "encourage" Chinese firms to establish an industrial and commercial presence in the major advanced economies through the acquisition of advanced technology and high quality brands. In 2014, Chinese deals in Europe amounted to \$18 billion, up from \$2 billion in 2010. On March 22nd, 2015, China National Chemical Corporation announced that it was acquiring Pirelli for \$7.7 billion. The same is happening in North America. In 2013, Shuanghui International acquired Smithfields, the largest U.S. pork producer, for \$4.7 billion and rebranded itself WH Group to enhance its positioning in China. Although there is no doubt that the Chinese acquisition strategy, reminiscent of the one pursued by the Japanese in the 1980s, still has a long course to run, it is less certain that Chinese firms can make the wrenching changes to their management practices that multinational businesses required and successfully managed their acquisitions. Other Asian industrial groups have already – as is the case for Indian companies – or are expected to embark on a similar course, marking another phase in the globalisation of business organizations.

The impact of the large domestic demand on the industrial structure of large Asian countries is particularly evident in the resource industries. The expansion of Asian national resources companies is driven by both security of supply concerns and a commercial drive to access new opportunities. Over the past decade, Asian private and state-owned multinationals have become increasingly competitive in international markets. Their successes have stroke fears in many milieus that Asian state-owned enterprises (SOEs) act as agents of their government in the pursuit of their foreign policy agenda. There is significant evidence that, as a rule, large

investments by Asian multinationals are commercially driven.²⁵ People familiar with major Chinese and Indian foreign investment projects know that they have not been problem-free, often saddle with substantial cost overruns. This has not gone unnoticed by Chinese authorities.²⁶

A more pragmatic response to the global expansion of Asian companies has been the increasing number of partnerships between Asian and Western multinationals where the Western companies trade their international and technical know-how for risk capital and access to Chinese, Indian and other large Asian domestic markets. The July 2014 cooperation agreement between SNC-Lavalin Inc. and China National Nuclear Corporation to build two CANDU reactors in Romania, followed by the November 2014 framework joint venture agreement to build Advanced Fuel CANDU Reactors ("AFCR") in China and develop opportunities for it globally constitute a good example of this trend. The AFCR technology was chosen because this reactor can use recycle uranium and plutonium produced by China's growing fleet of light water reactors ("LWR") and thus reduce considerably the hazards associated with LRW spent nuclear fuel. Hence, the merits of this agreement go far beyond its commercial and financial aspects; they include environmental and nuclear non-proliferation benefits of global import.

²⁵ For a recent analysis, see *By All Means Necessary*, Elizabeth Economy and Michael Levi, Council on Foreign Relations, Washington D.C., 2014

²⁶ Shao Ning, Vice-President of the State-Owned Assets Supervision and Administration ("SASAC") of the State Council commented at the April 2012 Boao Forum for Asia that he was: "...concerned about the Chinese enterprises going global because they lack the ability to operate internationally, have limited talent available, and know little about the foreign investment environment, especially the judicial environment". These comments were followed by the adoption of new rules governing foreign investment by large central government controlled SOEs, "The Interim Measures on Supervising and Managing Offshore Investments", State-Owned Assets Supervision and Administration Commission, 18 March 2012.

The natural resources supply imperative

The rapid rise of Asian economies will continue to have profound implications for the world economy in the decades ahead. In particular, their skinny endowment in natural resources in relation to their huge requirements is a major source of insecurity about the availability of energy, food, water and other commodities in sufficient quantities at reasonable conditions. The competition that ensues to preserve or secure adequate supplies for the future accentuates the strategic and political rivalries between major Asian economies and with bordering countries which, in turn, has a corrosive impact on the trust that must be nurtured between neighbours. The disruptions caused by China's curtailment of rare earth exports in 2010 in the wake of an incident in the East China Sea have demonstrated the vulnerability of modern economies to the use of resources as political tools.

The dependence of most Asian economies on seaborne supply translates into a scramble to secure an abundant and stable supply of natural resources which increases volatility in world commodity prices and the pursuit of policies pregnant with serious destabilizing effects, in the region and globally. The quest for resources carries significant ramifications for the Western corporations that must compete with state-owned resource companies and Asian government initiatives to access resources in different parts of the world. Europe must contend with its vulnerability to the unpredictability of supply of energy from the Middle-East and Russia. Well-endowed in natural resources, Canada and the United States must decide what role they will play, if any, to foster a less volatile and contentious international environment for strategic mineral resources and food.

Nowhere is the energy-water-food nexus and its ripple effects on the environment more challenging than in Asia since the strains on any one can cripple the others through the interdependence of these resources on one another and, in a domino effect, cause a disaster. Although the responsibility of Asian economies to the

preservation of the global commons should not be eschewed, their actions to avoid environment degradation and to contain climate change are first and foremost in their immediate interest. Already, water pollution, water scarcity and the desertification of large expanses are endangering the health of millions. Asia is also highly vulnerable to rising sea levels and intensified storms. According to the Center for Global Development, Asia accounts for seven of the world's ten countries most vulnerable to rising sea levels: Bangladesh, China, India, Indonesia, Japan, the Philippines and Vietnam. 42 million Asian people were displaced in 2010 and 2011 alone due to disasters caused by changes in climatic patterns. The high population density, particularly in their coastal megacities, intensifies the scale of the challenge. In addition to spurring rural-urban migration, the consequences in terms of inundation and salinization of agricultural lands, flooding and dwindling water supply are wide ranging. Confronted with those ecological challenges and the human cost stemming from the large proportion of their population that breathe unsafe air, an increasing number of Asian leaders are concluding that unless major actions are taken, the environment will no longer be able to keep pace with economic development.

Several indications provide comfort that willingness to address climate change at the global level is firming up. The November 2014 Accord between China and the United States on limits of CO₂ emissions is generally considered a meaningful breakthrough. This was followed in December 2014 with the Lima Call for Climate Action in which, for the first time, all countries committed to cutting their greenhouse gas emissions. The agreement provides that wealthy countries will help developing countries fight climate change by offering climate aid and investing in clean energy technology. Earlier in 2014, the United States and China, along with 12 other WTO members, have begun negotiating a plurilateral agreement on environment.²⁷ The purpose of

²⁷ This initiative builds upon the 2012 APEC member economies commitment to liberalize trade in 54 environmental goods by capping tariffs to 5 percent by the end of 2015.

the Environmental Goods Agreement is to reduce tariffs on about 400 products related to the fight against climate change. It is clear, however, that the key milestone is the Paris conference, in December 2015, where success hinges on the determination of the four major greenhouse gases emitters – China, the United States, the European Union and India – to come forward with proposals on curbing emissions.

Water insecurity and emerging tensions

Water stress is becoming a major cause of interstate tensions over shared resources, exacerbating long-time territorial disputes and imposing hardships on large populations. Asia is home to many of the world's great rivers and lakes, but its huge population and exploding economic and agricultural demand for water make it the most water-scarce continent on a per capita basis. China and India, for example, account for 37% of the world's population but have only 10.8 percent of its freshwater. Many of Asia's water sources cross national boundaries, and as less and less water is available, tensions between riparian countries will rise. The potential for conflict is further underscored by China's control of the Tibetan Plateau, the source of most rivers in Asia.²⁸ The major rivers originating from the Greater Himalayan region are vulnerable to climate change. The serious threat to food security in their downstream regions stemming from disruptions in flow and monsoon patterns consequent to a reduction in snow and glacier meltwater from the Hymalayans demands coordinate actions to deal with the long-term ramifications of growing water insecurity.

Efficient transboundary water management calls for regional collaborative mechanisms organized on a wide basin basis encompassing transnational rivers, lakes and aquifers, with norms and rules that promote sustainable practices,

²⁸ The major rivers originating from the Tibetan Plateau include the Amu Darya, the Brahmaputra, the Indus, the Yangtze, the Ganges, the Yellow, the Mekong, the Irrawaddy, the Salween and the Tarim.

conservation and water quality. Regional cooperation at the political and technical levels is necessary to mitigate the risks that arise from the damming of transboundary rivers and the overexploiting of aquifers that straddle international borders. However, to date, India's response to entreaties by its neighbours concerning transboundary rivers has not been very constructive, a legacy of the conflicts that have marred South Asia since the partition of India. For its part, China has given the cold shoulder to multilateral efforts to establish basin management organizations such as the Mekong River Commission and to co-riparian urgings to institutionalize water-sharing arrangements.²⁹ The consequences of this institutional deficit stemming from Asia's murky hydropolitics are fraught with risks that may well be more potent than armed conflicts since water is essential for food production; its growing scarcity coinciding with soaring food demand from changes in the diet of a rising urban middle-class population should not be casually dismissed.

The rising challenge of food security

Food security resonates in the psyche of people and, therefore, in perceptions of national interest. Consequent to rising incomes, increased demand for better nutritional foods and meat-rich diets will overwhelm the already stretched agri-food production capacity and further aggravate food security issues. The problems are compounded by the short and long-term challenges to food security posed by the effects of climate change which are most likely to undermine the already precarious state of food security in China, India and several other Asian countries.

²⁹ China has been more inclined to engage in bilateral agreements. The bilateral cooperation between China and Russia over the Amur River, which forms the border between the two countries, is a case in point. China is party to about 50 bilateral treaties concerning transboundary water resources despite the fact that many are related to multi-state river basins. The sticking point about water sharing agreements and basin management mechanisms is that they must cover the whole territory without regard to national borders.

The quest for food supply is not always innocuous; it can exacerbate tensions within the region. The large increase in per capital consumption of halieutical products by the population of China coupled with the fact that overfishing and heavy pollution in inshore waters has led to a rapid depletion of these resources which used to account for more than 50 percent of supply, means that the strong demand can only be met by increased catches in the offshore waters. As these waters are often located in neighboring countries EEZs or disputed territory, the stage is set for repeated clashes between fisherman and Coast Guard authorities, fueling tensions.

ASEAN leaders have stated that "food security remains a major challenge for ASEAN".³⁰ One major objective of the ASEAN Economic Community (AEC) is to build a single market and production base in the agriculture and fisheries sectors. It is expected that community wide standardisation mechanisms, coupled with single window policies, more harmonious safety standards and integrated transportation systems, will constitute powerful drivers of regional food trade and enhance their competitiveness as agri-food exporters to the rest of the world.

To cope with the food security challenge, food imports will have to be increased and an active foreign investment strategy in sectors where domestic production is unlikely to meet demand may need to be pursued. China, in particular, has been very determined in the pursuit of such strategic responses. In this context, thriving and healthy agri-food relationships with the European Union, the United States and Canada would bring immense benefits to all parties. The fear that the United States could leverage food supply for political or diplomatic gains against China does not stand to close scrutiny. Hence, concerted efforts should be made to hasten the spread of a paradigm shift in food security strategy where international agricultural and food resources are assigned a much larger role in addressing the Asian food challenges.

³⁰ Leaders statement at the 21st ASEAN Summit held in Cambodia in 2012.

Energy matters

According to the ADB, by 2035, most Asian countries will produce less than half the energy they need, and many will produce only a tiny fraction. Asia is thus heavily dependent on global markets to ensure the energy supplies necessary to sustain continued economic growth and eradicate poverty. Asia's trajectory toward increasing energy dependence spurs actions to diversify both the supply and fuel sources, lessen the detrimental impact on the environment and reduce the vulnerability of the lines of supply to disruptions and threats from unfriendly acts. These issues are bound to be at the forefront of national and international debates for years to come.

In Asia, coal is the cheapest fuel source, easy to transport, and available from multiple suppliers, which explains why demand was up over 400 percent from 1980 to 2010. Coal will continue to play a central role in Asia's energy mix for the foreseeable future despite the real efforts of Asian countries to insulate their economies from price shocks and supply disruptions by employing all available fuel sources, including coal, gas, nuclear, and renewable energy resources, to diversify their energy mix. For instance, in China, the growth of coal use has been curtailed from 9 percent in 2011 to 2 percent in 2013. Rising energy consumption from fossil fuels has serious implications for the environment. Meeting climate change goals and safeguarding the environment necessitate the adoption of measures and technologies to improve energy efficiency, the widespread use of clean coal technology (CCT) and heavy reliance on hydro and nuclear power for electricity base load.

The vulnerability of the hydrocarbon supply lines is another major source of security concerns: Japan and South Korea are almost completely dependent on seaborne imports; China and India import 90 percent of their needs by sea. The bulk of this cargo which transits from the Arabian Sea to the South China seas relies on the U.S.

Navy to patrol and secure Indo-Pacific sea lanes, a situation not totally satisfactory from a Chinese perspective.

The past decade has seen a radical shift in the global energy map as unconventional oil and gas production in Canada and the United States is ramping up at levels sufficient to displace traditional suppliers on the international energy market. Now that the United States is no longer dependent on the oil rich regions of the Persian Gulf, its commitment to Gulf security is bound to weaken, notwithstanding the fears that the region is increasingly unstable. Indeed, the proposition that guaranteeing stability in the Persian Gulf is no longer a core U.S. interest is gaining currency. What this means for the European Union and Asian countries that will be tributaries of Middle East oil producers is a question that is bound to come to fore.

The energy interest of Northeast Asia and North America are closely aligned. Rising Asian demand, the relative abundance of North American energy resources and the commercial viability of the new supplies are propitious conditions for increasing trans-pacific energy trade. Security is significantly improved since the North American countries are politically mature and stable and maritime transport over the Pacific avoids the chokepoints in the Indo-Pacific sea lanes and other threats, real or potential, in the China seas. It is important to note that the high-probability threats to regional maritime energy security in the Indo-Pacific straights are non-state threats – extreme weather, seismic activity, and piracy – rather than states.

Reaping the benefits of this profound paradigm shift in energy trade is dependent on the ability to overcome two major inhibitors that shackle the development of this new commerce. The first pertains to transportation infrastructure which will be a key factor in determining how much energy is exported from North America to Asia and Europe. The second impediment is the local and regulatory barriers that hinder the North American development of domestic energy infrastructure projects. The consequence of such domestic procrastination on the standing of both Canada and

the United States in international fora as proponents of open and transparent global markets is that it seriously undermines their influence and capacity to lead.

Notwithstanding the virtues of North American energy supply, it is implausible that China would allow itself to become dependent on this source to satisfy its energy needs. Moreover, China critical domestic resource shortages include food and many other mineral resources. In its global quest for resources, the main strategic challenge is to ensure that the source and supply lines are located, as much as possible, within an environment under its control or influence. The implementation of this strategic imperative has two major strands. The first is to secure access to the Indian Ocean, both in peacetime and in wartime, a concern exacerbated by its conviction that India's current and expanding naval capabilities, particularly in the Bay of Bengal and on the western Indian Ocean close to Africa, could easily curtail merchant and navy movements. In order to reduce its vulnerability, China has embarked on a comprehensive program aimed at circumventing the need to transit through critical choke points. Its strategic initiatives include the construction of the deep-sea port of Gwadar, located close to the Iranian border and the Strait of Hormuz, and overland transportation routes through Pakistan, the construction of ports and overland routes through Myanmar and the promotion of trade and investment to reinforce economic integration through bilateral cooperative treaties to facilitate commerce with China. Not surprisingly, New Delhi has been alarmed by Beijing concerted actions which is viewed as expansionist and aimed at encircling India, a suspicion fed by its growing conviction that the local military balance has tilted in China's favor.

China's preoccupation with the security of supply across the Indian-Pacific waterways is a major factor underlying the major build-up of its naval capabilities and the increase in naval cooperation with Bangladesh, Sri Lanka and the Maldives. China's modernization of its navy has spurred actions in the Asian countries most vulnerable to China's assertiveness, with the allure of an arms race in the making.

This has taken the form of substantial investments in the acquisition of naval capabilities, to the conduct of naval exercises with the U.S. Navy, the conclusion of revitalized bilateral security alliances with the United States and, concurrently, the establishment of a web of intra-Asian bilateral political and security relationships to augment their military capabilities and assuage their concerns about Washington's ability to honour its defense commitments.

Infrastructure Diplomacy

In October 2013, in a speech to the parliament of Indonesia, President Xi Jinping unveiled China's 21st Century Maritime Silk Road proposal. The aim is to expand port access to facilitate maritime trade across Southeast Asia, South Asia, the African coast and the Mediterranean. Although the benefits of enhanced regional connectivity are generally acknowledged, the strategic implications have given rise to concerns about its merits until such time as the South China Sea disputes are resolved. The claim that the Maritime Silk Road infrastructure will be used solely for economic purposes is met with skepticism. Concerns about China's true motivations are heightened by indications that the Maritime Silk Road passes through the disputed South China Sea, an aspect that would have serious implications on regional security. Questions about the roles the Chinese navy and maritime law enforcement agencies will eventually play in the Maritime Silk Road remain unanswered. These uncertainties have fueled domestic debates in key Asian countries that may make it difficult for China to implement its project within the timeframe it anticipates.

The second strand of China's strategy to open markets and secure resources is embodied in the Silk Road Economic Belt proposal put forth by President Xi Jinping during his September 2013 visit to Kazakhstan. This continental expansion policy is designed to gain access to the huge resources in the Russian Far East, in Mongolia, and Central Asia through the creation of a Eurasian "economic corridor" linking

Asian and European markets. From a Chinese perspective, these new trade routes are seen as a means to boost exports, provide new markets to important domestic industries and spur economic growth in China's interior and western provinces that have lagged far behind in the last decades. China's "infrastructure diplomacy" can also be seen as a response to the need to strengthen relations with countries on its continental periphery to compensate for the strained relations with its maritime neighbours.

The Silk Roads initiatives are a priority in Beijing's economic and foreign policies. The proposals are included in the Resolution of the Third Plenum of the 18th Central Committee of the Chinese Communist Party. They were highlighted as one of the priorities for China in 2015 at the annual central conference on economic affairs in December 2014. In the pursuit of its strategy, China can be seen as an über-realist power, implementing a modern version of colonialism; no political border need to change. President Xi Jinping's commitment in October 2014 to allocate \$50 billion to the capital of China's proposed AIIB, followed by his announcement in November 2014 of a US \$40 billion infrastructure fund focused on improving the connectivity – via road, rail and telecommunication – between China and its neighbouring countries to improve trade and other exchanges are clear indications of their determination to get it done.

Geography is a powerful determinant of policies. The outcome of China's expansion strategy is that it will increasingly become a continental power. The success in establishing efficient land connectivity between South/Central Asia with ASEAN and southern China will diminish the relevance of regional institutions focused solely on Maritime Asia such as APEC, unless its membership is expanded to include India and continental Asian countries. Géographie oblige! Failure to do so would likely see competing institutions such as the Shanghai Cooperation Organization strengthening considerably or APEC being replaced, for all intent and purposes, by the East Asia Summit as the preeminent venue for summit-level gatherings to address economic

as well as traditional and non-traditional security matters in the Asian region. Such an institutional evolution would confirm the erosion of the Western influence in the extended Asian region relative to China, India and Russia, since only the United States is a member.³¹

Neither allies nor enemies

U.S.-China relations are undoubtedly one of the most potent bilateral relationships in the world. If its rise is sustained, it is likely that China will soon pose a decisive challenge to U.S. primacy in Asia. The prognostics on the future of Sino-American relations vary from the cautious to the optimistic. Kevin Rudd cautions that “history is not overburdened with examples of how such transitions in geopolitical and geo-economic realities have been accommodated peacefully”,³² while Henry Kissinger pragmatically suggests that “the U.S.-Chinese relationship should not be considered as a zero-sum game, nor can the emergence of a prosperous and powerful China be assumed in itself to be an American strategic defeat.”³³ Paradoxically, the United States involvement in Asia could be seen by all major actors, including China, as a constructive force preventing rivalry between Asian powers from spiralling out of control. The prevalent view held by Asian leaders is that the United States has underwritten the long period of peace, security and stability in the region which has undergirded its prosperity. It is often forgotten that one of the U.S. trump cards in Asia is that, contrary to all other powers jockeying for position, it has no territorial ambitions in the area. Clearly, defending strict adherence to the UN Law of the Sea

³¹ The East Asian Summit is composed of ASEAN + 6 plus USA and Russia. ASEAN + 6 is composed of the 10 ASEAN members plus Australia, China, India, Japan, New Zealand and South Korea.

³² Kevin Rudd, Remarks at the 70th Morrison Lecture, Australia 2011. Mr. Rudd is a former Australian Foreign Minister.

³³ Henri Kissinger, *The Future of U.S.-Chinese Relations*, Foreign Affairs, March/April 2012.

Convention does not carry the same stigma as offensive actions to assert one's ownership of disputed territories.³⁴

Although China has not been involved in armed conflict with a neighbour since the Sino-Vietnam War of 1979, several flash-points could rapidly enflame and raise tensions to the level of armed conflicts.³⁵ China's actions in the diplomatic spat with Japan over the disputed Diaoyu/Senkaku Islands and with the Philippines and Vietnam over the Spratly Islands are seen as a harbinger of things to come. Tit-for-tat actions could spiral out of control even if some of them in and of themselves have little practical consequences. China's declaration of an Air Defence Identification Zone (ADIZ) over a large section of the East China Sea, including the Diaoyu/Senkaku Islands, is a case in point. In international law, ADIZ do not necessarily correspond to territorial limits; for example, Canada's ADIZ covers half of the Arctic Archipelago. The situation would become much more problematic if Beijing unilaterally declared an ADIZ over the entire South China Sea even though it would have no territorial basis in international law. The building of artificial islands on tiny outcroppings, atolls and reefs in the Spratly Archipelago to support its claims to about 85 percent of the South China Sea casts China as a bully since this string of promontories is well within the exclusive economic zones of the Philippines, Malaysia and Vietnam. The fear is that tensions arising from the territorial disputes with China, the status of Taiwan or from lethal provocations or collapse of North Korea, could escalate into protracted conflicts since the United States is often bound by a security alliance with aggrieved countries.

The importance ASEAN, Australia, Japan, South Korea and the United States have been giving to their relations with India are, to a large extent, prompted by their

³⁴ See statement of Secretary Clinton at the 2010 annual meeting of the ASEAN Regional Forum and Bader J.A., *Obama and China's Rise – An insider account of America's Asia Strategy*, Brookings 2012.

³⁵ Previous military conflicts subsequent to the Korean War include the Taiwan Strait Crises of 1954 and 1958, the Indian border clash of 1962 and the conflict with the USSR along the Ussuri River in 1969-71. All these conflicts were in China's immediate periphery.

determination to ensure that the Asian security environment remains pluralistic rather than Sinocentric. Moreover, India's democratic polity is seen as a fundamental value, a character that makes it a desirable partner for many Asian countries, the USA and other democratic countries, despite its often chaotic and unpredictable workings. After decades of estrangement, the rapprochement between the United States and India initiated by President Clinton, engineered by President George W. Bush and nurtured by President Barack Obama is significant.³⁶ The tangled relationships with Pakistan have long been a major impediment to US-India cooperation.³⁷ However, with the pull-out from Afghanistan, Pakistan is bound to lose significance for the United States. The two countries share a growing distrust of Pakistan and are alarmed by the widespread extremism there. The demonstrated perfidy of its military apparatus, the high level of corruption that mires the society, its toxic politics with an overt anti-American strand and the country's historical ties to China and support for Iran's nuclear program are not enticing factors for the United States whereas India has clear geostrategic value as a force capable of influencing its closest neighbors in ways that advances U.S. security interests and as a counterweight to China's rise.

India's Prime Minister Modi appears to be extirpating his country from the long-shadow of non-alignment which may have given it a moral high ground to soothe its self-esteem but little else. The defining characteristic of the relations with India is the mirror image of the one with China: whereas with the latter, strategic rivalry coexists with economic interdependence, with the former, strategic convergence has not translated into deep economic intercourse. Modi appears determined to seize the opportunity presented by the fact that Asian countries want to strengthen their economic ties with India as an economic hedge against overdependence on the Chinese market. The pragmatic makeover of India's foreign policy manifested itself

³⁶ There have been only three U.S. Presidential visits to India between 1947 and 1999. Since 2000, all Presidents have visited India; President Obama went twice.

³⁷ Talbott, Strobe, *Engaging India, Diplomacy, Democracy and the Bomb*, Brookings Institution Press, 2004.

through a renewed attention towards Southeast Asia and its new "Act East" policy – in formal opposition to the ineffective previous "Look East" policy. The India-Sri Lanka civil nuclear cooperation agreement concluded on February 17, 2015 in accordance with the International Atomic Energy Agency protocols, demonstrates that India "means business". The strongest break with the past is the "India-US Joint Strategic Vision for the Asia-Pacific and Indian Ocean Region", issued during President Obama's visit to New Delhi on January 26, 2015. The document accords prominence to India in the area between Africa and East Asia and draws India into partnership with the US in policing maritime security, "navigation and over flights throughout the region especially in the South China Sea". Another joint statement implicitly criticizing Chinese behavior was issued with Vietnam.

Being outspoken about substantive issues does not imply a more hostile approach. The shift in India's foreign policy approach and the rapprochement with United States does not foreclose New Delhi's ability to conduct its affairs on its own terms which, at times, may conflict with Washington's preferences. New Delhi will seek to maintain an independent foreign policy devoid of alignment in order to protect its strategic autonomy. New Delhi will resist playing the role of a balancer against China and being drawn into overt antagonism with Beijing. India is much more likely to engage China diplomatically and economically rather than trying to contain it. A few days after President Obama's visit, Indian foreign minister Susha Swaraj attended the Second India-China Media Forum in Beijing where she spoke of the current century being an Asian one. Prime Minister Modi will be visiting Beijing in May 2015, where his priority will be focused on reviving domestic growth and increasing trade with its largest trading partner. New Delhi's approach is in synch with China's strategy which favors a comprehensive engagement to immunize the relationship from points of friction growing out of control by increasing the costs of reverting to confrontation and preventing any one point of contention from defining the terms of the relationship.

There should be no illusion; India will most likely continue to be a dyspeptic partner for the United States efforts to address major multilateral issues. India will maintain privileged relations with Russia, in the words of Prime Minister Modi, "India's most important defence partner". During the recent visit of President Vladimir Putin to New Delhi, India agreed to purchase 12 Russian-nuclear reactors to address India's energy needs³⁸ and to manufacture advanced Russian military helicopters in India, despite the United States displeasure at the timing of the deal. India has been supportive of Russian's annexation of Crimea. During the visit, India unveiled the formation of an Indo-Crimean Partnership to foster trade between India and Crimea, now a Republic in the Russian Federation. Like Israel and Egypt, India intends to join the Russian-led free trade zone. The alignment with Russia must also be seen in the context of India's interests in Central Asia, a 21st century version of the Great Game. Despite enjoying old ties, cultural links and familiarity with key leaders, India is a minor player in Central Asia, elbowed-out by China, which now dominates the region's energy resources and transportation infrastructures and exerting political leadership through the Shanghai Cooperation Council. Nevertheless, Russia remains the critical balancer in the Central Asian competition from which India must be expecting significant advantages.

Though Japan is declining in relative power, its economic might ensures that it will continue to have a significant impact on the balance of power in Asia. To strengthen deterrence against emerging threats, it has embarked on a major investment

³⁸ The issue of trade in civil nuclear technology is a major bone of contention with the United States. In 2010, the Indian Parliament adopted a nuclear liability law that places excessive responsibilities on suppliers for accidents at nuclear power plants, effectively deterring US and other private firms from entering the Indian market. An *understanding* was reached during President Obama's last visit to India. New Delhi subsequently made it clear that it would not amend the CLND Act but will read the CLND Act to mean that suppliers' liability "is not a mandatory but an enabling provision" and that the CLND Act "channels all legal liability for nuclear damage exclusively to the operator." Whether nuclear technology suppliers will consider a press release issued by the Ministry of External Affairs explaining the ambit of the law as determinative of the risks arising from the provisions of Sections 17 and 46 of the CLND Act is an open question.

program in defense capabilities. Japan is also questioning the wisdom of constitutional limits that shackle its right to collective self-defense, bar its military from war and place a straightjacket on its alliances. While the cornerstone of Japan's foreign policy remains the U.S.-Japan alliance, it has systematically sought to nurture stronger security and military relations with other Asian middle powers as an hedge against overdependence on the United States security umbrella. On the economic front, Japan is pursuing a three-pronged trade strategy having joined the TPP and the RCEP negotiations and engaged in talks with China and South Korea to form the East Asia FTA. In tandem with the U.S. rapprochement with India, Japan is increasingly turning to India as an economic, political and security counterweight to China, a rational approach given their common interests in the maritime domain.

The convergence of Japan's balancing strategy with the objectives of the U.S. "pivot" to the Asia-Pacific presents an opportunity for joint leadership in a manner that favors regional stability. Clearly, the United States has a strategic interest in assisting Japan's efforts to enhance its role in international affairs. The strengthening of bilateral economic cooperation through, for example, a Japan-United States FTA, similarly to the one with South Korea, would constitute a step in the right direction. The challenge for the United States is to prevent its actions in concert with Japan from poisoning its critical relationship with China. In this regard, it will need to become much more adept at managing the key triangle relationships (China-Japan-United States, China-India-United States and India-Japan-United States) than it has demonstrated in recent years.

The risks of political missteps that would create serious tensions and have lasting economic consequences are aggravated by persistent doubts regarding the ability of the United States to muster sufficient financial, military and soft power to be considered the *primus inter pares* within the region, particularly by its "emerging giants". Comments by Asian analysts that Beijing appears to have concluded that the United States is on an irreversible path of decline and by European officials to the

effect that their Chinese counterparts exhibit an uncompromising attitude in their encounters indicate that the likelihood of a serious miscalculation is increasing. These are compounded by the belief that Asian countries will hesitate to align closely with the United States should a limited conflict with China occur for fear of compromising the economic benefits they derive from their commercial intercourse with China. This calculus is not peculiar to Asia. How to profit from China's huge markets and stock of capital without becoming vassals of its considerable economic power is a thorny issue in all capitals, including for Washington. Britain's decision to sign on as a founding member of the AIIB despite the open opposition of the United States constitutes a stark illustration of this new global reality.

These hesitations confirm that, for good or for ill, China remains the central strategic focus of Asia whereas the extensive economic, military and political presence of the United States in the Asia Pacific explains the enormous importance China attaches to the quality of its relations with the United States. This puts a premium on the quality and continuity of an effective institutional dialogue between China and United States at the highest levels. The Strategic and Economic Dialogue (S&ED) established in 2009 by President Barack Obama and Chinese President Hu Jiantao, is the key mechanism to fulfil this need, second only to the Leaders Summits.³⁹ The S&ED is centered around an annual meeting of the U.S. Secretary of the State and the Secretary of the Treasury with their Chinese counterparts. The extension of this bilateral dialogue to involve senior civilians and military officials to sensitive security issues such as nuclear force modernization, outer space, cyberspace, missile defence and maritime security, including the Taiwan Strait, must be considered a positive development. Veterans of the S&ED meetings observe that the conversations are

³⁹ The Strategic and Economic Dialogue is the successor to the former dual-track China-U.S. high level mechanisms of the Strategic Economic Dialogue initiated in 2005 by the U.S. Secretary to the Treasury, Hank Paulson, and the Senior Dialogue initiated in 2006 by the U.S. Deputy Secretary of State, Robert Soellik. These mechanisms had the support of President Georges W. Bush and President Hu Jianto. Their continuation, albeit under a new label, is testimony to a bipartisan consensus in the U.S. with respect to the need for continuous and systemic engagement with China.

more important than the immediate outcomes. According to former U.S. Secretary of Defense, Robert Gates,⁴⁰ the process has too often been held hostage to the vagaries of political jousts between the U.S. Congress and the White House; admittedly, China is not immune to similar opposing forces within its leadership and from powerful vested interests. A platform to exchange ideas and enhance mutual understanding, the venue has nonetheless been instrumental in stabilizing the China-U.S. relationship in periods of tension and preventing the downward spiral that was bound to occur if left unabated. Given the extensive scope of the relationships between the two countries and the magnitude of the economic intercourses, it is much more likely that progress will continue to unfold in an incremental way rather than in transformative developments.

The coming inflexion in the economic trajectory

The rapid ascendancy of Asia as an economic and political force in global world affairs has lured many to underestimate the huge challenges that beset the Asian economic engines and to posit that current economic trends would simply continue. While it is reasonable to assume that Asian economic growth still has a way to go, it remains that the long-term social and economic foundations of growth in both China and India are more fragile than is generally recognized.

Projections concerning growth in China must contend with the fact that the conditions that fuelled its long period of rapid economic growth are fading and, as President Xi is reported to have said on several occasions, "Chinese need to adapt to the new normal growth path". Between 2000 and 2015, the Chinese working-age population will have grown by 103 million, a surge that exerted downward pressure on wages and supercharged its export competitiveness. From 2015 to 2030, China working-age population will shrink by 69 million, with the opposite effects. Around

⁴⁰ Robert M. Gates, *Duty : Memoirs of a Secretary at War*, 2014.

54 percent of China's population is now living in cities, indicating that it has largely exhausted its surplus labor from rural areas. The inexorable contraction in the labor force means that China will grow old before it grows rich, at least in per capita terms. A similar reversal is occurring with respect to the profitability of investments in machines and infrastructure; according to the IMF, capacity utilization has fallen from about 90 percent in 2000 to around 60 percent in 2011.

Chinese authorities are cognizant of the urgency "to stand up to the test of striding over the middle-income trap."⁴¹ This can only be accomplished through rebalancing the sources of growth. The investment-driven growth has run its course, leading to worrying inefficiencies in the use of resources, a property bubble coupled with mounting debt and consequent adverse financial consequences. Moreover, it would be imprudent to rely on a further rapid expansion of the trade surplus to support the domestic economy. The transition to a more consumption-oriented growth has the added benefits of slowing the pace of widening income inequality and improving human welfare through more robust job creation and a more balanced development between coastal and inland regions. If successful, this rebalancing would reduce global economic imbalances and may reduce upward pressure on the price of several commodities. However, the policy challenges these new circumstances bring are of a different order of magnitude in complexity than what was the case in earlier periods.

India also risks remaining stuck in the middle-income trap, unless it can mobilize the will and social consensus needed to adopt and implement appropriate policies, arrest the rapid environmental degradation and avoid the occurrence of disruptive turmoil fueled by its ethnic-linguistic-religious diversity. Contrary to China, India's demography is favorable and its dependency ratios are falling. This "demographic dividend" will be wasted if India fails to ensure that its young population, boys and girls, is educated and has access to adequate healthcare and nutrition. To date, New

⁴¹ Executive Vice Premier Zhang Goali, June 6th, 2013.

Delhi policies regarding human capital development have been a miserable failure, if not in intent, for sure in implementation. The emergence of dynamic states growing at or near double-digit rates offers some comfort that India may gradually rid itself of the stifling regulations and rigid labor market institutions through power-sharing arrangements more typical of a mature federation.

A more promising development is the decision of ASEAN countries to transit towards the ASEAN Economic Community (AEC) as a means to make their region more self-sustaining. The goal is to create a single market and production base with the attendant free flow of goods, services, investment, capital and skilled labor and, thus, leverage its strength as a 625-million-strong consumer market. The economies of scale that will ensue are expected to prompt growth in regional investment and promote more balanced economic development throughout the Community. Although there are serious impediments to the AEC coming to fruition – political divisions, inadequate institutional infrastructure, huge differences in member states' levels of economic development – the successes achieved by ASEAN against many odds since its founding in 1967 is undeniable.

An uncertain world

The global dominance of Asia cannot be assumed as simply inevitable. China, India, Indonesia and Japan are confronted by an array of domestic challenges with little resolution in sight. Conversely, the capacity of the United States and Europe to rebound and embark on a growth path are too heavily discounted. The shale oil and gas phenomena and the re-shoring of manufacturing brought about, in part, by advanced technologies, are occurring; they are not figments of imagination. It is also worth keeping in mind that, in terms of output, the European Community and North American GDP only need to increase by 1.5 percent to match that of China growing at 7 percent.

Nor should it be assumed to be a foregone outcome that tensions in the Asia-Pacific will reach the boiling point and escalate into a regional outburst of catastrophic magnitude arresting the spreading of prosperity across Asia. Beijing is firmly convinced that China needs a stable international environment to achieve its "Chinese Dream".⁴² It has systematically engaged in economic integration and cooperation with friends and foes to address shared concerns and to diffuse security threats. It is noteworthy that the ASEAN economic interdependence with China has intentionally been maintained exclusive from the South China Sea disputes. Asian countries have demonstrated a strong shared orientation towards global affairs. Examination of the voting record in the United Nations General Assembly between 1974 and 2008 shows a substantial degree of convergence of ASEAN and China voting patterns which is higher than between EU members.⁴³ Unlike the situation that prevailed during the Cold War where trade relations between the Soviet and Western Blocks were virtually non-existent, Asia, especially China, is deeply integrated into the world economy. Moreover, their economic successes constitute a source of pride, self-gratification and fulfilment of national aspirations which acts to dampen nationalistic driven adventures. This reality is bound to weight in any calculus of the consequences of expanding a skirmish into a conflict, although we can never be certain that "cooler heads" will always prevail.

China is unlikely to abide to its "*Ta guang yang hui, you suo zuo wei*"⁴⁴ policy for much longer, at least in regards to Asia. President Xi's confident assertion of foreign policy at the Beijing APEC Summit contrasted with the attitude displayed by his predecessors for so many years and effectively relegated the United States to the role of second-fiddle. Notwithstanding the tensions in the China seas, it has

⁴² The phrase coined by President Xi at the 19th Party Congress is now standard in major policy discussions.

⁴³ Ferdinand, Peter, *Foreign Policy Convergence in Pacific Asia: The Evidence from Voting in the UN General Assembly*, The British Journal of Politics & International Relations, Volume 16, Issue 4, November 2014.

⁴⁴ Deng Xiaoping admonition translates approximately as, "Keep a low profile and take selective actions."

generally pursued a "good-neighbourly relationship and partnership" with countries on its periphery, with a strong emphasis on economic integration and multilateral cooperation to foster confidence. This Asia-centric mercantilist approach is likely to continue unless its territorial "expansion" gives rise to nationalistic and multiracial upheavals opposing China's investment made in pursuit of its quest for natural resources. However, there is no doubt that a geopolitical realignment will occur at the world level in response to the major shift in the global distribution of power, a return to the "old normal" where no one power in geopolitical or economic terms dominates the world.