

Southern Asia in the New Strategic Geometry

Remarks to the Pacific Pension Institute

Ambassador Chas W. Freeman, Jr. (USFS, Ret.)

Vancouver, B.C. , 14 July 2011

I am honored to be back at a Pacific Pension Institute (PPI) roundtable. And I'm happy to address the topic Marsha assigned – southern Asia in the new strategic geometry. This is an important, and timely subject that challenges us to recognize new and sometimes disturbing realities.

I want to begin with a caveat. Over the next half hour or so, I will be describing currently apparent long-term trends in Asia. I can imagine quite a number of short-term developments that might set these trends back – the bursting of China's real estate bubble and a resulting pan-Asian banking crisis, an American fiscal thrombosis that triggers another, even more severe global meltdown, a stumble into naval conflict between the United States and China, or other less plausible scenarios. But I'm going to pretend that I'm some sort of economist; I will just *assume* these potential disasters *away*. That should enable us to focus on what will most likely happen in the more likely event that current trends are not interrupted.

So I will speak on the premise that things will continue to go more or less right for China. For most of the past thirty-two years, that's been a safe assumption. "On the other hand," as economists so famously like to say, we live in a period of unprecedentedly dynamic change. Nothing can or should be taken for granted or regarded as inevitable.

PPI is an organization that channels the concept of the Pacific Rim. The idea of a community of nations to ring the world's greatest ocean makes sense. And it continues to have life. But, as the 21st Century progresses, the concept of the Pacific Rim as an organizing principle is being eclipsed by the progressive emergence of an integrated Asia centered on China. The other great powers of east and south Asia – Japan, India, Indonesia, Pakistan – as well as the United States, Canada, Australia, and Korea are reacting to this change more than driving it. I will have a few things to say about that toward the end of my remarks.

All things being equal, China will overtake the United States as the world's largest trading country in 2015. By 2016, it will be the world's largest national economy as measured by purchasing power parity (PPP). Three or four years later, given the anticipated effects of inflation and exchange rate movements, China will have the world's largest economy in absolute terms. Even if other countries in Asia, like India, Indonesia, and the other member states of the Association of Southeast Asian Nations (ASEAN) were not also gaining in wealth and power, the changes in China alone would transform the world. But all of Asia is reinventing itself. The impact is global.

In the initial phases of the Great Recession, China, India, and Indonesia were the only G20 members to post growth. Today they remain the G20's fastest growing nations. In PPP terms, they are, respectively, the second, fourth, and sixteenth largest of the world's economies.

India is expected to overtake Japan as the world's third-largest economy in PPP terms as early as next year. And it's often forgotten that at present ASEAN collectively has a nominal GDP larger than either India or Brazil and a role in world trade that is over twice as big as India's. Together Asian economies already account for one-third of world trade, more than twice as much as the European Union and four times more than the United States.

Then, too, China and India are the only current or future world powers whose defense budgets are programmed to continue growing rapidly in the years to come. India and Japan may not sit in the

U.N. Security Council but they already loom large in international decision-making. So, increasingly, does Indonesia. The impact of Asia on world affairs is large and rapidly growing larger.

And as a new and increasingly prosperous Asia appears, old geographical divisions are fading away. New international and regional relationships are emerging. The continent is connecting its formerly disconnected regions in the east and west, north and south.

Southeast Asia has become much more than just an intermediate zone that separates India from China, Japan, and Korea or Australia from the Asian mainland and Japan. The ten nations of ASEAN have emerged as an important factor in their own right in both Asia and the world. They are part of a band of nations to China's east, south, and southwest that shares both intensifying relationships with China and common apprehensions about the implications of its regional ascendancy.

From India and Pakistan to Indonesia and Vietnam, and onward to Korea and Japan, new linkages are forming in response to shifting balances of political, economic, and military power. Many of these, but not all, involve China. These linkages have major implications for investors as well as for governments. They entail many possible consequences, which include not only economic but also political and military opportunities and risks.

Change in Asia cannot, of course, be abstracted from change in the world as a whole. To understand what is happening in the southern band of Asia, how it is happening, and why, it's important to view the continent in its global context. The world order is evolving, regional balances of power are everywhere in flux, and the forces these shifts have unleashed are recalibrating the norms of foreign policy behavior in Asia as elsewhere.

It is said that non-Chinese Asia is the only part of the world still to see an American military presence as essential to preserve regional security against an external threat. Politicians in Washington ceaselessly proclaim that Asians demand that Americans act to redress the shifting balance of power by standing with them against a rising China. But is this an accurate description of what Asians want or is it what Americans, reasoning in terms more relevant to the past than to the future, think Asians should want?

In Asia, as elsewhere, the alignments fixed by the Cold War are being supplanted by variable international geometries amidst increasingly ambivalent and ever more complex relationships. The realization that nations can be “with us” on some issues but “against us” on many others may be emotionally unsettling, but it is a reality. The naive notion that there can or should be permanent enmity or solidarity between peoples has lost all credibility.

In the era that has ended, alliances against predetermined enemies were the defining elements in the world order. Nations made comprehensive, long-term commitments to each other to assure cooperation against a perceived common threat. That was what “alliance” was all about. Now threat perception varies from country to country and from time to time. And “entente” – limited cooperation for limited purposes, often for limited periods of time – is becoming the usual mode of international collaboration.

This is true even within existing multilateral alliance structures. In NATO, for example, member states now routinely form limited coalitions of the willing, while other members and the alliance as a whole remain aloof. (Think of hostilities with Libya, the pacification campaign in Afghanistan, or anti-piracy operations in the Gulf of Aden as recent examples of this.) Alliances no longer embody common purposes so much as they provide mechanisms for consultation, command, and control to facilitate bilateral or multilateral teamwork between ad hoc groupings rather than fixed assemblies of nations.

Meanwhile, those long bound to special relationships are deliberately offsetting them with new partnerships. (Think of Britain's efforts to supplement its ties to the United States with new links to Brazil and India. Think of India's continuing ties to Russia as it also reaches out to the United States, Indonesia, Vietnam, and Japan.) In many cases, comprehensive strategic associations that have lasted decades are giving way to limited partnerships – or entirely new partnerships are forming. (Think of the new arrangements for defense cooperation between Britain and France even as France simultaneously sells two Mistral-class amphibious-assault helicopter-carriers to the Russian Navy.) And countries are showing that they can cooperate on specific national security projects despite overall relationships that are competitive or even adversarial. (Consider the joint patrols that China and Vietnam carried out in the Gulf of Tonkin even as their forces maneuvered against each other elsewhere in the South China Sea.)

Depending on your point of view, what I am describing is either a revolution in foreign affairs or a return to a level of fluidity and cold-blooded calculation in the international order not seen for centuries. However one characterizes it, the new era clearly marks an end to the static foreign policy orientations and fixed alignments of the Cold War period. It calls for an agile diplomacy that can maneuver to stay on top of shifting coalitions, complex relationships, and bilateral ties that simultaneously embrace major elements of both contention and collusion. The evidence to date suggests to me that Asian nations like China, India, Indonesia, Malaysia, Singapore, Thailand, and Vietnam are having less difficulty adapting to the new diplomatic environment than the United States and nations long rigidly allied with it, like Australia, Canada, Japan, Korea, and the Philippines.

But, while Asians reinvigorate and adapt their diplomacy to new foreign policy realities, they are caught up in a process of economic integration that is radically altering traditional relationships among them and between them and non-Asians. China is now either the largest or the second largest trading partner of every nation in Asia and Oceania as well as the United States and Canada. If “greater China” – the China mainland, Taiwan, Hong Kong and Macau – is considered as an emerging economic confederation, then China's place in the regional hierarchy is still higher. Even the economy of China's self-described strategic rival, India, is reorienting itself toward China. The looming centrality of China in Asia – North, Central and West as well as South and Southeast Asia – is unmistakable.

The Asian supply-chain network that has become a mainstay of the global economy centers on China, which now accounts for nearly 30% of intermediate goods exports within Asia, up from 15% a decade ago. The establishment of this network was facilitated by the existence of an earlier, Japanese-led one. The relative ease of communication between so-called “overseas Chinese” and Chinese in greater China helped new supply chains come into being. But this economic network long ago transcended any ethnic parameters.

Supply-chain economics has meant that China buys more from most of its neighbors than it sells. China consistently runs deficits in intermediate goods trade with all its major Asian trading partners. (India, with which China runs large trade surpluses, is the exception that proves the rule. India is still largely outside global production networks.) It’s worth noting that, as the volume of Korean and Southeast Asian exports to China has risen, the value of their currencies has fallen in relation to the Chinese yuan. This has reduced the cost of their inputs to the products China puts in final form. In many cases, this effective cost reduction has more than offset the slow but steady appreciation of the yuan, enabling Chinese exports to become even more competitive in world markets.

But supply-chain economics alone do not explain China’s status as the driving force in Asian (and to some extent) global economic growth. Boosted by the January 2010 implementation of the China-ASEAN Free Trade Area, Indonesia’s trade with China rose by 50 percent last year. Indonesian textile exports to China were up by an astounding 70 percent, while rubber exports grew by one-third. Rising industrial demand in China and India has made Indonesia the world’s largest exporter of coal.

China now receives 20-25% of all capital goods exports from Japan and Korea, a fourfold increase from a decade earlier. China’s apparently insatiable demand for mineral resources has been the lead factor in a commodities boom, with particular benefit to Australia and Indonesia. At the end of last year, Chinese foreign direct investment (FDI) in Australia stood at \$34 billion. In

Indonesia, it was over \$10 billion and growing rapidly. China's surging domestic demand is becoming an ever more important factor in the economies of its neighbors to the south.

By 2020, China, India, and Indonesia will have middle class populations numbering 650, 350, and 150 million people, respectively. Private consumption in China is expected to rise at the rate of 17.6% per annum over the next five years. (In India, over the same period, the increase is projected at more than 13 percent, but no one knows whether India will open its market to foreign goods to anything like the extent that China has.) Japan, Korea, Taiwan, Hong Kong, Singapore, and some other Asian economies have sophisticated retail companies poised to meet the demands of increased private consumption of all kinds in developing Asia. Meanwhile, the aging of China's population has led to explosive growth in its health-care industry. Indian pharmaceutical companies, already among the world's strongest, are poised to become the major foreign beneficiaries of this development. All this underscores the prospects for further Asian economic integration.

Investment flows show similar trends. Last year, outward FDI from Southeast, South, and East Asia (including China but excluding Japan) rose by over 20 percent to a total of \$228 billion. Cross-border merger and acquisition (M&A) purchases by companies from the region surged to nearly \$94 billion, about half in greater China and nearly one-third in India. Asian investors have realized that some of the highest yields on equities, foreign exchange, commodities and alternative asset classes are to be found in their own region. This discovery has come as investors, central banks, and trade financiers are all seeking to diversify out of the U.S. dollar and when investments in both America and Europe look riskier and less lucrative than before. That's one reason China is now the largest destination for investment from its developed Asian neighbors.

Meanwhile, by the end of 2010, Chinese companies had invested over \$32 billion in Southeast Asia. Although much, much less has actually been disbursed, they had also committed almost \$40 billion each to India and Pakistan. Moreover, China is in the process of shifting its investment to the manufacturing, energy and trade and service sectors instead of mining and construction. Some Chinese industries affected by inflation are rapidly relocating to low-wage economies like

Vietnam, Cambodia, and Bangladesh. More than 1,000 Chinese companies have by now invested almost \$10 billion in Indonesia, creating tens of thousands of jobs.

The progressive internationalization of the Chinese currency is another factor changing the landscapes of Asian finance, banking, and foreign exchange. The Chinese are leading the way in reducing dependence on the dollar as a transaction currency. The use of yuan in trade settlement is expanding a lot faster than many outside the region realize. Despite the still-limited convertibility of the Chinese currency, some countries, like Malaysia, have begun to include it in their reserves.

The yuan is far from the only Asian currency that is gaining ground. Japanese asset managers are deploying investment specialists throughout Asia. Increasingly, they invest directly in the region's equity markets and companies rather than, as they often did before, indirectly through American Depositary Receipts (ADRs) or other derivatives. (Last summer, Daiwa, Nomura, and Kokusai each set up open-ended Indonesia equity funds.) Many investors in Hong Kong, Japan, Korea, and Singapore have begun to focus on India as a long-term bet. As another example of greater Asian focus on opportunities in Asia, a look at the figures for January this year shows that Thai investors bought Korean bonds worth 142.7 billion won. Other investment in Korean assets came from China, Japan, Malaysia and Singapore. All this has brought liquidity to many previously almost untraded Asian currency pairs. The volume of yen-rupee, yen-rupiah, and yen-Singapore dollar trading has notably increased.

But, if confidence in Asia's economic prospects is rising, the same cannot be said for its political and military situation. Here too the driving factor is China, and here too the stakes go well beyond Asia and its southern rim. Asia is already in many ways the global center of economic gravity. It is also where the United States' desire to sustain its ability to overwhelm every other nation militarily encounters the reality of rapidly improving Chinese defenses. It is therefore the locus of a growing Sino-American military rivalry that promises to have a decisive effect on the evolution of Asia and Asia's role in the world order. It is to that rivalry and its implications that I now turn.

In strategic terms, Southeast Asia was once the divider or buffer between China, Japan, and Korea on the one hand and India and the rest of South Asia – as well as the Middle East – on the other. In recent decades Southeast Asia has emerged as a channel and a bridge rather than a barrier to navigation and communication between Asia and the world beyond it as well as amongst Asia's extraordinarily diverse cultures and societies. Southeast Asia and its adjoining seas have thereby become strategically central to global prosperity. If you doubt this, consider that 36% of world shipping transits the Straits of Malacca and another 22% passes through the Lombok and Sunda Straits in Indonesia. The sea-lanes to China's south now carry more trade than any others in the world.

The South China Sea, which lies between Southeast Asia and greater China, contains the strategic lines of communication that connect China, Japan, and Korea to energy supplies crucial to their continuing prosperity. This sea is where the 21st Century's greatest navies will either learn to coexist and cooperate or fall into contention. These factors give the South China Sea – or West Philippine Sea, as Manila has recently renamed it – an importance beyond the fact that all or significant portions of its marine life and natural resources are coveted by both Beijing and Taipei on behalf of historic China as well as by Vietnam, the Philippines, Malaysia, Indonesia, and Brunei.

Sovereignty over all but a few of the islands in the South China Sea is contested between various members of ASEAN as well as between them and China. So are the boundaries of the exclusive economic zones (EEZs) generated by inhabited islands or continental shelves. In recent years, islets and reefs long claimed by China or Vietnam or seized more recently by Malaysia and the Philippines (who considered them no-man's lands and therefore up for grabs) have become the subject of escalating politico-military posturing and naval scuffles. The United States has, meanwhile, inched toward ever more direct assertions of interest in these territorial conflicts.

Dialogue between American and Chinese military officials has recently been restored. But the overt hostility of the two countries' defense establishments to each other can no longer be concealed. Each has identified the other as its principal enemy for planning purposes. Each is researching, developing, and producing weapons systems intended to destroy the forces and

military installations of the other. South China Sea issues figure heavily in the sometimes heated arguments between the Chinese and U.S. navies.

Last summer, the United States sided with Vietnam against China on the issue of whether negotiations to solve Sino-Vietnamese disputes should be bilateral, as China insisted, or multilateral, as Hanoi claimed to favor. The United States did this amidst serious tensions with China over U.S. arms sales to Taiwan and Chinese anger at aggressive U.S. probes of China's defenses by ships operating just off its coasts. Washington's rationale for embracing the Vietnamese position was presumably to demonstrate to Vietnam and other Asians that, despite its political and economic eclipse, America remains militarily strong, willing, and able to stand up to China in the Western Pacific. The point registered with all concerned.

Japan has been sufficiently disturbed by recent shifts in the balance of power in northeast Asia to have begun to cooperate militarily with south Korea, setting aside centuries of mutual antipathy. Last fall, a drunken Chinese fishing boat captain rammed a Japanese coast guard cutter near the disputed Senkaku (or Diaoyu) Islands. Washington took the occasion to reaffirm its willingness to defend Japanese administration of these islands. In the context of last year's tensions in the US-Japan alliance, this stance underscored America's utility to Japan as a counter to China.

As the United States was siding against China on territorial disputes in East and Southeast Asia, it was also competing to sell India a new generation "multi-role fighter aircraft" to counter China's modernizing air force. At the end of last year, President Obama visited Indonesia. Earlier this year, the president of Indonesia, retired General Susilo Bambang Yudhoyono was the chief guest at India's celebration of the 62nd anniversary of its independence.

I leave it to others to argue that these disparate events were parts of a coherent strategy. Still, it's hardly surprising that to many Chinese and some in Japan, Vietnam, Indonesia, and India, they

looked like an effort to align the United States with the southern rim of Asia against China. If that was in fact the intent, it misread the Zeitgeist in Asia and elsewhere.

Asian countries clearly welcome American willingness to back them as they tussle with China on specific issues. But the evidence strongly suggests that their willingness to use American power to their advantage does not signal a desire to enlist in an American-led coalition to counter China or the broad effects of its return to wealth and power. Asians are too much the cautious realists to embrace any such objective.

Similarly, Asians clearly value the American role in sustaining a balance within which they can maneuver as China rises, but this does not mean that they endorse Washington's determination to sustain its post-Cold War, unchecked ability to dominate the world by force. The aversion to the U.S. project of perpetual military hegemony in Asia and elsewhere is clearest in the case of India. New Delhi explicitly favors a multipolar world order in which checks and balances can operate. At the same time, India does not welcome competition from America in its South Asian sphere of influence any more than it does from China.

Contemporary Japan and perhaps Australia excepted, other Asians also do not favor their inclusion in an exclusive American sphere of influence designed to keep China in its place. They seek instead to use American power to enable them to craft accommodations with China that respect their interests. Consider the most recent evolutions of the various instances of apparent alignment against China that I mentioned a couple of minutes ago.

In April, India decided to buy a European, not an American fighter. There is some difference of opinion about why New Delhi made this decision. The one thing that can be said for sure is that India once again demonstrated its unwillingness to make a long-term commitment to the United States against China or for any other purpose. Earlier, India had dashed similar American expectations of a special relationship in return for bilateral nuclear cooperation. India remains determined not to compromise its freedom of diplomatic maneuver.

So far not much has come of New Delhi's hesitant effort to cultivate ties with Jakarta. Relations continue to develop, but slowly and inconclusively. By contrast, Indonesia's trade and cooperation with China are crashing ahead on many fronts. But Jakarta remains careful to balance its international relations. On June 17, for example, Chinese and Indonesian special forces conducted their first-ever joint training exercise. A month before, in May, Indonesia had exercised with the U.S. Navy.

To the surprise of many, on June 26, China and Vietnam announced a joint pledge to settle their maritime boundaries through peaceful bilateral negotiations without foreign involvement. In retrospect, Vietnam's earlier advocacy of multilateral negotiations appears to have been a tactic, not a conviction. In effect, Hanoi leveraged Washington against Beijing and then sidelined it. This has left the Philippines and the United States, which had bandwagoned with Vietnam, holding the bag.

China's leader-in-waiting, Xi Jinping, visited Tokyo ten days ago. This was a cordial but inconclusive encounter between two countries whose relations remain in transition to some new mutual accommodation that neither can yet define. Xi's visit put no process in place to resolve the Sino-Japanese conflict over the Diaoyu or Senkaku Islands. This is hardly surprising. Chinese on both sides of the Taiwan Strait regard those islands as part of Taiwan. Any compromise with Japan by either Chinese party would draw immediate accusations of a sell-out of sovereignty from the other. Until they have neutralized their differences over the status of Taiwan itself, neither Beijing nor Taipei can or will risk discussions of bits and pieces of what they see as Taiwan's territory. (What one or both of them might be able to do after some sort of reunification is, of course, another thing.)

Japan and China each recognize that neither has anything to gain from drifting into long-term confrontation. Japan remains committed to its alliance with the United States, which is an important guarantee of its independence. The same is true of Australia. But Japan's and

Australia's very real concerns about China do not offer a basis for enlisting them in the division of Asia between China and an American sphere of influence just off China's coasts.

Asians do not seek a return to either the ancient tributary system that subordinated them to China or to the status of protectorates of the United States. They will not commit themselves to each other, still less to China, the United States, or any other great power. They are happy to make use of American – or, for that matter, Chinese – power to the fullest extent they can, though only on their own terms and for their own purposes.

The ties to China and to each other of the countries on China's periphery are increasingly complex and mutually beneficial. These countries do not feel the need to demonstrate their loyalty to anyone other than themselves. Like the rest of the world, Asians are beginning to bob and weave and enter and leave coalitions as they must to advance their interests and sustain their independence. It is in this context that they intend to cooperate with each other as well as with America and other great powers, as specific circumstances or events justify their doing so.

In short, the southern rim of Asia will not accept domination by either China or the United States. Nor will Southeast Asian nations countenance the hegemony that India regards as natural in its near abroad. They do not want to sign onto a cabal led by Japan. They value their relations with the United States, Russia, and other great powers but will not compromise their freedom of diplomatic maneuver toward these powers or vis-à-vis each other. They do not want to submerge themselves in wider groupings, still less to join in anti-China coalitions directed by non-Asian powers.

These factors are creating a new order in Asia to which China is central but which China cannot and will not boss. Southern Asians are too resourceful and diplomatically agile to permit, let alone facilitate their own subservience to others' purposes. This is a very good thing.

Brave talk to the contrary notwithstanding, America's fiscal crisis is about to compel reductions in the U.S. military presence overseas, including in East, Southeast, and South Asia. But any politico-military vacuum created by American cutbacks is more likely to be filled by conflict resolution and new arrangements between rising powers in these regions themselves than by China. Asia looks to the United States to help it manage a transition to a new and more self-reliant order, not to build and hold a great wall on China's eastern and southern peripheries.

Asia's rise involves much more than the rise of China. It will not result in the restoration of some sort of bipolar world order but in the birth of much more complex arrangements both regionally and globally. Asians, not foreigners, will decide how they organize themselves to coexist with each other, how they manage a common prosperity, and how they relate to the world beyond their continent. The rest of the world should not be at all disturbed by this. It should instead welcome the gradual assumption by Asians of responsibility for their own affairs, seek to facilitate this, and embrace the opportunities for partnership that it offers.