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## **RICH REGION, STRONG STATES: THE POLITICAL ECONOMY OF SECURITY IN ASIA**

**POLICY BRIEF 2013-2, APRIL 2013**

### *The East Asian Political Economy: Stylized Facts and Security Debates*

Stephan HAGGARD

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#### **SUMMARY**

This policy brief links debates about the economic development of the Asia-Pacific to possible security implications. The brief makes four points. Past periods of high growth in the region have inevitably slowed, and China's will too. The main question is whether this happens gradually or as a result of crisis. Second, the global imbalances associated with export-oriented strategies and reserve accumulation have created strong dependence on the U.S. market. Third, the growth of intra-regional trade does not necessarily indicate a "decoupling" of the region. Increased Chinese leverage within the region may be exaggerated because of the continued role of international production networks in which Japanese, American, and European firms continue to play an important role. Finally, regional institutions are evolving and contributing to ongoing liberalization at the margin. But the institutional architecture remains fragmented and hamstrung by the tremendous diversity of the region's political systems and economies.

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Any consideration of the relationship between economics and security in the Asia-Pacific must begin with a stylized picture of the regional economy and current thinking about future trends. Some of what follows is fairly well known, yet the purpose is to link debates about the economics to debates about their political and security ramifications.

A first point concerns growth and patterns of growth. The flying geese pattern of growth in the region is well known, but somewhat less attention has been given to the historical tendency for high-growth phases to moderate over time, including through crisis. Linear projections of growth trends should be treated with extreme caution; the history of the Japanese miracle is a cautionary tale in this regard.

The second point about the region's growth is its high reliance on exports and the ongoing structural imbalances between the United States and the region; these are by no means limited to China. An ongoing issue of debate is the extent to which these imbalances generate leverage and in which direction. There are strong arguments that surplus countries face risks that are no less significant than those faced by debtors if the debtor is systemically significant, which the United States obviously is.

A third point has to do with the observed tendency toward intra-regional trade and the implications this might have for China's leverage in the region. The simple story of growing dependence on China is complicated by the continuing significance of international production networks and thus of extra-regional markets for final goods. Moreover, Chinese trade continues to depend on firms from outside the region as well. China may be more sensitive to developments in—and conflicts with—the United States and Europe than its changing trade patterns might lead one to believe. This was revealed quite dramatically during the financial crisis when the expectation of an Asian “decoupling” proved illusory.

A fourth cluster of issues has to do with new patterns of international organization in the region. Such developments are particularly significant given the finding that membership in such organizations, including economic ones, may have a restraining effect on conflict. The findings in this regard are mixed. On the one hand, regional institutions have flourished and some agreements have achieved substantial “depth,” including free trade agreements (FTAs) between the United States and several countries in the region (Australia, Singapore, and Korea). Significant agreements between China and its trading partners have been signed as well (the China-ASEAN FTA, the Cross-Strait Economic Cooperation Framework Agreement, and the trilateral investment agreement with Korea

and Japan). Yet at the political level, overarching organizations remain weak and hamstrung by substantial heterogeneity among their members. As a result, the extent of meaningful cooperation through—and delegation to—bodies with wider, trans-Pacific memberships remains limited.

## GROWTH AND IMBALANCES

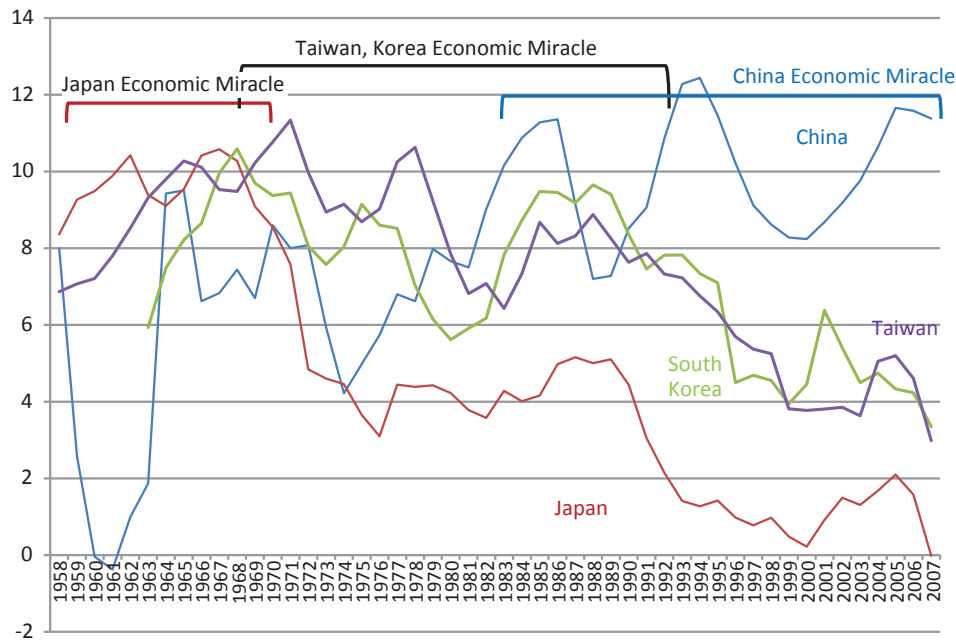
As this story is probably most well known it can be told quickly. The most distinctive feature of the Asia-Pacific is a cascading wave of new entrants into the world economy, starting with Japan and followed by the newly industrializing East Asian countries Korea, Taiwan, Hong Kong, and Singapore, then late-comers in Southeast Asia, and, most recently, by the socialist entrants China and Vietnam. The steady growth of the advanced industrial states from 1820 to 1950 resulted in an “expansion multiple”—the average size of their economies after this long phase of growth compared to before it—of 5.3. For Asia, these changes occurred in much more compressed high-growth spurts. For Japan the expansion multiple from its high-growth period (1950–1980) was 6.9, for the newly industrializing economies it was 7.2 (1965–1994), and for China it has been 12.5 (1978–2007, just prior to the crisis). These dramatic shifts have driven the revival of power transition theories, effectively and critically reviewed in Steve Chan's valuable 2008 *China, the United States, and the Power-Transition Theory: A Critique*.<sup>1</sup>

It is also, however, the case that all of these earlier miracle economies subsequently slowed, and in some cases in quite dramatic fashion. This can be seen in Figure 1. In all three, this slowdown exhibits both trend shifts in growth rates and sharp contractions associated with external shocks or crises. This is particularly evident in Japan, a country once believed on a path toward regional hegemony, in the first half of both the 1970s and 1990s, but it shows up in the financial crisis of 1997–98 in Korea as well. Sophisticated projections of China's long-run growth still leave us in a decidedly two-tier growth world with emerging markets outperforming the advanced industrial states. Yet virtually the only variables that we can use as long-run predictors with any certainty are demographic ones, and those trends are not favorable for any of the East Asian countries, including China.

In sum, the uncertainty surrounding long-run growth projections is great. Moreover, the possibility that growth might be disrupted by crises emanating from the financial sector or the real investment boom—

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<sup>1</sup> Steve Chan, *China, the United States, and the Power-Transition Theory: A Critique* (London and New York: Routledge, 2008.).



Source: World Bank, *World Development Indicators* (2012), accessed at <http://databank.worldbank.org/ddp/home.do>; For Taiwan, *Republic of China Statistical Abstract of National Accounts*, accessed at <http://eng.dgbas.gov.tw/ct.asp?xItem=28867&ctNode=2812>

**Figure 1.** Gross domestic product (GDP) growth rates

a “hard” versus a “soft” landing—cannot be ruled out. The strategic community tends to focus on the risks associated with a rising China. But what about the risks of China in crisis?

The second feature of the East Asian growth path is its strong reliance on exports and the corresponding tendency toward current account surpluses and the accumulation of reserves. These mercantilist preferences have not always been a feature of the region’s growth: Taiwan ran large current account surpluses during its high-growth period, while Korea was a debtor. Moreover, China is by no means the only surplus country (see Figure 2). But particularly since the Asian financial crisis, some have noted a return to a de facto fixed exchange rate regime in the region rooted in sustained intervention in foreign exchange markets. In a famous essay, Dooley, Folkert-Landau, and Garber labeled this system the “new Bretton Woods regime.”<sup>2</sup>

The political economy of rebalancing remains a lively topic of debate. Some have argued that an effective rebalancing is already taking place. China’s currency has appreciated by about 30 percent against the U.S. dollar since 2005, and China’s large stimulus in the wake of the crisis shifted demand toward the do-

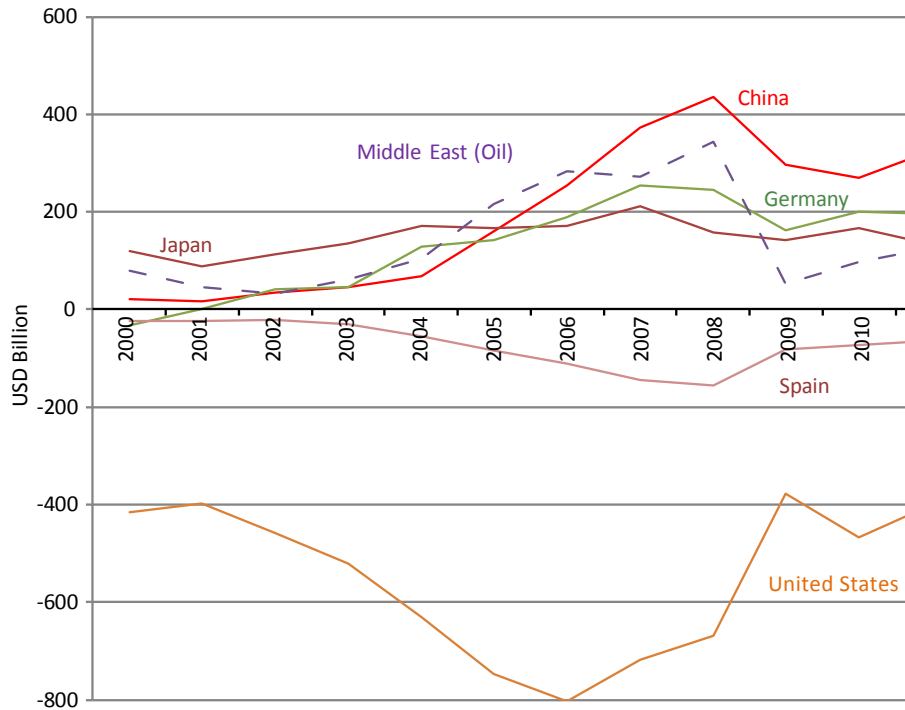
mestic market. On the other hand, some are skeptical about the capacity of Chinese leadership to undertake a sustained reform effort in this regard. It is interesting in this regard that a number of Chinese commentators view U.S. pressure on China to rebalance as having a strategic rationale. They note that Japan’s “lost decade” emerged in wake of the appreciation the United States forced on it under the Plaza and Louvre accords, which also failed to fundamentally alter the large bilateral imbalances they were designed to correct.

There are two key strategic questions surrounding the imbalances: whether the substantial surpluses that China has accumulated generate leverage and of what sort; and whether they will become an enduring source of serious friction. Views are mixed on the first question, but, if there is a consensus, it follows the adage attributed to Keynes that “if I owe you a pound, I have a problem; but if I owe you a million, the problem is yours.”<sup>3</sup> It is one thing for Germany and the European Union to push Greece around, and even there the difficulties are great. It is quite another thing for Chinese surpluses to generate leverage over the United States.

The central difficulty facing China is that the exercise of such leverage can only come through a credible threat to withdraw financing, which would adversely affect the value of remaining dollar-denominated as-

2 Michael P. Dooley, David Folkerts-Landau, and Peter Garber, “An Essay on the Revived Bretton Woods System,” National Bureau of Economic Research Working Paper 9971 (September) (Cambridge, MA: National Bureau of Economic Research, 2003).

3 Dan Drezner, “Bad Debts: Assessing Financial Influence in Great Power Politics,” *International Security* 34 (2009): 7–45.



Source: World Bank, *World Development Indicators* (2012), accessed at <http://databank.worldbank.org/ddp/home.do>.

**Figure 2.** Current account

sets in the central bank's portfolio. In addition, such action assumes that East Asian central banks have strong alternatives to holding the dollar. The Eurozone crisis, the long-run weakness of the Japanese economy and obvious limitations of other currencies (the Swiss franc, the pound sterling) suggest some of the difficulties. Ironically, the most effective way for East Asian economies to reduce their holding of dollar-denominated assets is to undertake rebalancing away from export-dependent growth toward domestic consumption that the United States (and others) have long been urging on them. In sum, China may seek to gradually shift away from dollar-denominated holdings. It may also seek to internationalize the renminbi, and has begun to do so, but these are long-run and gradual processes.

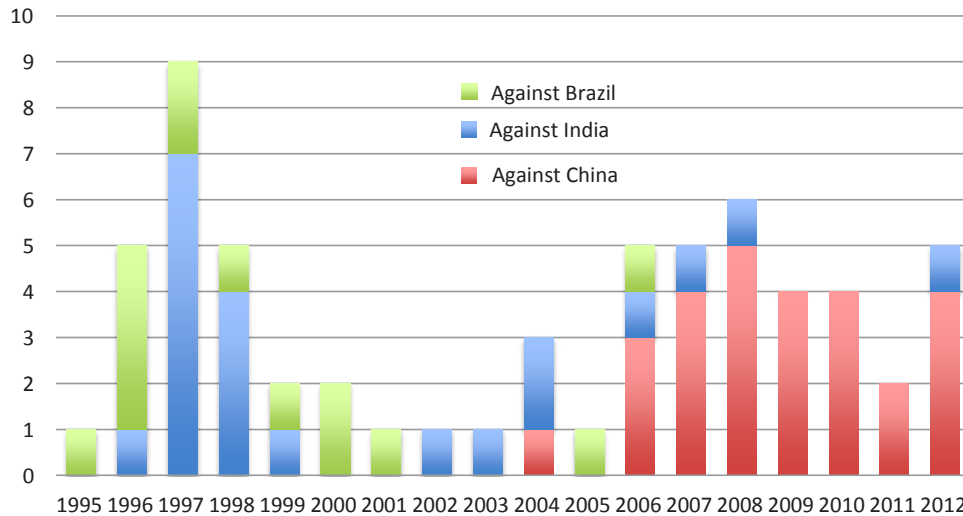
The second issue is the risk that sustained imbalances will become a source of ongoing friction. The evidence in the political economy literature in this regard is relatively strong: exchange misalignments are associated with protectionist pressures.<sup>4</sup> So far, however, students of trade policy have been more hard-pressed to explain the weakness of protectionist forces during and after the crisis than their strengths.

<sup>4</sup> See, for example, Lawrence Broz, "Exchange Rates and Protectionism," unpublished manuscript, UC San Diego, 2010.

The United States has indeed brought an increasing number of cases against China in the WTO, but it has not acted unilaterally in this regard, and trade policy is constrained by American investment in China (See Figure 3). The financial, investment, and trade co-dependencies between the United States, China, and the rest of the region—discussed in more detail in the next section—have placed certain restraints on bilateral relations despite political conflicts in both countries over the nature of the relationship.

## INTRA-REGIONAL TRADE: INTEGRATION AND DEPENDENCE

From a political economy perspective, perhaps the most striking development in the region is the changing pattern of economic integration—and dependence—associated with China's rise. All across China's periphery, the geography of trade has undergone fundamental change. This fact is usually shown by measures of the share of intra-regional trade. For example, if we define Asia as the ten ASEAN countries, China, Japan, Korea (the "+3" of the ASEAN + 3), Hong Kong, and Taiwan, these 15 countries accounted for 14.6 percent of world trade in 1980. At that time, 34.6 percent—just



Source: Data from World Trade Organization, “Chronological List of Disputes Cases,” accessed at [http://www.wto.org/english/tratop\\_e/dispu\\_e/dispu\\_status\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/dispu_status_e.htm).

**Figure 3.** U.S. WTO filings against Brazil, China, and India, 1995–2012

over one third—of these countries’ total trade was with one another. By 2008—the year the global financial crisis broke in earnest—these 15 economies accounted for 26.6 percent of world trade. Intra-regional trade had risen dramatically to 52.5 percent. To place this in perspective, this intra-regional trade share is roughly equal to what the EU had achieved in 1980.

The growth of the regional economy, fueled by a combination of rapid growth and proximity, gave rise to the so-called “decoupling” thesis, which had both economic and geostrategic resonance in China. Economically, it suggested the region was self-contained to a greater extent than it had been in the past and capable of sustaining growth regardless of what occurred in the United States and Europe. Strategically, the idea of decoupling had wider implications as well. It suggested the capacity of China to establish networks of dependence and informal influence that would place cross-cutting pressures on the U.S. and European presence in the region, including U.S. alliance partners.

The onset of the global financial crisis quickly put the decoupling thesis to rest. The rapid contraction of trade across East Asia, including in China, was met with major counter-cyclical efforts that had the effect of shifting demand away from the foreign sector toward the domestic economy. The wider policy debate also shifted course. Governments reconsidered the risks of export dependence and rethought the advantages of rebalancing toward domestic sources of growth, whether through investment (as occurred in China) or through stimulus to consumption.

What had happened? The short answer is that the rapid growth of intra-regional trade obscured the growing role of international production networks. With the exception of Japan, and, to a lesser extent Korea, export growth from Asia was always heavily dependent on foreign investment and the growth of what Gereffi, Humphrey, and Sturgeon called “buyer-driven” and “producer-driven” supply chains.<sup>5</sup> The first were structured by major retailers in the United States—and only later Europe and Japan—that played a crucial role in the early growth of Asian manufactured exports. Walmart is the current exemplar. The second are more complex supply chains dominated by a lead multinational. These firms structure a highly disaggregated production process involving multiple locations and trade between them in intermediate goods and components. Production of disk drives or iPods are examples, but they can be multiplied many-fold.<sup>6</sup>

The significance of these networks can be captured in several different ways.<sup>7</sup> One is to look more closely at intra-regional trade. The increase in intra-regional

5 Gary Gereffi, John Humphrey, and Tim Sturgeon, “The Governance of Global Value Chains,” *Review of International Political Economy* 12 (2005): 78–104.

6 David McKendrick, Richard Doner, and Stephan Haggard, *From Silicon Valley to Singapore: Location and Competitive Advantage in the Hard Disk Drive Industry* (Stanford: Stanford University Press, 2000).

7 Prema-chandra Athukorala and Archanun Kohpaiboon, “Intra-Regional Trade in East Asia: The Decoupling Fallacy, Crisis, and Policy Challenges,” ADBI Working Paper Series, No. 177 (December) (Tokyo: Asian Development Bank Institute, 2009).

trade has resulted largely from rapid increases in intra-regional imports; the expansion of intra-regional exports have been consistently slower. This fact suggests continued and even increasing dependence on extra-regional markets. The same point can be made by looking at the role of trade in intermediate goods and components. Intra-regional trade growth has depended heavily on increases in intermediate and components trade. At the onset of the financial crisis, about 45 percent of China's intra-regional imports were parts and components. Yet a third way of making the point is to consider value-added in Chinese manufacturing. China's export growth does not translate one-to-one into growth in value-added because of dependence on exports from elsewhere in the region and the low returns on the activities in which China specializes.

Yet a final way of making the point is to focus on the role of foreign multinationals, including not only Japanese, American, and European ones but those from the region as well. Data here is much less precise, but by some estimates as much as 50 percent of Chinese exports of manufactures may emanate from foreign firms.

The strategic implications are potentially significant. First, if we think that China's influence has grown as a result of its power to import from its periphery, we must be consistent by noting that China is itself constrained in the same way. Second, China's integration is not simply a function of reliance on extra-regional product markets but on the complex and delicate web of international production networks that span the region. As we learned from the Fukushima disaster, shocks to one piece of this system can ripple through the entire length of production chains from Japan through Southeast Asia to China and the United States. The existence of opportunity costs does not constrain conflict in any linear way, as shown by the wrongful pillorying of Norman Angell (he did not argue that interdependence would eliminate the chances of conflict, only that it would be more costly). Nonetheless, the regional political economy in which China is embedded has complex interdependencies not captured by trade data alone, and they involve both foreign firms and extra-regional markets in a significant way.

## REGIONAL INSTITUTIONS

Finally, something should be said about the emergence of regional economic institutions. For many years Asia and the Asia-Pacific were contrasted unfavorably with institutional developments in Europe. For a host of historical and geostrategic reasons, Europe developed robust multilateral institutions—most notably NATO and the European Union—while “hub and spoke” alli-

ance relations and Cold War divides limited the emergence of multilateral institutions, including economic ones.

This picture is no longer accurate; international institutions in the Asia-Pacific have mushroomed. Gorbachev's Vladivostok speech of 1986 and the gradual embrace of multilateralism on the part of China since the mid-1990s had a profound impact on the prospects for building regional institutions that cut across Cold War divides. We can now identify a number of major “institutional complexes” in the region, setting aside, for the moment, the proliferation of FTAs: the ASEAN proper, including the ASEAN Free Trade Area and the ASEAN Economic Community; the ASEAN+3 and associated institutions such as the Chiang Mai Initiative; the Trilateral Summits among China, Japan, and Korea that spun out of the ASEAN+3 processes; the East Asian Summit, which now includes not only India, Australia, and New Zealand but the United States as well; and the Asia Pacific Economic Cooperation (APEC). Following a somewhat different institutional trajectory from these Asia-Pacific groupings are the Shanghai Cooperation Organization, which includes China, Kazakhstan, Kyrgyzstan, Russia, Tajikistan, and Uzbekistan, and the South Asian Association for Regional Cooperation, which now has eight members.

In addition to these large regional complexes, free-trade areas have mushroomed and now number in the dozens within the region. Most significant from a strategic perspective are those between the United States and South Korea and Australia, the China-ASEAN FTA, the cross-Strait ECFA, and the Transpacific Partnership that is currently under negotiation. But this short list is by no means exhaustive. Korea, Japan, and China have all been active in constructing networks of FTAs as well.

That said, the critique remains that the overarching institutions of the Asia-Pacific remain “thin” in several senses:

- Institutions operate on the basis of consensus decision-making procedures that push toward modest “lowest common denominator” agreements.
- Commitments are non-binding, voluntary, and, in some cases, simply imprecise. As a result, they are not credible, and it is difficult for adjudication and third party enforcement to evolve.
- The extent of delegation to standing international secretariats or bureaucracies is limited.
- As a result, the apparently dense institutional environment does not really constrain actors in any meaningful way and is unlikely to provide the foundation for a more rule-governed or peaceful regional order.

**Table 1.** Heterogeneity in Asia-Pacific Institutions

	Europe mean	Europe standard deviation	ASEAN mean	ASEAN standard deviation	EAS mean	EAS standard deviation	APEC mean	APEC standard deviation
<b>Economic and Political Development</b>								
GDP per capita	31,189.72	20,704.56	10,472.30	15,188.48	17,894.76	18,736.20	20,364.96	18,033.90
Polity IV	9.6	0.7	0.7	6.3	3.5	6.7	5.9	5.5
<b>Economic Policy and Preferences</b>								
Economic Freedom: Overall Index	67.70	6.33	58.98	13.59	63.45	14.66	69.32	13.06
Trade and Investment Freedom	81.91	5.87	58.24	12.10	60.38	14.04	66.62	13.34
<b>International Alignments</b>								
UNGA voting with United States	0.23	0.06	-0.59	0.07	-0.39	0.36	-0.27	0.42

**EU countries:** Germany, France, United Kingdom, Italy, Spain, Poland, Romania, Netherlands, Greece, Portugal, Belgium, Czech Republic, Hungary, Sweden, Austria, Bulgaria, Denmark, Slovakia, Finland, Ireland, Lithuania, Latvia, Slovenia, Estonia, Cyprus, Luxembourg, Malta.

**ASEAN countries:** Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam.

**EAS countries (after 2010):** Australia, Brunei, Cambodia, China, India, Indonesia, Japan, Laos, Malaysia, Myanmar, New Zealand, Philippines, Singapore, South Korea, Thailand, Vietnam, United States, Russia.

**APEC countries:** Australia, Brunei, Canada, Chile, China, Hong Kong, Indonesia, Japan, South Korea, Mexico, Malaysia, New Zealand, Papua New Guinea, Peru, Philippines, Russia, Singapore, Taiwan, Thailand, United States, Vietnam.

*Sources:* GDP per capita from the World Bank's 2010 World Development Indicators, <http://databank.worldbank.org/ddp/home.do>, accessed August 8, 2012. PolityIV (-10 least democratic to +10 most democratic) from Monty G. Marshall and Benjamin R. Cole, Global Report 2011: Conflict, Governance, and State Fragility, <http://www.systemicpeace.org/polity/polity4.htm>, accessed August 1, 2012; Economic freedom (0 least free to 100 most free), Heritage Foundation 2011; UN voting scores (-1 never votes with the United States to +1 always votes with the United States) from Erik A. Gartzke, 2011, "The Affinity of Nations: Similarity of State Voting Positions in the UNGA" dataset at <http://dss.ucsd.edu/~egartzke/datasets.htm>, accessed April 12, 2012.

Why might this be the case? The simple answer is that the region remains incredibly diverse and this diversity limits the extent to which overarching institutions can reach consensus. Table 1 outlines several components of the region's heterogeneity. The table compares the Europe of the EU with three overlapping Asian groupings: ASEAN; the more inclusive East Asian Summit; and the still-more inclusive APEC, which includes not only Asian countries but a handful of Latin American ones as well. It considers indicators of economic and political development, economic policy, and international alignments, and institutional memberships. Table 1 reports both mean values on the indicators and their standard deviation.

Europe is very much richer on average than any of the Asian groupings, although the incorporation of the Southern and Eastern European countries has resulted in a more diverse union in terms of level of development. However, the differences between developed and developing countries are even more evident in all

of the Asian groupings. This diversity has been a consistent source of political differences within the region over trade policy, environmental, and other commitments.

Indicators of economic policy and preferences yield some surprises. An aggregate measure of "economic freedom" constructed by the Heritage Foundation and the *Wall Street Journal* has a strong libertarian foundation, capturing property rights, freedom of movement for labor, capital, and goods—including trade and investment—as well as measures of the fiscal burden and price stability. Because of the presence of advanced industrial states and countries such as Hong Kong and Singapore, the mean value of this indicator for the pan-Pacific APEC grouping is not that much different than Europe, where larger governments and labor market policies depress scores. However, when we isolate two dimensions of the index dealing with economic openness—trade and investment freedom—we see that Europe has a much higher mean score



and with much lower variance than any of the Asian groupings. Although economic reforms have dramatically shifted the political economy of the region over the last decade, differences in foreign economic policy have placed limits on encompassing economic agreements, such as the proposal for a Free Trade Area of the Asia-Pacific (FTAAP). Indeed, the proliferation of bilateral and “minilateral” FTAs arises precisely out of the inability to reach more overarching agreements.

For strategic purposes, the political differences are the most significant. The EU is made up entirely of democracies. Because of the inclusion of the United States, Australia, New Zealand, and Canada as well as new democracies in both East Asia and Latin America, APEC has a mean score on regime type that is just below the standard threshold for democratic rule. But the standard deviation of regime type in APEC is roughly equal to the mean. In ASEAN, the extraordinary political diversity yields a mean score of approximately zero—squarely in authoritarian territory—with wide variance around that mean. This political diversity is a major constraint on what regional institutions have been able to do, and goes to the broader issue—well beyond the scope of this paper—of the democratic peace: the greater likelihood that regimes of different sorts will fall into conflict.

The affinity scores measure the extent to which the countries in the region vote with the United States in the UN General Assembly, a simple proxy for the extent to which foreign policies are aligned. The theoretical range for any country is from  $-1$  (never voting with the United States) to  $+1$  (always voting with the United States); the scores are simply averaged across the regional memberships. As can be seen, Europeans clearly have a stronger affinity with the United States than any Asian grouping. Indeed, in all three of the Asian regional groupings, the affinity score with the United States is negative, although once again with high variance. Cooperation and institutional development in the region still face the headwinds of larger foreign policy differences.

In sum, economic institutions have shown a quite remarkable development over the last two decades, going far beyond earlier pessimism about the region. Dramatic economic reforms have reduced variance on key economic policies, including in China where the WTO accession process locked in an array of multilateral commitments that are largely under-appreciated in the United States. But remaining economic and even systemic differences have placed limits on the ability to converge around common approaches to the liberalization of trade and investment or the development

of common regulatory standards. The region is also characterized by diverse political structures, ranging from highly authoritarian cases such as North Korea, through intermediate regimes such as Singapore and Malaysia, to new and well-established democracies. These political differences circumscribe the extent to which governments are willing to delegate to international institutions and also shape governance arrangements. International institutions in Asia remain highly intergovernmental in form.

## CONCLUSION

This brief review of the political economy of the Asia-Pacific offers four findings of potential interest to students of the region’s security relations. First, it is now widely accepted that periods of very high growth are typically associated with a reversion to the mean. This will still mean that Asian output growth will exceed that of Europe, the US and Japan, but past experience suggests that crises cannot be ruled out during this transition process. Second, the global imbalances associated with export-oriented strategies and reserve accumulation have created strong mutual dependencies on both sides of the Pacific: the US depends on Asian capital flows, but these are the flip side of current account deficits the US runs with the region, deficits that have fueled Asia’s export growth. Third, the growth of intra-regional trade does not signal a closed regional bloc. While China’s influence in the region is clearly increasing, Japanese, American and European firms as well as those from Korea, Taiwan, Singapore and Hong Kong continue to play an important role in integrating the region.

Finally, regional institutions are evolving and contributing to ongoing liberalization at the margin. But the institutionalization of the Asia-Pacific is hamstrung by the tremendous heterogeneity of the countries in the region. This diversity has produced an overlapping set of institutions with different memberships and objectives. These institutions have moderating effects on behavior, but do not reflect a political consensus on the rules of the road. Whatever their merits, the traditional high politics of alliances and bilateral diplomacy will continue to play a crucial role in the region’s politics.

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