

## It's Not Just the Economy, Stupid: Asia's Strategic Dangers from the Financial Crisis

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Facing the worst economic crisis since the Great Depression, analysts at the World Bank and the CIA are just beginning to contemplate the ramifications for international stability if there is not a recovery in the next year. For the most part, the focus has been on fragile states such as some in Eastern Europe.

However, the Great Depression taught us that a downward global economic spiral can even have jarring impacts on great powers. It is no mere coincidence that the last great global economic downturn was followed by the most destructive war in human history. In the 1930s, economic desperation helped fuel autocratic regimes and protectionism in a downward economic-security death spiral that engulfed the world in conflict. And this spiral was aided by the preoccupation of America and other leading nations with economic troubles at home and insufficient attention to working with other powers to maintain stability abroad. Today's challenges are different, yet 1933's London Economic Conference, which failed to stop the drift toward deeper depression and world war, should be a cautionary tale for leaders heading to next month's London G-20 meeting.

There is no question the U.S. must urgently act to address banking issues and to restart America's economy. But the lessons of the past suggest that we will also have to keep an eye on those fragile threads in the international system that could begin to unravel if the financial crisis is not reversed early in the Obama administration and realize that economics and security are intertwined in most of the critical challenges we face.

Four areas in Asia merit particular attention.

**A Disillusioned Rising Power?** So far the current financial crisis has not changed Asia's fundamental strategic picture. China is not replacing the United States as regional hegemon, since the leadership in Beijing is too nervous about the political implications of the financial crisis at home to actually play a leading role in solving it internationally. Predictions that the United States will be brought to its knees because China is the leading holder of U.S. debt often miss key points. China's currency controls and full employment/export-oriented growth strategy give Beijing few

choices other than buying U.S. T-bills or harming its own economy. Rather than creating new rules or institutions in international finance, or reorienting the Chinese economy to generate greater long-term consumer demand at home, Chinese leaders are desperately clinging to the *status quo* (though Beijing deserves credit for short-term efforts to stimulate economic growth).

The greater danger with China is not an eclipsing of U.S. leadership, but instead the kind of shift in strategic orientation that happened to Japan after the Great Depression. Japan was arguably not a revisionist power before 1932 and sought instead to converge with the global economy through open trade and adoption of the Gold standard. The worldwide depression and protectionism of the 1930s devastated the newly exposed Japanese economy and contributed directly to militaristic and autarkic policies in Asia as the Japanese people reacted against what counted for globalization at the time. China today is similarly converging with the global economy, and many experts believe China needs at least 8 percent annual growth to sustain social stability. Realistic growth predictions for 2009 are closer to 5 percent.

Veteran China hands were watching closely when millions of migrant workers returned home from the Chinese New Year last month to find factories closed and jobs gone after the celebration. There were pockets of protests, but nationwide unrest seems unlikely this year, and Chinese leaders are working around the clock to ensure that it does not happen next year either. However, the economic slowdown has only just begun and nobody is certain how it will impact the social contract in China between the ruling communist party and the 1.3 billion Chinese who have come to see President Hu Jintao's call for "harmonious society" as inextricably linked to his promise of "peaceful development." If the Japanese example is any precedent, a sustained economic slowdown has the potential to open a dangerous path from economic nationalism to strategic revisionism in China too.

**Dangerous States:** It is noteworthy that North Korea, Burma, and Iran have all intensified their defiance in the wake of the financial crisis, which has distracted the world's leading nations, limited their moral authority, and sown potential discord. With Beijing worried about the potential impact of North Korean belligerence or instability on Chinese internal stability, and leaders in Japan and South Korea under siege in parliament because of the collapse of their stock markets, Pyongyang has grown increasingly boisterous about its claims to great power status as a nuclear weapons state. The junta in Burma has chosen this moment to arrest hundreds of political dissidents and thumb its nose at fellow members of ASEAN. Iran continues its nuclear program while exploiting differences between the P-3 (U.S., UK, and France) and China and Russia – differences that could become more pronounced if economic friction with Beijing or Russia crowds out cooperation or if

Western European governments grow nervous about sanctions as a tool of policy. It is possible that the economic downturn will make these dangerous states more pliable because of falling fuel prices (Iran) and greater need for foreign aid (North Korea and Burma), but that may depend on how much authoritarian leaders care about the well-being of their people or face internal political pressures linked to the economy. So far, there is little evidence to suggest either and much evidence to suggest these dangerous states see an opportunity to advance their asymmetrical advantages against the international system.

**Challenges to the Democratic Model:** The trend in East Asia has been for developing economies to steadily embrace democracy and the rule of law in order to sustain their national success. But to thrive, new democracies also have to deliver basic economic growth. The economic crisis has hit democracies hard, with Japanese Prime Minister Aso Taro's approval collapsing to single digits in the polls and South Korea's Lee Myung-bak and Taiwan's Ma Ying Jeou doing only a little better (and the collapse in Taiwan's exports – particularly to China – is sure to undermine Ma's argument that a more accommodating stance toward Beijing will bring economic benefits to Taiwan). Thailand's new coalition government has an uncertain future after two years of post-coup drift and now economic crisis. The string of old and new democracies in East Asia has helped to anchor U.S. relations with China and to maintain what former Secretary of State Condoleezza Rice once called a "balance of power that favors freedom." A reversal of the democratic expansion of the last two decades would not only impact the global balance of power, but also increase the potential number of failed states with all the attendant risk they bring from harboring terrorists to incubating pandemic diseases and trafficking in persons. It would also undermine the demonstration effect of liberal norms we are urging China to embrace at home.

**Protectionism:** The collapse of financial markets in 1929 was compounded by protectionist measures such as the Smoot-Hawley tariff in 1932. Suddenly, the economic collapse became a zero-sum race for autarkic trading blocs that became a key cause of war. Today, the globalization of finance, services, and manufacturing networks and the World Trade Organization make such a rapid move to trading blocs unlikely. However, protectionism could still unravel the international system through other guises.

Already, new spending packages around the world are providing support for certain industries that might be perceived by foreign competitors as unfair trade measures, potentially creating a "Smoot-Hawley 2.0" stimulus effect as governments race to prop up industries. The "Buy American" conditionality in the stimulus package was watered down somewhat by the Obama administration, but it set a tempting precedent for other countries to put up barriers to close markets.

Nations pushing the bounds of their trade commitments could overload the circuits of a system that can take two years to determine violations – more than enough time for a global meltdown. Climate change legislation is also likely to become a stalking horse for protectionism as legislatures enthusiastically embrace punitive tariffs against Chinese or

Indian goods that are produced outside of the framework for reducing greenhouse gas emissions.

Finally, competitive devaluation – already being pursued by China in the view of some economists – could intensify international protectionism and friction. Global trade has already contracted for the first time in over two decades and governments have only just begun exploring unilateral measures that could cause further barriers. Meanwhile, trade liberalization has stalled in the Doha Round of the WTO and the Obama administration has come into office expressing strong reservations about major bilateral free trade agreements already negotiated with allies like South Korea and Columbia. Even if the clarion call of protectionism does not lead to the kind of autarkic blocs that contributed to war in the 1930s, it could still distract governments from collaboration on common threats and slow the prospects for more rapid recovery.

### **Don't Worry, but Be Smart**

These danger signs do not mean that the worst case scenarios are *likely* to happen even if the economic crisis extends beyond 2009, but history and contemporary trends both suggest that they *could* happen if we are not careful. Fortunately, we can learn from past failings.

We know that it is important to fight protectionism, and the United States and our key allies can lead in that effort at home and through the WTO, APEC, and the G-7 and G20, or through other new or strengthened alliances that might be built between committed partners. We know that offensive trade liberalization through renewed efforts at the WTO or with the KORUS FTA would be the best defense of all against protectionism. We know that it is important to provide economic assistance to fragile states like Pakistan and through the World Bank and IMF even amidst our own financial crises. We know that it would be foolhardy to slash defense spending or to replace deterrence and strong alliances with weak diplomatic arrangements as we did in the 1920s and 1930s. And we know that we need a global strategy for revitalizing economic growth and recognizing its interconnections to security rather than seeking relative gains through unilateral approaches.