THE ECONOMIC AND STRATEGIC RISE OF CHINA AND INDIA

Asian Realignments after the 1997 Financial Crisis

DAVID B.H. DENOON

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Preface

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

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

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

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

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

The following are the three central themes of this book:

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

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

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

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

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

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

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

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

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

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

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

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New York University
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Abbreviations

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

Chapter 1

Overview

The Context

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

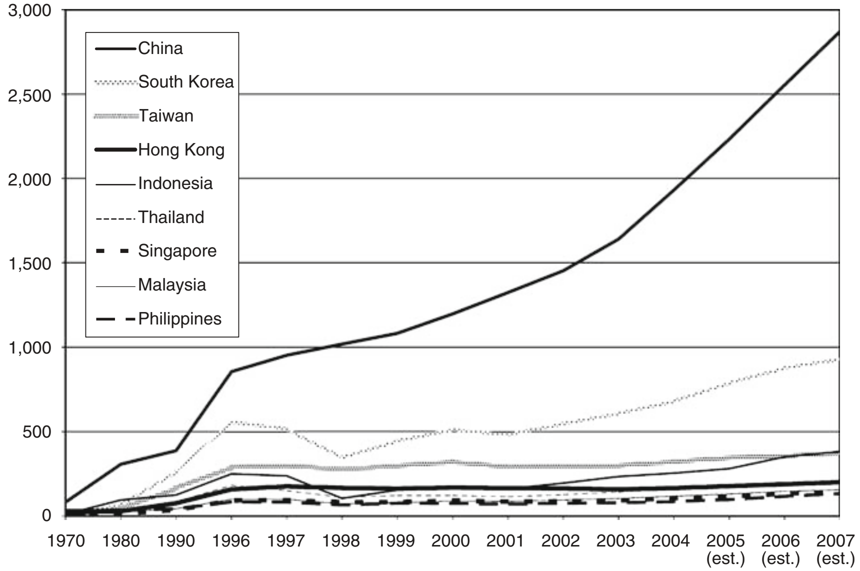
The financial crisis of 1997 hit East Asia like a summer storm. It was fast moving, intense, and powerful. Most importantly, though, it was unanticipated and none of the countries affected had made adequate preparations for the ensuing devastation. For example, just two months *before* the crash began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

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

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

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

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



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

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

Figure 1.1 Total GDP.

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

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

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