THE G4: UNDIMINISHED EXPECTATIONS

GEOPOLITICAL RIVALRY OR RAPPORT?

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PREPARED FOR PROFESSIONAL CLIENTS ONLY
After years of crisis and upheaval, some commentators have resigned themselves to an era of “mediocre” growth. But four of the world’s biggest economies* (Japan, America, China and India) are now in the midst of recovery, reform, or both. What if all four fulfilled their economic potential at the same time? That is the optimistic scenario examined in the G4 white-paper series. If this scenario materialized, the consequences would be profound. The G4 would lift growth and trade in the rest of the world, reverse the slide in commodity prices and support a rally in equity markets. Their rising prosperity would also shift the balance of power between them.

In the first paper in the G4 series, we argued that each of these economies has substantial “room to recover”, as and when demand improves. In the second paper, we examined the “supply-side” of these four economies, showing how labor, capital and productivity must evolve if these economies are to fulfill the G4 scenario. In this third paper, we explore the links between growth and geopolitics. Will the G4 scenario lead to greater rivalry or rapport between these four powers? And will their rivalry hurt growth - or perhaps even help it?

1. The G4: Undiminished Expectations - Room to Recover
2. The G4: Undiminished Expectations - The Sources of Growth
3. The G4: Undiminished Expectations - Geopolitical Rivalry or Rapport?
4. The G4: Undiminished Expectations - Investment Opportunities

* In terms of GDP measured at purchasing-power parity
Introduction

For the past decade, China, America, India and Japan have boasted the world’s four biggest economies, measured at purchasing-power parity (PPP) 1. For that reason, we call them the G4. The members of this group, which accounts for 44 percent of global GDP, exert a powerful economic pull on the rest of the world and each other. Their trade links and investment ties have drawn them into varying degrees of commercial interdependence.

But their economic intimacy coexists with an uneasy diplomatic rivalry. An ill-defined, long-disputed Himalayan border separates India from China, and an ill-defined, hotly disputed maritime border separates China from Japan 2. The other member of this quartet, America, also considers itself a “resident power” in the Asia-Pacific neighborhood, thanks to its longstanding military bases in Japan and South Korea as well as its sovereign territory in Guam 3. “We’ve been here, we are here, and we will be here,” as Hillary Clinton put it during a visit as secretary of state 4.

In a series of white papers, BNY Mellon has been exploring the G4’s economic prospects over the rest of this decade. Those prospects have dimmed, according to many commentators, thanks to structural shortcomings in all four economies and “secular stagnation” in some of them 5. But we think this conclusion is too hasty. Although we are not complacent about the threats to growth, we are also wary of premature pessimism.

We have therefore been asking ourselves what would happen if these four countries lived up to their reformers’ ambitions and began to fulfil their economic potential. To quantify these hopes, we have outlined a scenario in which India’s growth averages 8 percent a year until 2020, China’s averages 7 percent, America’s 3 percent and Japan’s 2 percent.

Previous papers in the series have described the economic assumptions behind this optimistic scenario and the possible market consequences. The scenario assumes that all four of these economies are now “underheating”: they exhibit substantial slack, which will leave them room to recover when demand revives. It also assumes that piecemeal reforms will be enough to ease the capacity constraints that will eventually bite in these economies as their recovery matures. If these assumptions hold, the financial consequences would be profound, including significantly higher share and commodity prices, as well as an increase in global GDP of about $18 trillion by 2020 6.

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1 IMF World Economic Outlook database http://bit.ly/1KWJXGZ
3 “America plays many roles in Asia: as an ally, partner, and friend; as a routine offshore presence; as a resident power; and as an agent of professionalism and capacity in service to a range of non-military needs, such as disaster response” - Robert Gates, former US Secretary of Defence http://www.iiss.org/en/events/shangri%20la%20dialogue/archive/shangri-la-dialogue-2008-2906/first-plenary-session-1921/dr-robert-m-gates-bce8
4 https://www.youtube.com/watch?v=0KuoutsZnT8
6 At constant market exchange rates and prices. See https://www.bnymellon.com/apac/en/g4/download-whitepaper.jsp
This paper’s theme is different. The implications of our G4 growth scenario would extend beyond the narrow economic realm into the lofty domain of great-power politics. Asia is not accustomed to all four of its major powers (native and “resident”) growing in confidence, power and prestige at the same time. Is the region big enough for all four of them?

This paper will therefore explore the links between economic recovery and national security—between prosperity and power. One might assume that economic success, which raises living standards at home, would also inspire peaceful cooperation abroad. But uglier outcomes—rivalry and conflict—are also possible. The causal link between growth and rivalry also runs in the other direction. Rivalry can harm growth—and perhaps sometimes help it.

The harm is easy to imagine. Diplomatic hostility, mutual suspicion and saber-rattling can be damaging to trade and investment, even if this ill-will never ripens into outright armed conflict. Tension can sap confidence and trust, diverting resources into futile arms races and costly defensive precautions.

But the relationship between rivalry and growth is not as simple as that, because geopolitical rivalry can also be conducive to growth. Take China for example. Its fear of being overshadowed and intimidated by foreign powers helped inspire its economic reforms. (“If we do not develop then we will be bullied. Development is the only hard truth,” said Deng Xiaoping, China’s paramount leader, during his Southern Tour of the Pearl River Delta in 1992.) For China’s leaders, economic success is a means to the larger end of national rejuvenation, reclaiming China’s rightful place in the world. “Why should China not aspire to be a “world power”? asks Ye Zicheng in his book “Inside China’s Grand Strategy”. “A country is just like a person. Without any ambitions or ideals, how could someone accomplish great things?”

China’s quest for greatness is, in turn, a powerful motivation for economic reform in Japan, India and even the United States, all of whom fear being pushed into the wings by China’s expanding role. To cite one recent example: China’s growing economic clout seemed to spur Japan and America to reach agreement with ten other nations on the Trans-Pacific Partnership (TPP) in October. And even if China’s rise was not (or should not have been) the principal reason for sealing the deal, it has proved a useful way to sell it back home: “If we don’t write the rules [for regional trade],” President Barack Obama has warned, “China will write the rules”.

7 “[N]ever before in history have China, India and Japan been strong at the same time,” wrote Brahma Chellaney of the Centre for Policy Research in Delhi in the preface to the 2010 edition of his book “Asian Juggernaut” (first published in 2006). The same theme was explored in Bill Emmott’s 2008 book “Rivalry.” This is the first time in history when there have been three powerful countries in Asia, all at the same time,” he wrote. To which he added, “That might not matter if they liked each other...but they do not.”

8 “Asia’s Warring States era has just begun,” writes Liu Mingfu, a former colonel in the People’s Liberation Army, in his ominous book “The China Dream.” “Today China, Japan, and India are acting out the Wars of the Three Kingdoms over the entire continent.”


10 ‘Obama’s trade deal will not tame China’ by Gideon Rachman, Financial Times, 18 May 2015

This paper will therefore present evidence that inter-power rivalry and economic growth follow a kind of “geopolitical Laffer curve”\textsuperscript{12}. Too much geopolitical tension is obviously harmful for economic growth. So, less obviously, is too little. Excessive rivalry poisons trade relationships, inhibits investment, sows uncertainty, and diverts resources into the modern equivalent of moat-digging and castle-building (think of today’s costly investments in data security, motivated by fears of state-sponsored hacking). But a modicum of geopolitical rivalry may be good for growth, if it motivates reforms or gives reformers the leeway they need to overcome domestic opposition.

The Geopolitical Laffer Curve

\begin{figure}[h]
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\includegraphics[width=\textwidth]{geopolitical_laffer_curve.png}
\caption{The Geopolitical Laffer Curve}
\end{figure}

\begin{itemize}
\item Full Sample
\item Excluding resource-rich countries
\end{itemize}

Source: BNY Mellon, based on International Country Risk Guide; World Bank World Development Indicators

The post-12/11 world

“In 1750, Asia had more than half of the world population and product. By 1900, after the Industrial Revolution in Europe and America, Asia’s share shrank to one-fifth of world product. By 2050, Asia will be well on its way back to its historical share.”


In 1980 the world’s economic center of gravity lay somewhere in the Atlantic Ocean, along a line of longitude 800 miles west of Morocco, according to calculations by Danny Quah, a Malaysian economist at the London School of Economics\textsuperscript{13}. By 2015 that line had shifted eastwards by about 70 degrees or over 4,000 miles. It now runs through Iran.

\textsuperscript{12} The original Laffer curve, drawn on the back of a napkin in 1974 by Arthur Laffer, sketched out a non-linear relationship between tax rates and tax revenues. Up to a point, higher tax rates yield greater tax revenues, as intuition suggests. But after a certain threshold, higher tax rates are so damaging to the economy (and so conducive to tax-dodging) that tax revenues actually fall. The upshot is that neither very low nor very high tax rates yield much tax revenue.


\textsuperscript{13} http://www.dannyquah.com/writings/en/2010/07/30/the-global-economys-shifting-centre-of-gravity/
The world’s economic centre of gravity, 1980-2050

Whether or not the G4 members achieve the above-consensus economic growth we are postulating, one thing is clear. This eastward shift in what Quah calls the world’s “economic center of gravity” will continue. By mid-century, according to Quah’s projections, this center of gravity will lie in China itself, another 2,300 miles to the east.

Economic progress, like geology and geomorphology, tends to be evolutionary rather than revolutionary. On occasion, however, the slow buildup of tectonic forces manifests itself in a sudden seismic event. China’s entry into the World Trade Organization on December 11th 2001 is perhaps one such breakthrough moment. From 2001 to 2008, China’s dollar GDP more than tripled in size. This acceleration in China’s growth was followed shortly thereafter by a boom in India: its GDP, measured at PPP, was on a par with Germany’s in 2003. Five years later, it had overtaken Japan’s.

By 2018, if the G4 scenario comes true, China’s share of global GDP will surpass its share of the global population for the first time since the 17th century. China’s economic heft will then match its demographic weight in the world, restoring China to something like its “rightful” position in the global economy.

15 IMF World Economic Outlook database.
16 BNY Mellon calculations, based on 2014 PPP GDP reported in the IMF World Economic Outlook and 17th-century GDP estimates reported by Angus Maddison. http://www.ggdc.net/maddison/Historical_Statistics/vertical-file_02-2010.xls
By 2020, if the G4 scenario materializes, China's GDP will be 30 percent bigger than America's (at PPP) and five times the size of Japan's. India's GDP will be well over half the size of America's (57 percent) 17.

17 This upheaval in the international order is less dramatic when the four economies are measured at 2014 market exchange rates (see chart). But the market exchange rates that prevailed in 2014 will not remain constant over the decade. India’s real-exchange rate in particular can be expected to strengthen quite dramatically if it grows as quickly as the G4 scenario suggests. See “G4: Undiminished Expectations: Room to Recover”
These shifts in economic strength drive matching shifts in military and political power. The combined defense spending of Asia’s three biggest economies—China, India, and Japan—now exceeds the military expenditure of the entire European Union, including the historic powers of France and Britain. Indeed, measured at PPP¹⁸, which takes account of low local prices in the G4’s poorer members, Asia’s three big powers now spend almost as much each year as the United States.

**Military spending**

¹⁸ Should we use market exchange rates or purchasing-power parities to convert non-US military budgets into dollars? Neither is ideal. Market exchange rates, which are determined by international purchases of goods and assets, provide a better guide to a country’s ability to buy military equipment and supplies that can be traded across borders. Weapons, vehicles, and fuel all fall into this category. On the other hand, purchasing-power parities better reflect a country’s ability to keep a given number of men under arms. India, for example, can maintain a large army more easily than can the United States, where a given salary would not stretch as far. The Stockholm International Peace Research Institute (SIPRI) prefers market exchange rates, partly because they are free of the statistical assumptions required to calculate purchasing-power parities. They write: “PPP rates are designed to reflect the purchasing power for goods and services that are representative of spending patterns in each country. Military expenditure is used to purchase a number of goods and services which are not typical of national consumption patterns.” For example, the price of conscripts can be assumed to be lower than the price of a typical basket of goods and services, while the prices of advanced weapon systems and of their maintenance and repair services can be assumed to be much higher.”
Tracking shifts in geopolitical power is now a favorite pastime of academics, think-tankers and official planners, especially in China. For them, one or two indicators (such as GDP and military spending) will not do. They rank states according to their “comprehensive national power”, using quantitative indices of bewildering complexity (see box).
Comprehensive National Power

“China’s analysts,” notes Michael Pillsbury, a Pentagon consultant at the Hudson Institute, “try to calculate mathematically the hierarchy of the world’s future major powers.” They aim to assess something called “comprehensive national power”, which reflects economic and military “hard” power as well as “soft” power, such as “spiritual culture, national historical tradition, and national cohesiveness,” as Ye Zicheng of Peking University describes it.

The quantification game began in earnest in 1980s Japan, where the country’s Economic Planning Agency published an index based on 17 factors, ranging from economic strength and military might to administrative efficiency and international friendships. In more recent years, India has joined the fun: its government has touted a National Power Index, calculated by the Foundation for National Security Research, which ranked India eighth in its latest iteration published in 2013 (see chart).

India’s National Power Index 2012

But these ready-reckoners are taken most seriously in China, where a bevy of different rankings compete for attention and credibility. A recent example from Hua Liao, Weihua Dong, Huiping Liu and Yuejing Ge of Beijing Normal University includes a country’s population, territorial size, energy production, natural resources, GDP, military spending and headcount, R&D spending and patent applications, as well as its “cultural appeal”, which is gauged by counting film production, international student enrollments, World Heritage sites, and even Olympic medals. By their measure, China is now twice as powerful as Japan.

19 “Inside China’s Grand Strategy: The Perspective from the People's Republic”
All of these national attributes, hard and soft, will shape the outcome of the great geopolitical game over the next century, according to a certain strand of thinking in China. General Liu Yazhou, the political commissar of China’s National Defense University, exemplifies this view. “In my opinion,” he writes, “the competition between China and the U.S. in the 21st century should be a race, that is, a contest to see whose development results are better, whose comprehensive national power can rise faster, and to finally decide who can become the champion country to lead world progress.” 20

On most measures, America has been the “champion country”, as General Liu would put it, since the second world war. But its lead is no longer prohibitively large: other rising powers can aspire to rival it, match it or even surpass it. Even in America itself, almost half (46 percent) of the respondents to a recent survey by the Pew Research Center thought that China had already replaced the US as the world’s leading power or would eventually do so (see chart). The word “eventually” is of course important: many things may become true eventually that will not be true for a long time. But China’s vast future potential exerts a force even in the present. “National power... includes both present power and potential,” as Ye Zicheng rightly observes. Other countries will act today in anticipation of tomorrow’s global pecking order.

Will China replace the US as the world’s leading superpower?

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Will G4 growth stir geopolitical rivalry or allay it?

Given rapid shifts in international standing, America’s ‘unipolar moment’ is hard to sustain. What will replace it? And how will each member of the G4 adapt to the new dispensation? The next four sections will examine the geopolitical consequences of the G4 growth scenario for each of its members and the bilateral relationships between them. A concise guide to the discussion is contained in the G4 geopolitics grid below.

### The G4 geopolitics grid

<table>
<thead>
<tr>
<th>Sino-US</th>
<th>Indo-US</th>
<th>US-Japan</th>
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<tbody>
<tr>
<td><strong>Positive effects</strong></td>
<td><strong>Negative effects</strong></td>
<td><strong>Positive effects</strong></td>
</tr>
<tr>
<td>Fast US growth may:</td>
<td>Defuse US protectionist sentiment, including concern about currency manipulation</td>
<td>Allow US to commit resources to APAC; renew its self-confidence; renew the rest of the region’s confidence in it</td>
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<tr>
<td>Fast Chinese growth may:</td>
<td>Lessen the need for diversionary disputes with Japan that can entangle the US</td>
<td>Threaten US economic hegemony; bolster China’s demands for “say and sway”</td>
</tr>
<tr>
<td>Fast Indian growth may:</td>
<td>Increase India’s credibility as a counterweight to China, leading to Chinese fears of encirclement</td>
<td>Increase India’s appeal as a market and investment destination; increase its credibility as a counterweight to China</td>
</tr>
<tr>
<td>Fast Japanese growth may:</td>
<td>Embolden Abe’s nationalism, heightening tensions with China, which might entangle the US</td>
<td>Increase Japan’s appeal as a market, especially after TPP; empower Abe, who is pro-US</td>
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The G4 geopolitics grid

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<thead>
<tr>
<th></th>
<th>Sino-Indian</th>
<th>Sino-Japanese</th>
<th>Indo-Japanese</th>
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<tbody>
<tr>
<td><strong>Positive effects</strong></td>
<td>Delay the day China supersedes the US as the regional hegemon worth backing</td>
<td>Increase China’s appeal as a market and source of investment; hasten its emergence as the regional hegemon worth backing</td>
<td>Increase India’s appeal as a market and investment destination; increase India’s credibility as a counterweight to China, inflaming Chinese fears of encirclement by Japan, US and India</td>
</tr>
<tr>
<td><strong>Negative effects</strong></td>
<td>Revive fears of US hegemony, encouraging India to take a balancing step towards Beijing</td>
<td>Delay the day China supersedes the US as the regional hegemon worth backing</td>
<td>Increase India’s appeal as a counterweight to China, inflaming Chinese fears of encirclement by Japan, US and India</td>
</tr>
<tr>
<td><strong>Fast US growth may:</strong></td>
<td>Allow China to invest more resources in India; increase China’s demand for Indian exports</td>
<td>Embolden China; increase its demand for commodities and water, crowding out India’s own demand</td>
<td>Strengthen China’s power and confidence, making Japan nervous</td>
</tr>
<tr>
<td><strong>Fast Chinese growth may:</strong></td>
<td>Increase its appeal as a market and investment destination</td>
<td>Embolden India and stiffen its spine in border disputes</td>
<td>Scare Japan into siding with India in a concert of democracies</td>
</tr>
<tr>
<td><strong>Fast Indian growth may:</strong></td>
<td>Increase India’s credibility as a counterweight to China, inflaming Chinese fears of encirclement by Japan, US and India</td>
<td>Increase India’s credibility as a counterweight to China, inflaming Chinese fears of encirclement by Japan, US and India</td>
<td>Increase India’s appeal as a market and investment destination; increase India’s credibility as a counterweight to China</td>
</tr>
<tr>
<td><strong>Fast Japanese growth may:</strong></td>
<td>Embolden Abe, who may pursue nationalist aims that anger China</td>
<td>Allow Japan to invest more heavily in India</td>
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2.1 China

Many American hawks are China bulls. They are fearful about China’s potential strength precisely because they are confident about its economic rise. That faith was dented this year when China’s economic slowdown and stockmarket turmoil culminated in a surprising devaluation of the currency. Thus when China’s president, Xi Jinping, arrived in the United States in September 2015 for his showcase state visit, he had to allay two conflicting concerns. The first was that China would become dangerously strong. The second was that its economy was dangerously weak.

In his policy speech in Seattle, he reassured investors and businesspeople that his government was committed to reform and development, insisting that this growth was necessary to eliminate China’s continued poverty not to enlarge its power. “Our per capita GDP is only two-thirds that of [the] global average and one-seventh that of the United States, ranking around 80th in the world,” he said.

The Thucydides Trap

His speech went down well with his audience, but posed two particular difficulties for his translators. First, he described his visit to Ernest Hemingway’s favorite bar in Cuba, where he drank a “mojito” (or “rum with mint on rocks”, as the translator helpfully described it). Second, he invoked something called the “Thucydides trap”:

“There is no such thing as the so-called Thucydides Trap in the world. But should major countries time and again make the mistakes of strategic miscalculation, they might create such traps for themselves.”

Thucydides was an ancient Athenian historian who chronicled the disastrous Peloponnesian War between Sparta, an established power, and Athens, a blossoming rival, in the 5th century BC. The war set a precedent for future conflicts that still haunts some observers today. When a “rising power rivals a ruling power”, trouble often ensues, according to Graham Allison, a historian at Harvard. The rising power’s “demand for greater say and sway” collides with “the fear, insecurity, and determination to defend the status quo this engenders in the established power”. Allison has examined 16 cases over the past five centuries. In 12 of them, the result was war (see table). This is the “Thucydides trap” that he named and Xi cautioned against in his speech.

22 http://www.chinaus-icas.org/sites/default/files/Full%20text%20of%20President%20Xi%27s%20speech%20in%20Seattle.pdf
23 http://www.youtube.com/watch?v=P9aQPvusITw&t=56m0s
24 http://www.youtube.com/watch?v=P9aQPvusITw&t=51m10s http://www.chinaus-icas.org/sites/default/files/Full%20text%20of%20President%20Xi%27s%20speech%20in%20Seattle.pdf
Thucydides Case Study

<table>
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<tr>
<th>Period</th>
<th>Ruling Power</th>
<th>Rising Power</th>
<th>Result</th>
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<tbody>
<tr>
<td>First half of 16th century</td>
<td>France</td>
<td>Hapsburgs</td>
<td>War</td>
</tr>
<tr>
<td>16th - 17th centuries</td>
<td>Hapsburgs</td>
<td>Ottoman Empire</td>
<td>War</td>
</tr>
<tr>
<td>17th century</td>
<td>Hapsburgs</td>
<td>Sweden</td>
<td>War</td>
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<tr>
<td>17th century</td>
<td>Dutch Republic</td>
<td>England</td>
<td>War</td>
</tr>
<tr>
<td>Late 17th - early 18th centuries</td>
<td>France</td>
<td>Great Britain</td>
<td>War</td>
</tr>
<tr>
<td>Late 18th - early 19th centuries</td>
<td>United Kingdom</td>
<td>France</td>
<td>War</td>
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<tr>
<td>Mid-19th century</td>
<td>United Kingdom</td>
<td>Russia</td>
<td>War</td>
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<tr>
<td>19th century</td>
<td>France</td>
<td>Germany</td>
<td>War</td>
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<tr>
<td>Late 19th - early 20th centuries</td>
<td>Russia</td>
<td>China</td>
<td>War</td>
</tr>
<tr>
<td>Early 20th century</td>
<td>United Kingdom</td>
<td>United States</td>
<td>No war</td>
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<tr>
<td>Early 20th century</td>
<td>Russia</td>
<td>Germany</td>
<td>War</td>
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<tr>
<td>Mid-20th century</td>
<td>Soviet Union</td>
<td>Germany</td>
<td>War</td>
</tr>
<tr>
<td>Mid-20th century</td>
<td>United States</td>
<td>Japan</td>
<td>War</td>
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<tr>
<td>1970s - 1980s</td>
<td>Soviet Union</td>
<td>Japan</td>
<td>No war</td>
</tr>
<tr>
<td>1940s - 1980s</td>
<td>United States</td>
<td>Soviet Union</td>
<td>No war</td>
</tr>
<tr>
<td>1990s - present</td>
<td>United Kingdom</td>
<td>Germany</td>
<td>No war</td>
</tr>
</tbody>
</table>

China does not have to do anything untoward or unusual to disconcert its neighbors and peers, Allison points out. “A risk associated with Thucydides’s Trap is that business as usual – not just an unexpected, extraordinary event – can trigger large-scale conflict,” he writes. The simple fact of China’s size and growth will be enough to unsettle the status quo. China’s population is more than four times that of the United States. That means its economy only has to become half as prosperous (measured by GDP per person) to be more than twice as large. In his book “The Rise of China versus the Logic of Strategy”, Edward Luttwak likens China to a very fat man entering a crowded elevator. Even if he is affable and courteous, he cannot help but make everyone else uncomfortable.

25 In PPP terms, 41 economies had a per-capita GDP that was more than half the US level in 2014.
Even if China treads lightly in global affairs for the foreseeable future, its rise could still cause a lot of upheaval within its more immediate neighborhood. Allison invites us to imagine what would happen if a rising China merely acted, within its region, the way a rising America acted within its backyard at the close of the 19th century. In that period, Allison points out, America declared itself “sovereign on this continent” and proceeded to act accordingly.

“All America liberated Cuba; threatened Britain and Germany with war [over disputes in Venezuela and Canada; backed an insurrection that split Colombia [creating Panama and its eponymous canal]... and attempted to overthrow the government of Mexico, which was supported by the United Kingdom and financed by London bankers.”

A new model of major-country relations

In his Seattle speech, Xi Jinping insisted that China does not seek hegemony. Rather than falling into the trap identified by Thucydides, China has proposed a “new model of major-country relations”. But the Americans are reluctant to endorse this new model without a clearer understanding of what it entails. They are as anxious as anyone to break the destructive, historical cycle of conflict between rising and ruling powers. But it is not yet clear how far each power expects the other to go to avoid that rivalry.

The Chinese may believe that the best way to avoid the Thucydides trap is for the ruling power (the United States) to give the rising power (China) a sphere of influence of its own in the Western Pacific. The Americans are not yet willing to go that far 26.

Washington appears determined to resume policing the South China Sea, “a crucial maritime artery that is used for up to 50% of global commerce” 27. In October it dispatched the USS Lassen, a warship, to sail within 12 nautical miles of the Subi Reef, which China claims as its territory, and which America claims is no one’s territory, because it only appeared at low tide before China built an artificial island on it 28. America is not even willing to stay out of China’s relations with Taiwan, which from China’s point of view is not a neighborhood squabble but a family one.

At the same time, we have yet to see anything to suggest Beijing will back off from its assertive stand in the region. We do not expect any weakening of Beijing’s desire to command the seaways on which its maritime trade depends: ocean-related economic activity accounted for a tenth of its GDP last year, according to one estimate 29. It will continue to seek to create “facts on the water” 30 by reclaiming land around disputed islands. Xi Jinping seems to believe that China can continue to ‘push the envelope’ regionally for now, while being careful to avoid direct confrontation with the US.

26 “[China] wants to be treated not as a US subordinate but as an equal, at least in the western Pacific... To bring this about means undermining US authority by picking small, but winnable, fights... To preserve the status quo, the US needs to prevent every one of China’s moves, something it has been unable to do. China needs merely to pick a few small battles that it knows the US has no wish to fight.” China is stealing a strategic march on the US’ by David Pilling, Financial Times, 28 March 2014


28 http://news.usni.org/2015/11/04/opinion-uss-lassens-transit-of-subi-reef-was-not-so-innocent


One Belt, One Road

One example of China’s newly expansive global vision is its ambitious “One Belt, One Road” (OBOR) initiative, announced by Xi Jinping two years ago. As part of that grand design, a Maritime Silk Road is intended to run from Quanzhou in China’s Fujian province, heading south to the Strait of Malacca and then across the Indian Ocean to East Africa and the Suez canal.

The initiative also includes the Silk Road Economic Belt (SREB), which will cross the Central Asian Republics before reaching Iran and Turkey. The combined OBOR vision faces a daunting list of practical and political impediments. But strong economic growth in China would provide Beijing with the means to pursue it and the diplomatic leverage to strike the many bilateral agreements (with 60 or more countries) it requires.

The consequences of the OBOR could be profound. In the near term, the belt will deepen and broaden competition for regional influence between Beijing and Moscow (a competition that will probably be resolved to Russia’s disadvantage and discomfort) 31. In the long term, a successful OBOR would put China in a resilient geopolitical position. Through commercial inducements and diplomatic persuasion, it would have secured a network of trade and influence across and around the vast Eurasian landmass. Because of its deep strategic importance, that landmass has been described as the “geographical pivot of history” 32, by classical theorists of the subject like Sir Harold Mackinder. By building a network across it, China would become much harder to contain in the event of any grand geopolitical tussle. In particular, neither Russia nor the United States and its allies could blockade China, even if they sought to do so.


New Silk Roads

Source: The Wall Street Journal

“The geographical pivot of history” is the title of Mackinder’s classic 1904 essay, one of the foundational texts of geopolitics. It marked the end of an era in which inter-state competition drove an outward expansion of empires. By 1904, the world’s dimensions had been largely mapped; its territories staked out and claimed for one flag or another. There was no unsurveyed, uncolonized space into which to expand. Great power rivalry would henceforth take place within defined global borders. The world had become a closed vessel, which would only amplify the din and danger. “Every explosion of social forces, instead of being dissipated in a surrounding circuit of unknown space...will be sharply re-echoed from the far side of the globe,” Mackinder wrote.

The metaphor is similar to Luttwak’s idea of a crowded elevator without enough room for everyone’s comfort. But how helpful are these metaphors? Geography is inelastic - fixed in supply. But the same is not true of national pride or prosperity. Global trade, investment and commerce can expand indefinitely as economies become more productive and more useful to each other. China’s outward economic expansion will increase its clout in world commerce. But it will also increase the overall volume of commerce. To adapt Mackinder’s metaphor: any explosion of economic rivalry will be dissipated in an expanded circuit of commerce.

This is simply to say that China and the rest of the G4 are not locked into a zero-sum contest for prosperity and national fulfilment. Even hard-headed observers like Henry Kissinger recognize that “economic interdependence is the ballast and propeller of the overall relationship” between the US and China. The healthy Chinese growth envisaged in the G4 scenario will only deepen that interdependence.

The two countries’ leaders are hardly blind to this fact. Reflecting on the annual US-China talks known as the Strategic and Economic Dialogue, Thomas Christensen, a former State Department official now at Princeton University, noted that the US officials were keen to offer any helpful advice they could to China’s economic policymakers. “The American entourage... could have been accused of a lot of things - preachiness, condescension, ignorance of China’s local conditions... but it could not reasonably be accused of trying to harm China,” Christensen notes. The visitors’ biggest worry was not that China would sustain fast growth but that it wouldn’t.

The Thucydides trap and other disturbing historical analogies fail to translate to the present era in two obvious ways. They do not translate easily to an era that is both post-colonial and nuclear. Germany in the late 19th and early 20th century sought colonial possessions to match those of its European rivals. Japan in the 1930s seized commodity-rich territories in North-Eastern China to fuel its growth. Today’s rising powers can buy the commodities their growth requires on a reasonably open international market, without having to plant their flag in the nations that produce them.

Moreover, with the advent of nuclear weapons, the great powers cannot hope to survive a direct war of any significance. Thus the kind of fierce, uninhibited war that Thucydides documented is neither necessary to acquire resources nor is it feasible in a nuclear age, beyond strictly circumscribed skirmishes or indirect proxy battles.

33 “The China Challenge: Shaping the Choices of a Rising Power”
Softly, softly

Even the hawks on both sides accept that the two countries cannot fight a straightforward war. So even if some of the geopolitical games they play are genuinely zero sum, the competition between them will take more subtle forms. “The wars one must fight are political wars, economic wars, science and technology wars, diplomatic wars,” as Wu Chunqiu, of the Academy of Military Sciences, has put it 34.

Steady growth in China will expand its soft power. That will encourage Beijing to express its regional aspirations primarily through its powers of economic attraction. The OBOR initiative is one prominent example of that. We also expect China to continue to promote the Regional Comprehensive Economic Partnership (RCEP) negotiations (to which America is not a party), irrespective of the fate of the Trans-Pacific Partnership (which does not include China) 35. The RCEP, which has been stalled since Abe’s return as prime minister, featured prominently in China’s revived trilateral talks with Japan and South Korea in November.

Beijing has relied on soft-power projection even in the case of Taiwan, the geopolitical controversy that perhaps lies closest to its heart. In 2010 Beijing agreed an Economic Co-operation Framework Agreement with Taiwan that was intended to be commercially attractive and therefore geopolitically seductive 36. It offered more generous access to the vast mainland markets than Taiwan offered to its own market in return 37. This charm offensive culminated in an unprecedented November meeting in Singapore between Xi Jinping and Ma Ying-Jeou, Taiwan’s president.

Another example of China’s economic power is the Asian Infrastructure Investment Bank (AIIB). This new multilateral lender reflects Beijing’s growing aspiration to be a ‘rule-maker’ rather than a ‘rule-taker’, building international institutions of its own to add to the cluster of organizations bequeathed by the US and its allies after the second world war. China started down this path as long ago as 2001 with the establishment of the Shanghai Cooperation Organisation (SCO), which will soon add India and Pakistan to a membership that now includes Russia and four of its neighbors (Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan) 38.

The AIIB also reflects China’s frustration with the G7 over its persistent failure to reform the International Monetary Fund and the other Washington-based international financial institutions (IFIs), despite profound shifts in the economic weight of their members. The latest attempt to reform the IMF is being blocked by the US Congress 39.

In proposing the AIIB, Beijing may have originally hoped merely to boost Chinese exports in industries where it now suffers from domestic overcapacity. But whatever its original motivations, the AIIB initiative is proving far more successful than even Beijing can have expected.

34 http://fas.org/nuke/guide/china/doctrine/pills2/part08.htm
35 The RCEP involves all the members of ASEAN plus six countries with which ASEAN has bilateral trade agreements (Australia, China, India, Japan, New Zealand and South Korea) accounting for around 40% of world trade.
36 Under the deal, the mainland agreed to lower tariffs on 539 products worth about 16 percent of its imports from Taiwan. Taiwan, in turn, agreed to cut duties on 267 items worth 10.5 percent of its mainland imports. In addition the mainland said it would open up 11 service sectors; Taiwan just seven. http://www10.iadb.org/intal/intalcdi/pe/2014/13556.pdf
37 The ECFA is a good example of China’s preferred approach, but not a particularly successful one. Despite the deal’s generosity (or perhaps because of it), the agreement has been viewed with suspicion in Taiwan. Opinion polls point to the (pro-independence) Democratic Progressive Party (DPP) candidate, Tsai Ing-wen, securing victory in the 16 January 2016 presidential election, even if her party does not secure a majority in elections to the legislature, which are to be held on the same day.
38 At that point its members will encompass more than half of the world’s population. Afghanistan, Belarus, Iran and Mongolia are also observers; a number of other countries attend as ‘dialogue partners’ or ‘guests’
US allies have joined in droves, including key regional partners such as Australia and South Korea. To judge from progress since April of this year, Beijing now seems to want to set up a genuinely world-class financial institution that will better reflect the contemporary composition of the world economy, even if China, the original instigator, remains primus inter pares.  

China also expresses its economic soft power within established international institutions. It seems particularly keen for its currency to gain inclusion in the International Monetary Fund’s special drawing rights (SDR) basket. In the absence of further market turbulence, the IMF Board may decide as early as this November to admit the renminbi in September 2016. We would not expect the US to block such a move.  

American hawks worry that China is intent on circumventing international rules and institutions, which were designed by the Western powers for a very different world. But the SDR example suggests something subtly different. For a country supposedly intent on supplanting existing international institutions, China cares an awful lot about its standing within them.  

The problems that unite  

Even outside of the economic realm, the world poses a variety of difficulties that will invite Sino-American co-operation rather than conflict. The US and China have worked together on a diplomatic response to Iran’s nuclear ambitions. Co-operation is also possible on climate change. Thanks to China’s rising prosperity, its public and policymakers have become newly sensitive to the environmental side-effects of development. The 7 percent growth envisaged in our G4 scenario will entail a further evolution of China’s economy beyond industrial smokestacks and a further reduction in the carbon intensity of its GDP. That may possibly create room for further co-operation on climate change, beyond what may be a successful outcome to the Paris climate change conference (COP21) this coming December where hopes are high that agreement will finally be reached on a binding global emissions reduction treaty.  

North Korea is another potential issue on which the two can co-operate. Since Obama’s overtures to Pyongyang in 2012 were rebuffed, the US president has largely ignored the threat posed by the rogue state. The next US president may be willing to work with China to try to resolve this chronic concern. Over the past few years, the views of Beijing and Washington have converged somewhat, even if neither has yet been able to come up with a viable formula to bring peace and stability to the peninsula. Seoul’s strong relationship with both capitals (a tricky balancing act) could be the catalyst for yet more policy coordination here.  

Let us finish this section with one final reason for optimism. Even if China’s unprecedented economic expansion is potentially destabilizing abroad, it is stabilizing at home. Steady growth of 7 percent would help consolidate Xi Jinping’s authority at the helm. It would also ease socioeconomic tensions, reducing any perceived need to stir up nationalism as a distraction from economic setbacks.  

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2.2 United States

Global leadership is a prize but also a burden. Many Americans resent the obligations and chores of superpowerdom. A majority (51 percent) think the country does too much to help solve world problems, according to a 2013 survey by the Pew Research Center. A similar proportion (52 percent) think the “US should mind its own business internationally”. Americans were not always so eager to keep themselves to themselves. Back in 2002, when the attacks of 9/11 were a more immediate memory, only 30 percent of Americans favored such geopolitical hermeticism.

Rather than losing ground in a closely fought competition to lead the world, America may therefore simply withdraw from the contest. That would result in a “non-polar”, leaderless world, overseen by a “G-zero”, as Ian Bremmer of the Eurasia Group has put it. In many parts of the world, he argues, the emerging powers are unwilling to shoulder the burdens that America is beginning to shirk.

“For the first time in seven decades, we live in a world without global leadership,” Bremmer has written. America is hamstrung by “endless partisan combat and mounting federal debt.” At the same time, “America’s chief competitors remain too busy with problems at home and in their immediate neighborhoods to shoulder the heaviest international burdens.”

Should we then be talking about a G-zero rather than a G-four? That description may fit some parts of the world, but not Asia, which suffers if anything from a surfeit of potential leaders. Bremmer first voiced this argument during the dark days of the global financial crisis. His description of a hamstrung US seems less apt 6-7 years on. Partisan combat is as fierce as ever. But America’s economy is stronger than it was in 2008-9 and its government debt remains spectacularly easy to finance. The US is not facing insupportable demands on its productive capacity, as it did in the “guns and butter” era of the late 1960s and early 1970s. Back then, the competition between the cold war abroad and the war on poverty at home resulted in an overstretched economy, plagued by high inflation. Today, the US has an understretched economy marked by subdued inflation. In an era of underemployment and underproduction, America has the capacity to do more at home and also abroad, if a tight-fisted Congress were to permit it to do so.

Besides, America is in relative not absolute decline (as Bremmer freely concedes). Both its GDP and population will be bigger in 2020 and 2030 than they are today, barring any unforeseeable catastrophes. In principle, any global duties it can afford to shoulder today will be more affordable for its bigger economy in five and 15 years’ time, provided these duties do not become vastly more costly or complex to perform. If America can cope with policing global shipping lanes today, for example, its bigger economy should remain equal to the task in 2020 and 2030.

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42 http://www.people-press.org/2013/12/03/public-sees-u-s-power-declining-as-support-for-global-engagement-slips/
43 http://www.theguardian.com/commentisfree/cifamerica/2009/mar/02/america-russia-china-india-brazil
44 See also: https://www.foreignaffairs.com/articles/united-states/2008-05-03/age-nonpolarity
45 http://www.amazon.co.uk/381/dp/B007HO81AS/ref=sr_1_3?s=books&ie=UTF8&qid=1445245813&sr=1-3&keywords=ian+bremmer
47 US labor-force participation is at its lowest rate since 1977, according to the Bureau of Labor Statistics.
48 http://www.census.gov/population/projections/data/national/2014/summarytables.html
The US pivot to Asia

Rather than quietly receding from the Asia-Pacific region, America has reasserted its commitment to it. In response to China’s rise, President Barack Obama has officially adopted a so-called ‘strategic pivot’ (now known as ‘rebalancing’). This rebalancing entails raising America’s naval presence in the Pacific Basin from 50% of its total resources to 60% by 2020. It also now includes completing the 12-country TPP.

Obama has not, in our view, been a great exponent of the pivot in practice. But his administration has successfully concluded negotiations on the TPP, and the resulting agreement will eventually be ratified, we believe, despite the many short-term obstacles in its way. The US will also, we believe, achieve its objective of redeploying naval resources.

The next US president is also likely to focus more closely than Obama on foreign policy in general and Asia in particular. China’s rise will compel attention. At the same time, America’s traditional preoccupation with the Gulf will fade. Thanks to improvements in fracking technology, the US is less dependent than it was on its Gulf allies to keep a lid on the price of oil. If an uptick in Middle Eastern tensions raises the oil price by $10-20 a barrel for any length of time, America’s nimble shale (tight-oil) industry will revive, increasing supply and limiting further increases in fuel costs. This change in the oil industry will inevitably reduce America’s incentive to engage in the Middle East, which we believe will continue to be afflicted by fundamentalist terrorism, instability and violent conflict, principally between Sunni and Shia.

We also believe that the nuclear accord with Iran will likely lead to a gradual rapprochement between Tehran and Washington (however stridently leaders in both countries claim otherwise). That thaw would further diminish concerns about Iran, which has arguably been America’s biggest policy ‘problem’ in the region since the military withdrawal from Iraq (and until the rise of Islamic State).

It seems likely therefore that Asia, at least, will be overseen by a G4 not a G-zero in the coming years. That is especially likely if America achieves the 3 percent growth envisaged in our optimistic scenario. That growth would allow America to remain a fully “present” resident power, committing energy, resources and attention to the Asia-Pacific region. As a consequence, it will keep rubbing up against China’s expanding presence in the same neighborhood. That raises a difficult question: will strong economic growth in America allay geopolitical friction in Asia or increase it?

A US economic revival would have some unambiguous benefits for the country’s relationship with China. It would make it easier to resist protectionist “China-bashing” at home, where many people blame China for stealing US jobs. This kind of rhetoric has been a theme of this year’s presidential primaries and may intensify when TPP appears before Congress.

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48 The negotiating parties to the TPP are Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States and Vietnam.

49 China is not a party to the TPP, but many lawmakers cite it when arguing for or against the pact. For example, when Vietnam devalued its currency shortly after China’s renminbi devaluation in August, Democrats in Washington were quick to see Vietnam’s move as a response to China’s “currency manipulation”. They called again for provisions in the TPP to counter this perceived threat.
Some of this is no doubt empty posturing: candidates from both parties commonly talk tough about China on the campaign trail only to become more pragmatic once installed in office. However, thanks to the growing distrust between the world’s two largest economies, there is a danger that this established pattern will prove historical rather than habitual. This danger will be substantially reduced if the US economy is growing vigorously and creating jobs briskly.

The benefits of a well-resourced US commitment to Asia are also easier to appreciate if one considers the alternative. If America were to recede from the Asia-Pacific region, countries that now rely on the US to keep the peace would have to bolster their own defenses. Each country’s military build-up – however defensive in intent – would unsettle its neighbors, prompting further rounds of military expansion in response. The result of this multilateral arms race might be a region that is, in sum, more militarized as a result of American inattention than it would have been had America shown a steelier commitment. It would also be less stable. Instead of a manageable bipolar balance of power between China and America, the region would be characterized by an uneasy multilateral balance of power between China and a host of nervous neighbors, who would be loosely co-ordinated at best.

Set against this alternative scenario, a revived American economy and a renewed US commitment to the region should increase regional stability not jeopardize it. By boosting America’s standing, it would reassure America’s allies about their security guarantees. That would help to ease their nervousness over an assertive China, thereby reducing one source of regional tension.

The only danger is that an overconfident America could itself become another source of regional upset and nervousness. The United States, with its self-belief restored, could become dangerously assertive in the APAC region. Consider, for example, the report ‘Revising US grand strategy toward China’, authored by Robert Blackwill and Ashley Tellis and published by the Council on Foreign Relations in March 2015.50 The report argued that America’s efforts to integrate China into the liberal international order had backfired, allowing China to threaten America’s “primacy” in Asia. In response, they argued, Washington needed a “new grand strategy” that centers on “balancing the rise of Chinese power rather than continuing to assist its ascendancy.”

In practical terms, this “balancing” amounts to limiting technology exports to China, signing trade agreements that discriminate against the country, bolstering America’s friends and alliances in the region and “improving the capability of U.S. military forces to effectively project power along the Asian rimlands despite any Chinese opposition”. The new grand strategy also has one other requirement upon which its other elements depend: “revitalizing the US economy”.

The report, which received plaudits from leading Republicans in particular, was, we believe, in part responsible for the uptick in China/US tensions in the first half of the year. Writing in the *Financial Times*, Richard McGregor - correctly, in our view - argued that pursuit of the Blackwill/Tellis strategy would “undoubtedly” be seen by Beijing “as a strategy of containment”. By adopting this strategy, the US would “ensure that China continues to behave like a rival in Asia, and... becomes one”51. Others go further, warning that the report invites America to set off down the “realist road to war” 52.

As the debate over the Blackwill/Tellis report shows, Americans are still trying to decide how best to deal with China. The outcome of that debate is still very much up for grabs. Indeed, the only people who seem sure about the debate’s likely conclusion are the Chinese themselves. “In Beijing’s eyes, the US is deeply opposed to China’s rise,” according to Kevin Rudd, the former Australian prime minister. “A document circulated among the Communist party leadership last year summed up the consensus view. American strategy towards China, it said, had five objectives: to isolate the country, contain it, diminish it, divide it and sabotage its political leadership... [It is] the Chinese view that the US will never willingly cede its status as the preeminent power in Asia and the world.” 53

The Chinese do not have to look very far to find evidence for their view. From Beijing’s perspective, US deployments in the region look at least consistent with a containment philosophy, even if they are not confirmation of it. From Beijing one sees:

- US military stationed nearby in Japan and South Korea;
- the US building closer military ties with Vietnam and the Philippines;
- US military over the horizon in Australia and to the southwest in Pakistan;
- and closer ties, including military exchanges, between India and the US.

Hawks in both China and the US would therefore expect a revitalized US economy to heighten tensions in Asia. Strong growth would allow the US to pursue the more confrontational grand strategy that Blackwill and Tellis advocate and that Beijing hawks have long expected.

There are two reasons why this outcome should be avoided, however. If, as we have argued, China relies more on soft power than hard to further its interests, it will inspire less active resistance from its neighbors (or from the United States for that matter). That will sap regional support for any grand strategy to stymie its continued rise. Conversely, if America is too assertive - especially if it treads clumsily on China’s deepening economic ties with its neighbors - it will fray the very friendships and partnerships on which the Blackwill/Tellis strategy depends.

One such partnership is with India, where Blackwill served as ambassador. China’s power has pushed it closer to the United States. But American pugnacity would do the opposite. It is to India that we now turn.

51 http://blogs.ft.com/the-world/2015/05/beijings-island-factory-tests-washingtoms-pivot-to-asia/
52 http://thediplomat.com/2015/05/balancing-china-and-the-realist-road-to-war/
53 ‘America and China are Rivals with a Common Cause’ by Kevin Rudd, Financial Times, 16 April 2015. See also “A Tipping Point in US-China Relations is Upon Us”, by David Lampton: http://www.uscnpm.org/blog/2015/05/11/a-tipping-point-in-u-s-china-relations-is-upon-us-part-i/
2.3 India

Bill Emmott’s book “Rivals” - one of the few to consider Japan, India and China in parallel - begins with the controversial nuclear pact America agreed with India in 2006. The deal, which diluted the global non-proliferation treaty to accommodate Delhi’s nuclear ambitions, showed how far America was prepared to go to woo India, an emerging power and fellow democracy, which it saw as a potential counterweight to China. In Emmott’s view, the boldness of America’s overture - and the scale of the diplomatic prize - bore comparison with President Nixon’s breakthrough visit to China in 1972.

The deal also, however, illustrates the prosaic difficulties that still bedevil relations between the world’s two biggest democracies. Not all of India’s policymakers were happy about the agreement. The Left parties in particular hated “the idea of cosying up to Uncle Sam”, as Emmott puts it. And US firms have yet to profit from the deal because of their wariness about India’s sweeping liability laws, an obstacle Obama claims to have resolved on his India visit in January 2015 54.

The United States is viewed with measurable warmth and admiration by the Indian public 55. India’s current prime minister, Narendra Modi, also draws large crowds on his US visits, where he is feted by American residents and citizens of Indian origin. This popular goodwill between the two countries does not always translate into easy diplomacy, however. The US is often exasperated by India’s policymaking inertia, and India’s policymakers are frequently offended by US clumsiness and indelicacy. Witness, for example, the visceral outrage they felt when an Indian diplomat was arrested for underpaying her maid in New York.

America’s policymaking elites have made up their mind about India, seeing it as a strategic partner, fellow democracy and promising market, not as an impoverished socialist backwater. But much to their surprise, India’s elites have not yet made up their mind about America.

The arc of freedom or prosperity

The 8 percent growth envisaged by the G4 scenario will make India a more appealing market and a more credible counterweight to China. That will only increase its allure to the US and Japan. Both suitors court India partly by appealing to the democratic values they share. “It is incumbent upon us two democracies, Japan and India, to carry out the pursuit of freedom and prosperity in the region,” said Shinzo Abe, Japan’s prime minister, on one visit to the country 56.

But although India is proud of its democratic principles, it has not traditionally sought to export them or allowed them to limit its foreign friendships. It has presented itself to the world first and foremost as a post-colonial, developing country, which has sought common cause with other developing countries, democratic or otherwise. India is, for example, poised to join the Shanghai Co-operation Organization. It retains close ties with Iran and Russia.

54 http://www.thehindu.com/opinion/lead/looking-beyond-nuclear-liability/article6996284.ece
55 According to the Pew Research Center, 70% of Indians have a favorable impression of the US.
It was a founding member of China’s Asian Infrastructure Investment Bank and an Indian national heads the BRICS bank, officially known as the New Development Bank. As Zorawar Daulet Singh of King’s College London has put it, Modi “does not appear constrained by any deep ideological preferences other than to secure India’s place in the sun.”

India spent much of the cold war trying to remain “non-aligned” with either capitalism or communism. Something of that attitude remains. It does not want to succumb to China’s influence. Nor does it entirely welcome America’s. It is keen to preserve its “strategic autonomy”, which is in many ways the reincarnation of “non-alignment”, according to Rohan Mukherjee of Princeton University. If Japan fears American abandonment, India is a little afraid of American entrapment, he notes. Indeed, its eagerness to preserve its distance and keep its options open sometimes prevents it from actively exploring the opportunities that deeper partnerships could offer, he argues.

There are, after all, two ways to remain equidistant between China and the United States. One is to remain equally close to both of them. The other is to remain equally aloof from each of them. South Korea, perhaps more than any other country, has exemplified the first approach. India too often drifts towards the latter.

Sino-Indian tensions

Can India still afford to keep the US and Japan at a comfortable distance given China’s rise? The country’s hawks have long fretted about China’s growing clout. The country was named as “potential threat number one” by India’s defense minister in the days before India’s 1998 nuclear test 57. China occupies large tracts of territory - principally Aksai Chin - that India claims as its own. It sponsors India’s principal enemy, Pakistan, helping it to become a nuclear-weapons state. Its navy has acquired access to ports en route to the Persian Gulf and beyond, a “string of pearls” (as the Pentagon calls it) that encircles India and unnerves the country’s hawks. And China’s ambitious hydrologists and engineers talk about disrupting or even diverting the flow of one of India’s major rivers, the Brahmaputra, which originates amid the glaciers of Tibet.

With world attention focused on tense maritime borders in east and southeast Asia, China’s land-border dispute with India seems to be almost forgotten, at least outside of the subcontinent itself. As well as Aksai Chin (a mountainous desert now part of Xinjiang autonomous region in China), India also claims the Trans-Karakoram Tract on the grounds that the territory, ceded to China by Pakistan, did not belong to Pakistan in the first place. China, for its part, claims territory within the Indian state of Arunachal Pradesh, ceded to India by Tibet, on the grounds that Tibet was not then a sovereign nation. China and India have already gone to war once, in 1962, over their disputes 58.

57 India’s prime minister, Atal Bihari Vajpayee, also cited China in a letter to President Clinton: “We have an overt nuclear weapon state on our borders, a state which committed armed aggression against India in 1962. Although our relations with that country have improved in the last decade or so, an atmosphere of distrust persists mainly due to the unresolved border problem. To add to the distrust that country has materially helped another neighbour of ours to become a covert nuclear weapons state,” Vajpayee wrote. http://www.nytimes.com/1998/05/13/world/nuclear-anxiety-indian-s-letter-to-clinton-on-the-nuclear-testing.html

58 After several failed attempts to reach agreement over disputed territory along the 3,225km Himalayan border, China on 20 October 1962 launched simultaneous offensives in Ladakh and across the so-called McMahon Line (set under the Simla Treaty of 1914 between the British government and the authorities in Tibet and therefore effectively the boundary between China and India, albeit never recognized by Beijing). China pushed Indian forces back on both fronts before declaring a ceasefire on 20 November and withdrawing its forces from the disputed areas. Although the border dispute was the main pretext for China’s assault, other issues also played a part, not least India’s decision to grant asylum to the Dalai Lama in the wake of the 1959 Tibetan uprising – a situation which still prevails and which may be one reason for China’s seeming reluctance seriously to address resolving the dispute.
Beijing has managed to resolve all of its land-border disputes with other countries, often showing remarkable pragmatism in doing so. With India, it formally agreed in 1996 to find a resolution and to demarcate a Line of Actual Control. That wish for a solution has been repeated by successive generations of China’s leaders, including Xi Jinping. But the dispute festers on. Its pettiest manifestation is surely China’s issuance of “stapled visas” 59 to Indian visitors from Arunachal Pradesh on the grounds that they do not need a visa to visit their own country.

In addition to the visa wars, Indians worry about the potential for a water war. Between them, China and India muster nearly 40% of the world’s population, but only a little over 10% of the world’s fresh water. One major watershed sits squarely within the disputed border area.

Some Indians fear that China will disrupt the flow of the Brahmaputra river, which begins in Tibet, flows east at high altitude, before plunging steeply and turning sharply towards North-East India at the “Great Bend”. China is trying to harness the river’s energy by building “run-of-the-river” hydroelectric dams that generate power as the water flows past 60. It denies harboring more ambitious plans to divert the river, so that it continues east at the Great Bend rather than turning south. Nonetheless, some strategic thinkers in Delhi are worried. “Upstream dams, barrages, canals, and irrigation systems can help fashion water into a political weapon that can be wielded overtly in a war, or subtly in peacetime to signal dissatisfaction with a co-riparian state,” argues Brahma Chellaney of the Center for Policy Research in Delhi 61.

As things stand, these Sino-Indian frictions - visa wars, water wars, the string of pearls - create worry rather than actual harm. China is damming the upper reaches of the Brahmaputra, but denies that it will disrupt, let alone divert, the river’s flow. Perhaps it could use the river to “signal dissatisfaction” with India, as Chellaney fears. But a country as powerful as China has many easier ways of sending such a signal. The two countries’ disputed border remains a potential flashpoint between them. But although Beijing shows little urgency in settling the issue, it has no interest in escalating it either: it is after all preoccupied with other disputed borders at sea.

China’s so-called “string of pearls” - friendly ports in Myanmar, Bangladesh, Sri Lanka, Pakistan and elsewhere - is probably not a deliberate strategy to surround India. These ports are instead necessary to repair, resupply and refuel China’s merchant navy so that - even in the absence of operational aircraft carriers - it can protect Chinese shipping far from the country’s shores. Over 40 percent of China’s imported oil must pass through the Strait of Hormuz, according to the US Department of Defense, and over 80 percent passes through the Strait of Malacca 62.

59 These are visas stamped not in the visitor’s passport itself, but on to a loose page stapled into the passport. http://www.thehindu.com/news/national/stapled-visa-issue-with-china-still-unresolved/article7268941.ece


61 “Coming water wars”. The International Economy, Fall 2009. For a less alarming account, see “China-India Water Disputes: Two Major Misperceptions Revisited”, by Zhang Hongzhou. RSIS Commentary January 2015.

String of Pearls
Chinese political influence or military presence.

India’s democratic traditions may set it apart from China philosophically. But democratic pressure will also compel it to make the most of China commercially. Modi won the 2014 election on a promise to restore India’s economic momentum. That economic imperative will remain paramount in his dealings with China, a rich source of investment and technology. Despite Delhi’s concerns over China’s regional ambitions and its close ties with Pakistan, its relations with Beijing should therefore remain calm, in our view. That will allow trade and investment between the two economies to grow, albeit slowly, even as security exchanges between India, the US and Japan also deepen, albeit gingerly.
2.4 Japan

Japan and the United States have one of the deepest security alliances in the world, with about 50,000 American troops stationed on the ground and America’s nuclear umbrella extending overhead. At the same time, Japan and China have one of the deepest economic partnerships in the world, thanks to heavy Japanese investment in Chinese manufacturing facilities, supplied by a rich array of sophisticated Japanese parts-makers. Japan’s trade with China is now more than 50% greater than its trade with the United States. The intimacy of Japan’s economic relationship with China is, however, equaled by the bitterness of their historical entanglements. China accuses Japan of denial and amnesia about the militarist depredations of the 1930s and 1940s. Japan suspects China of the opposite: an insistent picking at historical scars.

Only six years ago, Japan seemed somewhat torn between the country on which its economy depended and the country on which its security depended. Under the new leadership of the Democratic Party of Japan (DPJ), Japan seemed keen to forge closer ties with China, even if that meant loosening its embrace of the United States. At that time, China’s economy was poised to overtake Japan’s, even as American capitalism seemed to be in free fall. A long-running debate over the relocation of a noisy American marine base in Okinawa was souring the mood. It may have also occurred to the Japanese that China could bring greater pressure to bear on North Korea. The secretary-general of the DPJ, who had described Americans as “somewhat monocellular”, travelled to Beijing at the end of 2009 with an enormous entourage, including 143 members of the Diet, seeking closer ties with China as part of what Japan described as an East Asian Community.

Japan’s flirtation with China was, however, rudely interrupted by the dispute over the Senkaku Islands (known as the Diaoyu in China), which are claimed by Japan, China and Taiwan. In September 2010 a Chinese fishing boat collided with two Japanese Coast Guard vessels after ignoring orders to leave disputed waters close to the islands. The captain of the fishing boat was arrested and held in Japan for two weeks, prompting a vitriolic Chinese response.

“The impact on Japanese opinion was… not merely strong but downright structural,” argues Edward Luttwak in his book “The rise of China versus the Logic of Strategy”. Only 9 percent of Japanese now have a favorable impression of China, according to the latest Pew survey, whereas 68 percent of them take a favorable view of America. Japan-China relations lapsed into a period of “hot economics, cold politics” as Li Mingjiang has put it.

63 Benno Ferrarini of the Asian Development Bank has developed a measure of “vertical trade”, which captures trade across borders in parts and components. According to this measure, Japan and China have the most vertically integrated trade relationship in the world, because such a high proportion of China’s exports contain parts imported from Japan.


65 “Japan’s love-bubbles for China” The Economist January 28th 2010 http://www.economist.com/node/15393357

66 “The rise of China vs the logic of strategy”, by Edward Luttwak.


68 China demanded an apology, froze high-level contacts with Japan, arrested four Japanese employees of Fujita corporation, and tolerated aggressive protests outside the Japanese embassy. (The dispute even resulted in Chinese music promoters cancelling an appearance by a Japanese boy band.)

69 “China and Japan: Hot economics, cold politics?” in Purnendra Jain and Lam Peng Er (eds), Japan’s Strategic Challenges in a Changing Regional Environment.
Since then, the Sinophile DPJ has been buried by two landslide victories for the Liberal Democratic Party (LDP) led by Shinzo Abe, a staunch supporter of the United States. “America is an awesome country,” Abe declared in his 2015 speech before a rare joint session of Congress, describing how its meritocratic culture intoxicated him as a young man in New York. Abe also has a complicated relationship with China, where his grandfather, a former prime minister, served as a top industrial planner during Japan’s occupation of Manchuria in the 1930s.

Although Abe’s LDP may lose some seats in an upper-house election due in mid-2016, we expect Abe himself to be in office for at least another three years. He remains determined to pursue his economic agenda, known as Abenomics. That includes ratification of the TPP, which would open Japan up to external pressure for reform—much as Commodore Perry’s “black ships” spurred Japan to modernize after sailing into Tokyo harbor in 1853.

Abe has also demonstrated his determination to push through constitutional change, even in the face of majority public opposition at home. He sponsored a reinterpretation of Article 9 of Japan’s constitution, which governs Japan’s Self-Defence Force (SDF). That reinterpretation, which would allow the SDF to defend an ally overseas, was approved by parliament earlier this year.

It is important to stress that we see nothing sinister to date in the reinterpretation of Article 9. Seventy years after the end of the Second World War it is something of an anomaly, it seems to us, that Japan can still do little or nothing to protect vital national interests away from its own shores. Consider, for example, a scenario in which the US military drawdown in the Gulf leaves a security vacuum in the region that endangers the shipping of countries like Japan that are still highly dependent on Middle Eastern oil and gas. Even after the latest reinterpretation of Article 9, it is doubtful that Japan would be able to protect its tankers with its warships, in our view.

We are not alone in seeing a direct relationship between Abe’s economic ambitions and his nationalist aspirations. Abe’s supporters often allude to the 19th century Meiji Revolution, which recited the slogan “Fukoku kyōhei” or “enrich the economy, strengthen the military.” The 2 percent growth outlined in the G4 scenario would represent a striking success for Abe’s economic strategy. That success would strengthen and embolden him, boosting his determination and his ability to pursue his defense and security goals. Those goals may include further reinterpretations of the constitution and hikes in Japan’s defense spending. Furthermore, we anticipate that, to try to win over more public support for his military reforms, it will suit Abe to present China as a threat to Japan’s territorial integrity.

None of this will go down well in Beijing. It is acutely sensitive to any expressions of Japanese nationalism or self-assertion. But although Beijing will find Abe’s unabashed nationalism distasteful, it may also, on occasion, find it useful. Abe’s Japan provides a handy lightning conductor to help China’s government defuse domestic discontent and frustration. The violent anti-Japanese protests in 2012, for example, distracted the public from the Bo Xilai scandal, according to Perry Link of the University of California, Riverside. Both Beijing and Tokyo may therefore be tempted to play a dangerous game of deliberately raising tensions from time to time.

72 http://www.nybooks.com/blogs/nyrblog/2012/sep/20/beijings-dangerous-game/
With luck, however, the satisfying growth implied by the G4 scenario will lessen the need for diversionary disputes designed to distract the public from other grievances. The cheaper yen, engineered by Abenomics, has also attracted flocks of Chinese tourists to Japan as well as fresh Chinese investment in Japanese property. It is, therefore possible, that the G4 scenario will leave China more contented at home and less disputatious in the East China Sea, even as it makes Japan more assertive abroad.

**Beyond Buddhism**

If China’s new swagger has rejuvenated Japan’s longstanding alliance with the United States, it has revolutionized Japan’s relationship with India. That relationship has a 1,500-year history, dating back to the arrival of Buddhism to Japan from India via China. Some adventurous Japanese pilgrims now make the same journey in reverse, visiting a sacred Bodhi tree in the impoverished Indian state of Bihar - where the train network would test anyone’s serenity of mind.

On official visits, politicians from Japan and India also often mention Justice Radhabinod Pal, an Indian judge who served on the Tokyo war-crimes tribunal (the International Military Tribunal for the Far East). He wrote a long dissenting judgment that condemned Japan’s wartime conduct but also dismissed the war-crimes charges levelled against it, arguing that the charges were hypocritical and retroactive examples of victor’s justice. According to the Pew Research Center, 63 percent of Japanese have a favorable impression of India (even as only 46 percent of Indians have a favorable view of Japan).

These historical links have allowed Delhi and Tokyo to consistently boast of a strong and friendly relationship. But until the end of the cold war, their exchanges had little substance (beyond India’s status as the biggest single beneficiary of Japanese aid). Their relationship was inhibited by Japan’s close alignment with the US during a time when India remained either “non-aligned” or close to the Soviet Union.

Thus, it was not until well after the end of the Cold War that a strategic relationship between the two really started to develop. It was built on the December 2006 “Joint Statement towards Japan-India Strategic and Global Partnership”. The following year the two countries took part in joint naval exercises (together with Australia, Singapore and the US) in the Indian Ocean, known as Malabar 2007. This was followed on 22 October 2008 by a bilateral security pact and now regular joint naval exercises. Japan says it is prepared to invest in infrastructure in India’s Arunachal Pradesh, a Himalayan state that China claims as its own. And if India completes the purchase of Japan’s US-2 search-and-rescue aircraft, it may become the first country to import Japanese military equipment since world war two.
Abe has made no secret of his wish to deepen the security relationship further. He has spoken of a “confluence of the two seas” (a phrase he borrowed from a Mughal prince), arguing that “peace, stability and freedom of navigation in the Pacific Ocean are inseparable from peace, stability and freedom of navigation in the Indian Ocean” 79. He praised India for agreeing to export rare-earths to Japan when China reportedly threatened to cut off supply. And he has praised the trilateral talks between India, Japan and the United States, which were raised to the level of foreign ministers in September this year 80.

Abe’s team believe that Japan’s foreign policy should reflect the country’s democratic values as well as its security concerns and commercial interests. They favor “value-oriented diplomacy” and talk grandly about an ‘arc of freedom and prosperity’ with India at its center 81. When Modi visited Japan in September 2014, Abe greeted him with a warm hug - a public display of diplomatic affection that is rare in Japan 82.

Japanese investors are also beginning to embrace India. Their direct investments amounted to over $2 billion in the fiscal year ending March 31st 2015, making Japan the fourth biggest source of FDI into the country 83. During Modi’s 2014 visit, Japan promised to plough 3.5 trillion yen of public and private money into India over the subsequent five years 84. Some of this investment will flow into flagship projects such as the Delhi-Mumbai Industrial Corridor (DMIC), a string of industrial parks and so-called “smart cities” clustered along a dedicated freight railway. Direct investment will help cement the relationship between the countries, creating an India-friendly business constituency in Japan that will lobby for closer relations.

It is then the two countries’ shared anxiety about China that explains their need for a strengthened relationship. It is their common democratic traditions that explain Abe’s enthusiasm for that relationship. But it will be their growing commercial links - the arc of prosperity as much as the arc of freedom - that will guarantee their relationship’s durability, even after Abe steps down.

83 http://dipp.nic.in/English/Publications/FDI_Statistics/2015/india_FDI_June2015.pdf
Conclusion to Part 2

In their economic relationships, India, America and Japan are all “long” China. But in their security relationships with each other, the three democracies have sought a reassuring hedge against a stronger, and more assertive Middle Kingdom. That hedging strategy will make China nervous, increasing the geopolitical tension it is designed to protect against. But we expect that China’s response will be largely limited to demonstrations of its growing soft power.

Li Mingjiang has described Japan-China relations as “hot economics; cold politics”. Our scenario for G4 geopolitics foresees a similar combination of temperatures: hot economics among all four members, warmer politics between its three democracies, and cool relations between those three and China.
Will geopolitical rivalry hurt growth - or help it?

In the previous part of this paper we asked whether G4 growth would ease geopolitical rivalry or intensify it. In this third part, we will turn that question around: Is geopolitical rivalry good or bad for growth?

At one level, the answer is obvious: peace and prosperity go hand in hand. Some scholars have argued that the international economy prospers when one country, alliance or empire is strong enough to achieve “hegemony”, deterring all efforts to displace it. A strong, hegemonic power has the economic capacity to provide international “public goods”, keeping the peace, enforcing the rules of international engagement, and serving in extremis as a lender of last resort. It also has an incentive to do so: by virtue of its economic size, it captures a large share of the benefits, even if other countries also free-ride on its efforts. “For the world economy to be stabilized, there has to be a stabilizer - one stabilizer,” as Charles Kindleberger has put it.

In their 2008 book ‘Power and Plenty’, the economic historians Ronald Findlay and Kevin O’Rourke describe a variety of hegemonic regimes, including the Pax Mongolica of the 13th and 14th centuries, the Pax Britannica of the long 19th century and the Pax Americana that has prevailed since the second world war. These eras of hegemonic stability were good for commerce, permitting the growth of trade and the integration of markets. When they ended, they ended badly, with rising protectionism, economic disruption and violent conflict between the rising power and the incumbents.

There is, then, a danger that the erosion of US hegemony will prove similarly disruptive. When America dominated the world economy, it bore the costs of running the show, partly because it reaped such a large share of the benefits. In a multipolar world, the United States may begin to wonder why it must shoulder these burdens, when other countries are enjoying a growing share of the benefits. The same question, turned on its head, will also nag at the rising nations themselves: why should America continue to monopolize the prerogatives and privileges of global leadership, when Asia’s great powers are qualified to take on parts of the role themselves?

The end of US hegemony may, therefore, open up a variety of dormant geopolitical issues - such as the maritime border claims of US allies or the role of the US navy in policing Asian sea-lanes. Simply raising these questions might be enough in itself to hurt economic progress, because of the uncertainty it would generate. For international commerce that these questions are settled often matters more than how they are settled.

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85 Hegemony sounds brutal and domineering. It can be, but need not be. “If leadership is thought of as the provision of the public good of responsibility, rather than exploitation of followers or the private good of prestige, it remains a positive idea,” notes Charles Kindleberger in his book, The World in Depression, 1929-1939. See also After Hegemony by Robert Keohane.

86 Kindleberger, “The World in Depression, 1929-1939”

87 This being said, Messrs Findlay and O’Rourke are careful to make clear that war between Britain and Germany in 1914 does not fit the historic pattern in the sense that its causes are manifold and significantly more complex.
One particularly damaging example is the previously mentioned dispute over the Senkaku Islands or Diaoyu Islands, claimed by both Japan and China. In 2012 China condemned the Japanese government’s decision to buy the islands from a private Japanese owner. By mid-September, anti-Japanese protests in a variety of mainland cities spilled over into violence. Japanese-brand cars were vandalized and department stores looted. A number of factories and restaurants were damaged and a Toyota sales outlet was torched. The economic consequences of this spike in geopolitical tension are easy to see in the statistics. After the riots, Japanese firms sharply curtailed their direct investment in China, preferring to expand operations in ASEAN instead (see chart).

**Japan’s outward direct investment (ODI)**

![Japan's outward direct investment (ODI)](chart)

Source: Japan External Trade Organization (JETRO)

Riots are an unusually stark deterrent to investment. But other, humdrum barriers are also harder to remove in the absence of geopolitical goodwill. For example, India’s fear of being encircled by China-friendly ports (the aforementioned “string of pearls”) may prevent it from reaping the full benefits of China’s proposed investment in a 21st century Maritime Silk Road.

Another timely example is the proposed **bilateral investment treaty** (BIT) between China and the United States. When Xi Jinping’s state visit to the US was first agreed a year or so ago it was hoped that a deal on the BIT could be announced during his stay. But (we understand) some major hurdles remain to be overcome. Some of those obstacles are no doubt narrowly commercial. But others are possibly geopolitical. The Chinese, for example, complain about America’s opaque Committee on Foreign Investment in the US, which can block investments that, in the committee’s view, compromise national security. Few proposals end up being barred on these grounds. But the committee’s criteria are unclear and the prospect of a time-consuming review, whatever the outcome, serves as a deterrent to investment.

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91 The US government also worries that American technology companies may cede sophisticated parts or knowhow to China that may ultimately hurt US security. In February 2015, for example, four Chinese supercomputing centres, including the National University of Defence Technology, that had used US-origin chips were put on a US government list of entities that could or “have been involved in activities contrary to the national security and foreign policy interests of the United States” [http://www.hpcwire.com/2015/04/08/chinese-supercomputing-orgs-placed-on-us-entity-list/](http://www.hpcwire.com/2015/04/08/chinese-supercomputing-orgs-placed-on-us-entity-list/).
Historical scholarship, investment statistics, and current events all, therefore, illustrate the potential economic dangers of geopolitical tension. But that is not the whole story. The same range of evidence - history, statistics and contemporary events - also suggest that geopolitical rivalry - up to a point - can benefit growth.

One timely example, as mentioned at the outset of this paper, is the Trans-Pacific Partnership. Obama showed little enthusiasm for free-trade agreements during his first five years in office. Only geopolitics can explain his sudden embrace of the TPP as a cause worth pursuing. Although Sino-US rivalry has hampered talk of the bilateral investment treaty, it has spurred negotiations on the TPP. “If we don’t write the rules, China will write the rules,” Obama told the Wall Street Journal in a May interview. “We will be shut out….We don’t want China to use its size to muscle other countries in the region.” Thus, in common with other commentators, we see the TPP as being of strategic, as well as economic, significance. If nothing else, it will allow Obama’s Democratic Party to counter Republican attacks on the party’s alleged weakness on national security, a potentially key issue in the 2016 presidential election 92.

The same motive also appears to animate Japan 93. If anything, Abe’s strategic hopes for the TPP are even loftier than Obama’s. “The TPP goes far beyond just economic benefits,” he told a rare joint session of Congress. “It is also about our security. Long-term, its strategic value is awesome. We should never forget that.”94

Geopolitical worries, which explain Abe’s enthusiasm for the TPP, surely also help explain his embrace of the rest of Abenomics, including bold monetary stimulus. Before his 2012 comeback as party leader, Abe was known as a nationalist hawk not a monetary dove. But the first passion led to the second: halting Japan’s economic stagnation was a necessary condition for his other, more geopolitical aims. It is hard for a nation to square its shoulders and straighten its back if its economic lungs are deflating.

A similar logic motivated economic reforms in both India and China. “India is… in awe of China’s economic growth,” noted Shekhar Gupta, a prominent Indian journalist, in the mid-1990s. “It would have been impossible to find the impetus for economic reform without the inspiration of China’s success... and the fear that both [China and Pakistan] could leave [India] behind.” As Gupta went on to explain: “Most Indian policy-makers continue to assert that China, rather than Pakistan, will be India’s long-term security threat. This makes it imperative that India does not fall too far behind China economically.”95

China itself shared similar insecurities. By the early 1990s, the initial success of its economic reforms had been interrupted by high inflation, the 1989 Tiananmen Square protests, and the pain of subsequent sanctions. The forces of economic conservatism were gathering strength, with Jiang Zemin, the general secretary of the Communist Party, waiting to see which way the wind would blow 96.

92 ‘Obama’s trade deal will not tame China’ by Gideon Rachman, Financial Times, 18 May 2015.
93 ‘Japan’s moment to lead on TPP’ by M P Goodman, CSIS, 6 October 2014
94 However, we also agree with Gideon Rachman of the Financial Times that: “Unfortunately for Washington and Tokyo...the TPP - even if it happens - is not a significant enough step to justify all the geopolitical hopes invested in it... [It] is too late to prevent China becoming the core of the Asian economy - with all the political and strategic gains that implies. China is already the biggest trading partner of most of the important nations in the TPP negotiations - including Japan, Singapore and Australia - and it is the second biggest partner of the US itself.”
96 “How China’s Leaders Think” by Robert Lawrence Kuhn
It was at this moment in 1992 that Deng Xiaoping, China’s aging paramount leader, undertook his celebrated Southern Tour, bestowing his blessing on the manufacturing miracle in Shenzhen and other coastal cities. He urged China to redouble its efforts to “open up” - not because getting rich was “glorious”, but because it was geopolitically necessary. “Our country must develop. If we do not develop then we will be bullied. Development is the only hard truth,” he said.

The idea that geopolitical rivalry can inspire growth is in fact an old one. In his General Economic History, published in 1923, Max Weber argued that “the competitive struggle (among the European nation states) created the largest opportunities for modern western capitalism.” States had to compete for mobile capital and skilled artisans by creating hospitable conditions in which these productive forces could flourish. Contending kingdoms had an incentive to innovate and explore lest they fall behind their neighbors. Their political fragmentation also ensured that any bold, progressive venture that failed to find a backer in one Court or capital, could find a supporter in one of its rivals.

This restless, interstate rivalry is often contrasted with the placid political hegemony achieved by several of China’s ruling dynasties. Powerful Middle-Kingdom emperors could foster growth and innovation if it suited them. But they could also stifle it if they so chose. Some of them did. In 1430, for example, the imperial court decided to halt China’s epic overseas explorations. The “reactionary rulers of the later Ming period clearly preferred a stable and controllable environment”, notes Joel Mokyr in The Lever of Riches. “Innovators and purveyors of foreign ideas were regarded as troublemakers and were suppressed”.

The comparison between one Chinese regime and another is also instructive. Political competition rose and fell over China’s long history, as Pak Hung Mo points out in a recent collection of articles. In the gaps between dynasties, China often succumbed to anarchy or invasion, a destructive form of geopolitical competition that did nothing to help the economy. But in other periods, geopolitical rivalry and economic growth seemed to flourish in unison.

The Song dynasty (960-1275), for example, faced constant external threats from Jin and Mongol invaders. But this insecurity did not prevent, and may have spurred, a great flowering of innovation and commerce. The government encouraged irrigation, education and international trade. “Private printing was popular, and water-powered machines for spinning hemp thread appeared.” This period of political tension saw the introduction of gunpowder (used in early cannons, grenades and flamethrowers), paper money and the “discovery” of true north using a compass.

What lesson can we draw from these historical comparisons? The simplest conclusion is that the relationship between rivalry and growth is not simple. Political competition may help growth, but “only within an ‘optimality band’”, argue Peter Bernholz and Roland Vaubel in their survey of Asian history. “When a political system veered outside the band in one direction, towards overmuch central control, creativity was restricted... On the other hand, where political fragmentation [led to] instability and warfare, creativity may have been unable to flourish – or if it did, it may not have ripened into full innovation.” The relationship between geopolitical rivalry and growth is, therefore, non-linear. Too much rivalry is bad for growth. But so is too little.

99 The political fragmentation of Europe, with a number of competing states not dominated by a single center, meant that there was more room for the exercise of choice between alternative social, political, and economic policies as well as competition between states for military and economic supremacy”, note Findlay and O’Rourke in “Power and Plenty”. In their view, the “intensely competitive European states system” may have been a necessary, if not sufficient, condition for Europe’s industrial success. See also The European Miracle by Eric Jones, 1981.
100 Political Competition, Innovation and Growth in the History of Asian Civilizations, edited by Peter Bernholz, Roland Vaubel
101 Ibid.
The Geopolitical Laffer curve

This non-linear relationship, as we pointed out in the introduction, is reminiscent of the so-called Laffer curve, named after Arthur Laffer in 1974. According to Laffer, tax rates that are either too high or too low will both diminish tax revenues. The relationship between the two follows a rotated U-shape.

Can we draw a similar curve for geopolitics? Since Laffer sketched his curve on the back of a napkin, economists have attempted to quantify its slope and peak. Attempting a similar exercise in the messy realm of geopolitics is much more difficult, inviting the charge of spurious precision. Nonetheless, we will try.

To do so, we will draw on data compiled by the International Country Risk Guide (ICRG). For each year since the mid-1980s, the guide has assessed the external threats facing over 140 countries. These threats range from diplomatic pressure, territorial disputes and trade restrictions at one end of the spectrum to all-out war at the other. Countries that enjoy almost total security from external conflict, such as the Netherlands, receive a top rating of 12 on their scale. Less fortunate countries invaded from all sides (such as Lebanon during its civil war) rate zero. America's security rating, according to the guide, fell as low as 5.5 after the 9/11 attacks in 2001. India's fell even lower in the year after Indira Gandhi, the prime minister, was assassinated in 1984 (see charts).
How do these security scores correlate, if at all, with economic growth? Unsurprisingly, low-scoring countries, cursed by acute geopolitical woes, tend to suffer devastating economic misfortune. Liberia’s per-capita GDP shrank by over 30 percent a year on average in the first half of the 1990s, a violent five years in which the country averaged just 3.4 out of 12 on the ICRG security scale.

But the relationship between security and growth is not tight. Nor does it seem to be linear: more security is not always associated with better economic performance.
The chart below plots security ratings against growth for 140 countries in the ICRG database, showing five-year averages from 1985 to 2014. The data are very scattered, suggesting only a loose relationship between conflict and growth. And the numbers certainly do not rule out a non-linear Laffer curve relationship: plenty of countries exposed to some insecurity nonetheless grow quickly. And some countries exposed to no outside threat nevertheless grow at miserable rates.

**Conflict v growth 1985 - 2014**

A non-linear trend fitted to the data suggests that the best security rating for growth is not the top score - 12 - but rather 9.85 - which happens to be roughly the level of insecurity facing the US, Japan and India right now.

This cursory examination of the data is suggestive. But how robust is the non-linear relationship we have hypothesized? A full investigation would require building a complete model of economic growth, which would allow us to test for the separate influence of geopolitical rivalry once all other determinants of growth are taken into account. That is beyond the scope of this paper. But we can report three robustness checks.

**Natural resources.** The geopolitical Laffer curve may simply reflect the presence of oil and other natural resources in some countries. Economies rich in these commodities often suffer from internal strife and external predation. They can also grow very quickly, provided the squabbling over their natural resources does not prevent the extraction of those riches. In these cases, it would be a stretch to say that the geopolitical rivalry is helping growth in any causal sense. The more accurate interpretation would be that both the geopolitical rivalry and the growth are functions of a third variable: the presence of natural resources.

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102 The sample includes every country in the ICRG database over each five-year period for which we have at least three years of growth data. The growth data come from the World Bank's World Development Indicators database. The data cover 140 countries and 30 years (i.e., six 5-year periods) from 1985-2014. In principle, therefore, there could be 840 observations. In practice, because of missing growth data, there are only 784.

103 Second-order polynomial.
But removing resource-rich countries from the sample does not overturn the non-linear relationship (see chart). The exclusion takes out some of the biggest growth disasters, where conflict destroyed the economy. But it leaves other cases where countries prospered in the presence of modest external threats. The peak security rating falls to 9.7.

**Convergence.** The geopolitical Laffer curve may also be a side-effect of economic convergence. Secure, conflict-free countries often boast mature economies, which tend to grow more slowly than late-developing, “catch-up” economies. This plodding growth is not a consequence of the peace and calm they enjoy; it simply reflects the fact that they have exhausted the easy gains of imitation-led growth.

To control for this effect, we compared each country’s growth rate to the pace one would expect given its level of per-capita income. We then tested the relationship between geopolitical security and “atypical” growth, i.e. growth that is faster (or slower) than one would expect given a country’s per-capita income. The relationship was much the same as before: countries with a security score of 9.54 grow faster than countries with less security or more.

Finally, we included country “fixed effects”, a statistical procedure that removes variation between countries, allowing only for variation within countries over time. We calculated the average growth rate and security rating for each country (over the period 1985-2014), then compared fluctuations around those two averages. For example: when security falls below the Indian average, what happens to India’s growth? Is it above or below India’s average rate?

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104 We removed any country, in any period, that reaped resource rents averaging over 20 percent of GDP on average, as measured by the World Bank.

105 The relationship between growth and per-capita GDP in our sample also appears to be non-linear. High-income and very low-income countries grow more slowly than countries in the middle—contrary to some notions of the middle-income trap.
The results are shown in the chart below. As one would expect, there are many cases (200 out of 629) of above-average security coexisting with above-average growth. There are also many cases of subpar security and subpar growth (155). But there are also a large number of “off-diagonal” cases that defy this simple intuitive relationship. Subpar security coexists with above average growth surprisingly often: in 126 out of 629 episodes. And better-than-average security often coexists with worse than average growth (146 episodes).\(^{106}\)

**Conflict v growth 1985 – 2014**

(excluding resource-rich countries, including country fixed effects)

Source: BNY Mellon calculations, based on International Country Risk Guide; World Bank World Development Indicators

**Combinations of security and growth, 1985 – 2014**

(excluding resource-rich countries)

<table>
<thead>
<tr>
<th>Security and Growth</th>
<th>Cases</th>
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<tr>
<td>Above-average security and growth</td>
<td>200 cases</td>
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<td>Subpar security; above-average growth</td>
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<td>Above-average security; subpar growth</td>
<td>146 cases</td>
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<tr>
<td>Below-average security and growth</td>
<td>155 cases</td>
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Each “case” refers to a five-year period in a country’s history; averages refer to a country’s average per-capita growth rate or ICRG security score from 1985 -2014.

Source: BNY Mellon calculations, based on International Country Risk Guide; World Bank World Development Indicators

\(^{106}\) In two out of the 629 cases, growth or security was exactly average.
THE G4: UNDIMINISHED EXPECTATIONS

GEOPOLITICAL RIVALRY OR RAPPORT?
Conclusion:
Pax Indo-Pacific

Will the G4 growth scenario result in fiercer geopolitical rivalry or a happy rapport between four interdependent nations, each secure in their own prosperity? And will geopolitical rivalry help or hinder growth? The above analysis yields three conclusions, one tentative, one firm, the third provocative.

The provocative conclusion is that geopolitical rivalry, up to a certain threshold, may help growth. China's urgent commitment to reform and opening up in the past three decades was inspired partly by the fear of being bullied by outside powers. India's patchier reforms were likewise inspired by the fear of being bullied by China. And in Japan, Shinzo Abe embraced dovish macroeconomics as the best way to win support for his hawkish politics.

To pick a more recent and specific example: China has sought to promote the renminbi as an international currency fit to rank alongside the dollar, euro, pound and yen as a member of the International Monetary Fund’s SDR basket. The international prestige China attaches to SDR membership has encouraged it to press ahead with financial reforms, even in the face of a marked economic slowdown and considerable market tumult.

What about our other two conclusions? We can firmly predict that the G4 scenario will bring the US, Japan and India closer together. Sustained growth in China will be disconcerting to the other three countries, however emollient and self-effacing China tries to be. (And it is not trying as hard as it once did.) To extend Edward Luttwak’s metaphor: when a portly man enters a crowded elevator, he makes everyone else uncomfortable—and he also pushes them closer together.

Three percent growth in America will contribute to this closeness. As well as allowing the incumbent superpower to sustain a greater presence in Asia, growth will revive America’s confidence in itself and its allies’ confidence in it. Likewise, the success of Abenomics will embolden the man for whom it is named, allowing him to indulge his longstanding love of America and his more recently discovered passion for India. Furthermore, India’s appeal as a market, an investment destination, and a counterweight to China will be bolstered by the 8 percent growth our optimistic scenario foresees for it. The only danger is that America and Japan will be overeager in their courtship of the world’s biggest democracy, which has traditionally remained aloof from other major powers in the name of preserving its autonomy.

Our final conclusion is more tentative. We believe that the G4 scenario need not lead to greater hard-power antagonism between China and the other three powers. If China’s economy does well, the country’s leadership will have little need to stoke nationalist passions as a diversion from domestic frustrations. Beijing will also have the legitimacy and popularity it requires to douse any nationalist flames that start of their own accord.

Strong growth will also deepen the economic interdependence between the four. In the past, when a rising power challenged a ruling power, they often lapsed into conflict: the Thucydides trap identified by Graham Allison. But these battles were mostly wars for natural resources, trading privileges and colonial possessions. In today’s nuclear age, the option of all-out war - or anything that might lead to it - is no longer available. Nor is it necessary. The world economy is not a closed vessel. It can expand to accommodate the ambitions of its constituent nations.

Today, upstart powers are known as “emerging markets”, which appeal to incumbent powers as targets for investment not invasion. The competition for commodities has led, in many instances, to oversupply not a cornered market. And territorial disputes between these four great powers are limited to thin-aired Himalayan plateaus and half-submerged, scarcely defensible islets in the sea.

In the end, Luttwak’s metaphor of the crowded elevator does not do justice to G4 relations. Their prosperity does not take up room in a confined space, it creates the space it fills.

If these four countries grow as fast as our scenario suggests, they will, by decade’s end, have a combined $45 trillion economy to enjoy. That economic success - the result of their commercial endeavors - will be enough, with luck, to accommodate and appease their geopolitical ambitions.

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108 As previously noted, water could become a source of conflict between India and China, partly because its supply is inelastic and it is not traded in a global market.

109 At constant 2014 prices and exchange rates
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