

EAST ASIA FORUM

ECONOMICS, POLITICS AND PUBLIC POLICY IN EAST ASIA AND THE PACIFIC

Vol.5 No.2 April-June 2013 \$9.50

Quarterly



Coming to terms with Asia

Yiping Huang China the key in shaping the Asian century

Wendy Dobson Asian institutions and global influence

Hugh White The new security order

Ross Garnaut China's contribution to climate mitigation

Shekhar Shah How will India be part of the Asian century?

and more . . .

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ISSN 1837-5081 (print)
ISSN 1837-509X (online)

From the Editors' desk

No matter how one looks at the numbers, the Asian economies are bound to have a central role in the global economy this century.

This fact has many implications. First, it suggests where the opportunities for growth are going to be over the coming decades. Already the Asian economies account for almost 40 per cent of global output. The Asian century is here. Within Asia there are already half a billion consumers who, by OECD reckoning, are among the world's middle classes, compared with a billion in Europe and North America. On conservative estimates of relative income and population growth, the middle classes in Asia will grow to 3.2 billion by 2030 but remain a bit under a billion in Europe and North America. Second, the remarkable change in the structure of the world economy, which has seen economic weight realign roughly with population weight after 200 years of being out of sync, is being accompanied by Asia's growing political influence. The rise of China, and also India, challenge the role of the established European and North American industrial powers in a number of ways.

Already managing economic crises has required incorporation of the emerging powers into global economic governance, notably through the establishment of the G20 heads of government summit after the global financial crisis of 2008. The post-war Bretton Woods international system is under review. International financial and currency arrangements are changing in ways that are difficult to predict. The post-Cold War political and security architecture is under scrutiny, with the rise of China and the new powers. Asia's rise is also influencing the centre of cultural gravity. Countries not only within the region but around the world are adjusting in various ways and with varying degrees of purpose to these realities.

In this issue of EAFQ leading analysts from throughout Asia, from America and from Europe address these developments. Some things are clear, though they may have been thus far under-recognised. China, India and the other Asian powers will have a greater role in global affairs. But there is much that is yet to be determined, and it is clear that this theme is one to which we will return.

Peter Drysdale and Ken Henry

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JAYANT MENON

A SIA'S rise as an economic force over the past 40 years is one of the most successful development stories of modern times. If Asia can continue to expand at the robust rates of recent history, it could account for more than half of global output in 2050. Average per-capita incomes could rise above US\$40,000 (in constant purchasing power parity terms), similar to that of Europe today, and there may no longer be any poor countries in Asia.

In many ways, what we are witnessing is not the 'emergence of Asia' but the 're-emergence of Asia'. In 1820, Asia accounted for just under 60 per cent of total global output, with China and India together accounting for nearly half of global GDP. This was

followed by nearly two centuries of economic decline in Asia, ignited by the European industrial revolution—a trend that has now been reversed. Embracing economic openness and structural reforms, China and India have rapidly re-emerged as key engines of the global economy. Indeed, across the region countries from Cambodia to Indonesia are participating in the robust economic expansion that has helped lift hundreds of millions out of abject poverty. Yet, a number of developing economies in the region are still mired in low or modest growth rates. As a result, the region's much-touted prosperity is still mainly confined to East Asia. The Asian century will not be realised unless its growth is broadly based and its prosperity also extends across South Asia, Central

Indian women carrying potable water near Ahmadabad. If this is to be Asia's century, nations will need to lift the region's 'remaining millions out of poverty'.

Asia and the Pacific Islands.

Given Asia's diverse and complex social and economic landscape, its rapid yet uneven rise offers both significant challenges and important opportunities. So Asia's future success has to be earned. If this is to be Asia's century, then it must tackle both the near- and long-term challenges that lie ahead. Policies that were effective in the past when Asia was largely a low-income, capital-scarce region are less likely to be effective in the future.

Asia needs to lift its remaining millions out of poverty, and the pattern and quality of growth will be

Issue Editors

Peter Drysdale and Ken Henry.

Editors

Peter Drysdale, Head, East Asia Forum and East Asian Bureau of Economic Research, Crawford School, ANU.

Shiro Armstrong, Executive Director, East Asia Forum and East Asian Bureau of Economic Research, Crawford School, ANU.

Editorial Staff

Sam Wall, Kai Ito, Rosemary Tran, Mark Fabian, ANU.

Editorial Advisers: Peter Fuller, Max Suich.

Production: Peter Fuller, Words & Pics.

Original design: Peter Schofield.

Email Peter.Drysdale@anu.edu.au,
Shiro.Armstrong@anu.edu.au.

The views expressed are those of the individual authors and do not represent the views of the Crawford School, ANU, EABER, EAF, or the institutions to which the authors are attached.

COVER PHOTO: Time of the dragon. By 2025 almost half of the world's economic activity will occur in Asia. Picture: David Pedre / ©iStockphoto.com.



Published by ANU E Press
The Australian National University
Canberra ACT 0200, Australia
Email: anuepress@anu.edu.au
Web: <http://epress.anu.edu.au>

important. If growth continues to increase inequalities and polarisation within countries, then social cohesion will be at risk. Rising inequalities between countries could result in mass migrations or even conflict. A number of countries are also finding it difficult to break out of the middle-income trap. So they need investment in human capital and in research and development to make the transition from 'catch-up' to 'frontier' entrepreneurship. Some countries, like China and Japan, have to prepare for ageing populations, while others need to find fruitful and satisfying employment for their rising working-age populations. Populous countries like India stand to benefit from the demographic dividend only if sufficient jobs can be created to absorb their growing labour force. If they fail, massive unemployment and associated social ills are the likely result. A lot of Asia's future growth, perhaps up to 75 per cent, will be generated in urban centres, and it is estimated that Asia's urban population will likely double to three billion by 2050. Rising urbanisation, and the stress that it imposes on its cities, is another significant challenge requiring early planning.

All of these issues need to be addressed within the overarching ambit of environmentally sustainable growth as the race for resources gathers pace. The real crisis that the world needs to worry about is not the next economic or financial meltdown but one where population growth leads to conflict resulting from competition for scarce and dwindling resources, exacerbated by an increase in the frequency and severity of natural disasters. Food, clean air, drinking water and arable land would all be hotly contested.

Asia's coming of age signals an

inevitable change in the global economic and political order. While this shift has been long anticipated, world economic and political governance has yet to adjust to these developments. The elevation of the broader G20 to guide the world economy, replacing the G7, heralds a new beginning. But Asia still needs to prove it can be a responsible partner in the global agenda. As its influence increases, Asia must take greater ownership in preserving the global commons, and be seen to act as a responsible global citizen. Regional and global dialogue that fosters conflict-avoiding cooperation will be important factors in sustaining the region's growth and development.

The signs are that Asia will rise up to face these challenges and that this will indeed be the Asian century. But the Asian century is not just Asia's century—it should be a century of shared global prosperity. While the opportunity-cost to Asia of failure is high, it will also affect the rest of the world. Realising the Asian century is in all our interests. **EAFQ**

Jayant Menon is Lead Economist at the Office of Regional Economic Integration, Asian Development Bank (ADB), and Adjunct Fellow at the Arndt-Corden Department of Economics, Australian National University.

This article draws upon an earlier presentation to an IMF-Australian Treasury-Reserve Bank of Australia conference, which itself was based on the ADB-Centennial Group publication, Asia 2050. The views expressed are those of the author and do not necessarily reflect the views and policies of the ADB or its Board of Governors or the governments they represent.

China the key in shaping the Asian century

YIPING HUANG

THE advent of the Asian century inevitably implies a greater global role for the Chinese economy. While the shift of global economic gravity towards East Asia started almost half a century ago, it was the emergence of China as a global economic power that finally became the cornerstone of the Asian century. Over the period 2001–12, China regularly contributed between one-quarter and one-half of world economic growth. If the Chinese economy maintains an average of 7 per cent growth in the coming years, it should overtake the United States to become the largest economy in the world before 2020.

The Asian century could be the first time in human history when world affairs are managed collectively by a group of countries at different levels of development and with different political regimes. The new reality is that developing countries will have a significant say on issues of global governance issues. Collaboration between China and the United States should form the centrepiece of the future coordination mechanism for the world economy, although most parties involved are sceptical about the proposition of a formal China–US (G2) arrangement.

China's rise as one of the global economic leaders poses significant challenges for both China and the rest of the world. China will need to introduce reforms to improve its transparency and the predictability of its decision process. Its leaders will

also need to adapt to the new ways in which the world reacts to it. As a large economy, whatever China does could affect the world economy significantly and invite responses from the rest of the world. For instance, today China already accounts for 11 per cent of the world's total exports. Continuous rapid expansion of Chinese exports could force significant structural changes in other countries. This is perhaps why China is already the world's number one target country of trade disputes and sanctions.

But the world may also need to accept China as a new global player. Despite the expected reforms, China is still an emerging market economy and won't become a Western-style democracy any time soon. Even if China does become the world's largest economy before the end of the decade, its GDP per capita will only be a little over US\$10,000—less than one-third of that in the United States and Japan. But the income level and political system should not prevent China from becoming a responsible global economic leader. China's participation

... the Chinese economy is already in the middle of the transition from 'economic miracle' to 'normal development'

in the G20 and other international dialogues should be helpful steps in redefining the relationship between China and the world economy. The recent agreements reached by China and Australia, on annual top-level dialogue and renminbi convertibility, among others, are good examples of such cooperation. If Australia could work with China, so could the other developed and developing countries.

Regardless, China will likely play a significant role in transforming the world economy in the coming decade, especially as its own growth model evolves. That growth model may be characterised as one of strong economic growth and serious structural imbalances during the first three decades of economic reform. This was caused primarily by the asymmetric liberalisation approach taken during the reform period—product markets have been almost completely liberalised but factor markets have remained under significant distortions. The generally depressed costs of capital, energy, water, land and labour serve as a special mechanism subsidising the corporates but taxing the households.

As a result, China became one of the dominant contributors to world economic growth and a source of global disinflation. It nearly monopolised the labour-intensive manufacturing industries, making it difficult to find low-cost consumer goods not made in China. It also single-handedly fuelled the so-called 'super-cycle' of the commodity markets.

Gravity shift and its discontents

But all this may change now. Following recent increases in costs of production, especially cost of labour, the Chinese economy is already in the middle of the transition from 'economic miracle' to 'normal development'. China's trend growth has probably already shifted to the 6–8 per cent range, down from 10 per cent, accelerated by rapid demographic change. In the meantime, economic structure has also started to improve, shown by a narrowing current account surplus, rising consumption share of GDP and improving income distribution. Transition of the growth model has just started and could lead to slower growth, higher inflation pressure, improved income distribution, more balanced economic structure, accelerated industrial upgrading and more volatile economic cycles.

These changes will also affect the world economy significantly. China may quickly shift from a source of global disinflation to one of global inflation. It should force new international divisions of labour, by rapidly losing labour-intensive industries and moving up the value chain. Its demand for commodities should slow as GDP growth decelerates and investment share of GDP edges down. But consumption should expand more dramatically, as a result of continued growth and rebalancing, making China the most dynamic consumer market. Slower but better-quality Chinese growth would support more sustainable expansion of the global economy in the Asian century. **EAFAQ**

Yiping Huang is Professor of Economics at Peking University and at the China Economy Program, Australian National University.

SOURABH GUPTA

AT THE stroke of midnight on 15 August 1947, when India officially became an independent state after two centuries of British rule, Prime Minister Nehru observed that moments when the old gave way to the new occurred but rarely in history.

Yet it is happening again today, albeit stretched out over a grander, multi-decade time horizon, as a half-millennium of western economic, political and perhaps intellectual hegemony gradually cedes to the rising world of Asia and the Asia-Pacific.

Given its magnitude, this 'gravity shift' eastwards is bound to inject an added element of instability to international relations. The recent demise of Cold War ideologies has already seen competition over models of development emerge along fault lines of culture, religion and civilisation. The West's efforts to preserve its traditional leadership position, even as its ability to dominate global economics and politics diminishes, will also lead to increased turbulence in the international system.

This instability during the long transition period will manifest itself in a deficit of international governance, as key global actors play out their own version of a prisoner's dilemma—a system in which no subset of powers can succeed on their own, yet none trusts others enough

to produce constructive cooperation and coordination. Ritual exercises in international buck-passing will be the order of the day along with attempts to hoard agenda-setting authority. The promise of the Asian century will be slow to be realised.

This will be evident on a number of fronts.

For global economic rebalancing to succeed, the locus of global consumption must accompany the eastward movement of manufacturing, trade and investment that has already occurred. Yet the East Asian economic model's ability to deliver domestic aggregate demand on par with its hyper-competitive production capabilities appears to be in significant doubt. Meanwhile, the G20 process, after having served as a useful temporary expedient for global reflation, has neither delivered on its reciprocal, peer-pressure-driven Mutual Assessment Process to head-off future imbalances nor on more basic provisions, such as revision of the formula used by the IMF to rebalance its quota shares

The bedrock principles of rules-based multilateralism and non-discrimination also need to be preserved for the global trading system to prosper. Yet globalisation-induced wage competition is currently driving advanced economies to take selective approaches to trade negotiations that embed discrimination and diversion.



The benefits of education: a girl leaves Mauchak Scout High School, Bangladesh, after lessons. A 'resolute focus on growth and welfare' for all in society will provide the best prop for peace and stability in the Asian century.

The final success of such negotiations is not assured, and states' fidelity to 'open multilateralism' is unlikely to move beyond rhetoric. Meanwhile, the rough blueprint of a final Doha Round agreement languishes on the sidelines.

Additionally, the zero-sum economic calculation that underpins multilateral environmental talks means that a negotiated compromise on reducing global emissions reduction is likely to remain an ever more distant prospect. Pollutive extraction and production processes and volatility in global commodity and food prices will continue to plague developed and developing countries alike.

Accommodating—and accelerating—the financial liberalisation of savings-surplus Asian stakeholders within a broader institutional architecture of inter-governmental liquidity and solvency risk management will be key to ensuring that the international monetary system remains in balance

and prospers. But far from endowing international financial institutions with an imaginative role to facilitate this kind of architectural reform, incumbent stakeholders seem to have stumbled at the low hurdle of merit-based personnel selection and IMF quota review.

IN THE meantime, tsunami-like capital flows continue to exact punishment on exposed banking, capital and other asset markets in developing and developed countries alike; the dollar's standing as an anchor currency is eroded daily by its persistent and large deficits; and China's fidelity to its administered deposit rates, undervalued currency, and export of deflation bears unhappy parallels with Washington's own myopic approach to the monetary order of the early 1920s.

Ensuring that the 'gravity shift' eastwards does not contain the seeds of its own destruction will depend

to a large extent on the ability of Asia's rising stakeholders to exchange obligation for power. But, ultimately, it is neither wealth nor power but prosperity—understood as welfare for all in society—that will afford an immanent principle of order and self-restraint in the Asian century. A resolute focus on growth and welfare, despite its distributional challenges internationally, will provide the best prop for peace and stability, and a continued intertwining of pan-Asian and trans-Pacific destinies.

For China—a great civilisation that has lasted an eternity by learning to trade military ambition, and the culture that sustained it, for permanent economic growth—this imperative, along with the attributes required to wield leadership, ought to be reasonably familiar. **EAFO**

Sourabh Gupta is a Senior Research Associate at Samuels International Associates Inc., Washington DC.

The new security order

HUGH WHITE

COMING to terms with the Asian century means coming to terms with the biggest change in the global distribution of wealth and power since the Industrial Revolution. This change is driving nothing less than a revolution in the Asian regional order. For the West, it means having much less power over how that order is conceived and maintained. For Asian countries it means that for the next few decades by far the most important new power will be China, as its economy not just overtakes America's

but grows to perhaps twice the size. For Asian countries, it also means learning again to live with powerful neighbours without the comforting intermediation of preponderant Western power. For Australia, it means both of these things. No wonder it is not proving easy.

Eventually, if the current trend of rising per-capita productivity is sustained, a number of populous Asian countries will acquire the wealth and power to shape and shake the regional order in ways which until now only Japan has been able to pretend. These countries will include India

and Indonesia but especially China, and coming to terms with the Asian century will mean coming to terms with what this means for China's ability to reshape the Asian order to serve its interests.

The first question, then, is: what does China want? There are two common views about this. The first is that China wants very little—only to be a bigger and more responsible supporter of the US-led status quo. Those who take this view say that China is the main beneficiary of the stable order created by American primacy, and its rulers cannot afford



A soldier on a visiting US Navy ship surveys the Hong Kong skyline. America will not be able to dominate Asia in the face of Chinese opposition.

PICTURE: ALEX HOFFORD / EPA / AAP

to disturb it. Certainly, China wants stability, but this argument assumes that China thinks that the only possible foundation for stability is US leadership. Beijing does not see it that way. The Chinese believe Asia could be just as stable and peaceful under its own leadership. The argument that the Chinese want very little also assumes that the Chinese have no ambitions other than to be rich. But it seems clear the Chinese also want the status and respect they feel is becoming of a unique and exceptional civilisation, and will be willing to run risks to get it. In this way, they are very much like America.

The second view of China's ambitions is that they are far-reaching. The examples of Nazi Germany, Imperial Japan and Stalinist Russia lead some to assume that any rising power must inevitably aim to overturn every aspect of the pre-existing order—territorial, economic, political, ideological, even moral. Many people fear that China too has these ambitions. But this fear underestimates China's immense stake in many aspects of the current order of which it has been by far the biggest beneficiary. In this way, it is very unlike the disruptive rising powers of the 20th century—there is no evidence that China has territorial ambitions, notwithstanding its assertiveness in the South China Sea. It has no political or ideological agendas, and no reason to change the economic order. In fact, China seems to want to change very little about the global or regional order except its own role in it, and even there its leadership ambitions seem primarily limited to Asia.

So perhaps the rest of the world could learn to live with Chinese leadership if things otherwise remained unchanged, but this is still a potentially risky and unsettling



'Assertiveness' in the South China Sea: a Chinese trawler attempts to grapple a US Navy vessel's towed acoustic array in an encounter south of Hainan Island in March 2009.

prospect. It is risky because once in charge China's ambitions might grow, and it could start acting more like the rising powers of the last century. It is unsettling because leadership is so deeply tied up with identity, especially for the leaders themselves. We can be sure that the Chinese will be deadly serious about asserting their leadership in Asia, and America will be equally serious about defending theirs.

Coming to terms with China's and the United States' competing ambitions requires understanding how much power each country will have. China is becoming immensely powerful, but America will remain very strong too. China will also be surrounded by other very strong states, including Japan, Russia, India and perhaps Indonesia. Even on the most bullish projections, China will not be able to dominate Asia against all these surrounding powers. But equally, even if America recovers strongly from its current economic and fiscal problems it will not be able to dominate Asia in the face of Chinese opposition. So the Asian century will not belong to any one country. It will be a time either of

systemic rivalry and frequent conflict or of carefully cultivated compromise and cooperation between the region's major powers.

And this means, finally, that coming to terms with the Asian century means coming to terms with the risks it presents and the options available to avoid them. We have to acknowledge China's power and ambitions, but without simply surrendering to them. Whether we can avoid escalating strategic rivalry and, at the same time, avoid Chinese hegemony depends on our ability to simultaneously accommodate China's ambitions and rein them in. It is necessary to decide how hard to resist China, how much to concede, and how to draw and enforce the limits to these concessions. We need to understand the consequences of getting any of this wrong. Above all, we need to quickly grasp just how different the Asian century is going to be. **EAFQ**

Hugh White is Professor of Strategic Studies at the Strategic and Defence Studies Centre, Australian National University.

Developing Asia and the middle-income trap

HOMI KHARAS

DEVELOPING Asia's share of nominal global GDP has risen inexorably over the last 30 years: 7.5 per cent in 1980, 10.5 per cent in 1990, 14.5 per cent in 2000 and 26 per cent projected for this year. This has happened despite a major regional financial crisis in 1997–98 and a number of global crises in food, fuel and energy, as well as the longest-lasting and deepest recession in history in Asia's major trading partners in the advanced world. The strength and resilience of developing Asia's growth over such a long period of time invites speculation as to what the future may bring. Simple extrapolation of past trends coupled with the fact that Asia has a large and fast-growing middle-class population produces forecasts of an inevitable Asian century.

Asian policymakers should beware of complacency and pay heed to the example of Latin America. Developing Asian economies are large (US\$23 trillion in 2013) but not rich. The average income per capita of someone in developing Asia is still less than US\$7000 per year. That is about half the income level of a Latin American and is approaching the income level reached by Latin America when it became trapped and stagnated. Latin America's post-World War II growth strategies based on urbanisation and credit-fuelled public sectors were unsustainable and real incomes in Latin American have consequently

grown by only 1 per cent in real capita terms per annum for the last 30 years.

Could East Asian countries suffer the same fate? Might the strategies that allowed them to grow from poor- to middle-income countries now fail them as they strive to become advanced economies? This is the question preoccupying policymakers across the region.

Asian countries could get trapped in middle-income status, unable to compete with low-wage competitors in standardised manufactured exports or with advanced economies growing on the basis of innovations and advanced technology. Take the case of Malaysia, a highly successful exporter that has also attracted large amounts of FDI and is ranked as number 25 in the world in competitiveness. Since the

South Korea, Taiwan, Hong Kong and Singapore have made the transition to advanced economies. In each case, strong domestic political and bureaucratic forces had to be overcome . . .

Asian financial crisis—and since it reached an income level similar to that of Latin American nations at US\$10,000 per annum—its growth rate has fallen by one-half.

Or look at China, which is also slowing down and showing signs of weakness in the housing and local-government development projects that have kept its economy booming at double-digit rates for over 20 years. Both need new strategies to keep growth high.

In Malaysia the strategies include moves to stop the outflow of the talent and capital of its dynamic ethnic Chinese business community. For China, new strategies may include rebalancing towards domestic demand and levelling the playing field for the domestic private sector. Both countries face the challenge of altering course to reflect their shifting comparative advantage in the face of resistance from vested interests that have grown rich and powerful from the status quo.

There is no uniform policy prescription for avoiding the middle-income trap. It is not a destiny but an obstacle to be overcome. South Korea, Taiwan, Hong Kong and Singapore have made the transition to advanced economies. In each case, strong domestic political and bureaucratic forces had to be overcome to unleash a new wave of dynamism before these countries could move ahead. Their paths were different but they shared a willingness and ability to change course.

Most Asian countries are unlikely



Kuala Lumpur's Petronas Towers loom over a construction worker painting an enclosure wall on a building site. As part of its efforts to boost growth and so avoid the middle-income trap, Malaysia has put policies in place to stop the outflow of talent and capital.

to face immediate economic danger. Indeed, the Asian Development Bank is forecasting a very respectable 6–7 per cent growth in the near-term. But middle-income traps build slowly over time. They strangle economies by absorbing resources that could otherwise be put to more effective use and by constraining policy space. For example, resources can get tied up in inefficient public enterprises, low value-added exporters, risky bank credits or speculative asset booms. Policy space can be reduced when public spending has to deal with pressing problems of social assistance, health care or environmental clean-up that could have been avoided

if more inclusive and sustainable growth strategies had been pursued from the start.

At its heart, the middle-income trap is a governance failure: an inability to take a long-term view of the best way forward for society as a whole. Avoiding the trap can take careful preparation and implementation over a decade or more. Building top-tier universities, forming fair, transparent and accountable public institutions, building a culture of prudent risk-taking and a mindset of environmental sustainability are not processes that happen overnight. Politically, the shift from the 'rule of man', where an enlightened leader can be relied upon

to make the right choices, to a 'rule of law', with institutional structures that produce predictable and sound decisions, is hard to accomplish. But unless middle-income Asian countries take the long view and change course they could fall, like many Latin American countries, into middle-income traps of their own making.

EAFO

Homi Kharas is a senior fellow and deputy director of the Global Economy and Development, Development Assistance and Governance Initiative at the Brookings Institution. He is co-author of An East Asian Renaissance: Ideas for Economic Growth.

Asian institutions and global influence

WENDY DOBSON

A SIA'S rapid economic ascent raises expectations in the rest of the world of greater political influence, even leadership, by Asian countries and questions about Asia's regional institutions. With some exceptions, as when South Korea hosted the G20 summit in 2010, Asian governments tend to focus on their own interests and regional institutions operate with Asian-style pragmatism, with a focus on cooperation and incremental change.

There are good reasons for this diplomatic style but what does it imply for the future? Can Asia's institutions manage the geostrategic impact of China's rise or will they be overwhelmed by rivalries among the large powers?

Historical tensions impede regional integration efforts. Asian economies prize national independence and its corollary, non-interference. So ASEAN, the best-established intergovernmental institution in Asia, follows the 'ASEAN way' of non-intrusive and gradualist decision-making. It has become a hub in a complex network of bilateral free trade agreements (FTAs) that criss-cross the region but still lack links among China, Japan and Korea. In finance it created the CMIM to be an emergency financing mechanism with an independent surveillance function and IMF links. Indeed participation in global frameworks for trade and finance have been important to some

In pursuing its core interests China has neglected to articulate broader goals that might serve its neighbours' interests and has permitted uncoordinated initiatives to be taken

of the region's economic 'miracles'—notably China's reform and opening since it joined the WTO.

Asia's focus on economic development was made possible by peace and political stability. Wealth, not bullets, has been the route to power and influence, with stability underwritten in the post war period by US military alliances. More recently the East Asia Summit (EAS), the preferred leaders' forum for political and security cooperation, has seen its credibility strained by China's assertive boundary claims and insistence on dealing with them as bilateral issues. The resulting tensions have caused alarmed governments to hedge by calling for a higher US profile in the region.

In short, international relationships

and institutions are an important adjunct to regional ones. Without formal agreements among the region's leading powers none can provide regional leadership. Instead ASEAN's institutions help to channel rivalry like that between China and Japan into its cooperative forums where it manages their competing initiatives with its variable geometry of ASEAN-Plus memberships.

Looking to the future, trade initiatives show the most promise because they are easier to manage than security and political issues, focusing mainly on tariff reductions in goods, tolerating exceptions and treating lightly the complex issues of liberalising services, competition policy, intellectual property rights and investment. Still, Asia's trade agreements show the value of a gradualist approach. The China–ASEAN FTA was a catalyst for ASEAN+3 and ASEAN+6 proposals, which ASEAN's blueprint for a Regional Comprehensive Economic Partnership (RCEP) now aims to harmonise. In finance CMIM, although so far untested, has the potential to promote macroeconomic cooperation and prevent future financial crises.

But it is the evolving trade initiatives that will shape the future in Asia and beyond. It is well known that the benefits of comprehensive trade liberalisation are maximised when the largest countries—on both sides of the Pacific—are included. APEC's 21 members recognised this



A formal handshake before the US Secretary of State, John Kerry, and Chinese Foreign Minister, Wang Yi, get down to business in Beijing in April 2013. International relationships and institutions continue to serve as important adjuncts to their regional counterparts.

when they endorsed the Free Trade Area of the Asia Pacific (FTAAP) as a long-term goal to be achieved if competing agreements head in the same direction. The RCEP and the ASEAN+ negotiations are one track; the Trans-Pacific Partnership (TPP), which aims to be a comprehensive, high-quality FTA, is another. With its 12 negotiating parties, the TPP is generating liberalising momentum through a ‘contest of templates’ designed to shape eventual patterns of integration across the Pacific.

The region’s security institutions face complex challenges. How to manage China’s boundary claims and its so-called ‘coercive diplomacy’?

In pursuing its core interests China has neglected to articulate broader goals that might serve its neighbours’ interests and has permitted uncoordinated initiatives to be taken by a plethora of Chinese players. Neither the EAS nor the global framework provided by the Law of the Sea Treaty has yet succeeded in managing these heightened tensions beyond asserting ASEAN’s Declaration of Conduct.

Alternative frameworks for managing regional security cooperation are all contested: China’s neighbours resist any reassertion of its historic hegemony; Australian proposals for a concert of major

... more participation and leadership in the global institutions will serve both regional and global interests

powers as well as ideas for a China–US G2 are opposed by ASEAN and by other large countries; and ASEAN’s East Asian Community proposal is moving so slowly it could be overtaken by rivalries among the large economies.

Can Asia’s pragmatic regional order manage these intraregional strains and rivalries? Competition among trade templates will be good for all parties because it will further open markets and possibly supply fresh momentum for global talks. Security cooperation is weaker but so far Asia has avoided zero-sum conflict. Financial cooperation deepens understanding of each other’s macroeconomic performance and can warn of potential problems. As Asia’s economic significance continues to grow and its interdependence deepens, more participation and leadership in the global institutions will serve both regional and global interests. In coming to terms with the Asian century, Western nations will need to recognise Asia’s new weight and speed up the reforms in global governance necessary to reallocate power accordingly. **EAFQ**

Wendy Dobson is Professor at the Rotman School of Management and co-Director of the Rotman Institute for International Business, the University of Toronto.

Challenges of the Asian financial markets

PICTURE: LAURENT FIEVET / AFP PHOTO / AAP



Ready money: Chinese efforts to internationalise the renminbi are gaining momentum.

TAKATOSHI ITO

IT IS almost certain that the 21st century is the Asian century in terms of the real side of the economy—growth, trade, consumption and investment. What is not certain is how Asia will integrate financially and what will happen to Asian currencies. When the West feared the rise of the Japanese economy in the 1980s, some predicted that the yen would become an international reserve currency. But the Japanese government did not push internationalisation of the yen until it was too late, and when the bubble burst the Japanese economy weakened and the country entered a period of long stagnation. Now, the question is whether the Chinese renminbi (RMB) could become the default international currency in Asia.

The Asian currency crisis of 1997–98 made countries realise that what is important is not fixing their currencies to the US dollar but ensuring that they are not too volatile. Floating currencies became necessary as capital markets were opened, which in turn was essential to secure the inflow of foreign direct investment (FDI). On the other hand, a completely free currency float was thought to be undesirable because volatile currency movements would harm exports.

In the aftermath of the Asian currency crisis, Asian countries intensified their financial integration and cooperation to make the region better able to withstand internal and external shocks.

First, more policymakers were interested in the ‘basket currency’ arrangement because it seemed to provide a balance between flexibility and stability. Many were attracted to the idea of keeping Asian currencies jointly floating against the US dollar and the euro, but loosely binding them to each other

at the same time to ensure stability. Asian governments even looked to the Exchange Rate Mechanism, an arrangement that led to the creation of the euro, as a model for the region. But critics emphasised that Asia relied on exports to the United States and Europe, so stability against the US dollar and the euro could not be sacrificed.

Another difficulty was the lack of political will. There was academic support for the creation of an Asian Monetary Unit (AMU) so that currencies would not deviate too much from the weighted average in the region. But such a concept required mutual commitment, and the idea did not gain political traction. This kind of arrangement continues to attract recognition. The Research Institute of Economy, Trade and Industry (RIETI, a Japanese government-sponsored research institute) still publishes AMUs for reference daily, and the figures show Asian currencies converging around the central value of AMU in the medium run. But the recent eurozone sovereign debt crisis, which partly stems from Europe's adoption of a single currency not backed by a fiscal and banking union, dampened any remaining enthusiasm towards a more unified exchange rate arrangement in Asia.

Second, many ASEAN+3 countries saw reserve pooling as the most attractive form of financial cooperation after the Asian crisis. In particular, crisis-hit countries like Thailand, Indonesia, Malaysia and Korea thought reserve pooling could offer a safety net. Thailand's rescue by the IMF, Japan and other Asian countries in August 1997 was a model, however imperfect, for future reserve pooling arrangements. While soon after that rescue a proposal for regional reserve pooling—dubbed

the Asian Monetary Fund—was shot down by the IMF, the United States and China, leaders of other nations continued to push towards a regional mechanism. In May 2000 ASEAN finance ministers agreed on the Chiang Mai Initiative (CMI), a network of bilateral swaps. The size of CMI grew in several stages and eventually evolved into the Chiang Mai Initiative Multilateralization agreement (CMIM) in 2010, which sets up a self-managed reserve pooling system.

The environment has changed since the IMF opposed an Asian Monetary Fund in 1997. The recent eurozone crisis produced a regional liquidity assistance mechanism, the European Financial Stability Facility, as a temporary arrangement. Later, Europe created a permanent body, the European Stability Mechanism, to ensure financial stability, which effectively allows for regional reserve pooling, just as the Asian Monetary

The internationalisation of the renminbi, if fully implemented with capital account liberalisation, has the potential to unite (most of) Asia as an RMB bloc. Trade invoicing, settlement and bond issues would all take place in RMB within the bloc

Fund would have done. Having seen this body at work in Europe, the IMF would surely not oppose the transformation of CMIM into a genuine reserve pooling system with a secretariat at the ASEAN+3 Macroeconomic Research Office (AMRO).

But while these regional efforts to rationalise currency arrangements and create reserve pooling systems are encouraging, they leave an opening for China. And the Chinese effort to internationalise the RMB is gaining momentum. It remains to be seen whether its successful internationalisation will replace the Asian Monetary Fund and CMIM partially, if not completely.

The Chinese government started promoting the internationalisation of the RMB in 2009—telling Chinese companies that they should invoice exports and imports and settle contracts in RMB, if possible. There are difficulties, however, because if the trading partners of Chinese companies agree to invoice and settle with Chinese currency they have to bear the currency risk and hold RMB for trade finance. Foreign companies will be reluctant to do so unless the RMB becomes a fully convertible currency; that is, a currency with no restriction of any type, current or capital, on foreign exchange transactions.

In the area of reserve currency, the People's Bank of China (PBOC) has started to implement currency swap arrangements with other central banks. First, the Chinese government allows RMB-denominated bonds to be issued and for them to be owned by other monetary authorities as foreign reserves; and, second, it allows a swap arrangement for contingency. The Japanese government became the first advanced country to agree to hold RMB bonds. If this movement

becomes widespread, it will increase the share of RMB bonds in the pool of global reserve assets. On the other hand RMB–local currency swap arrangements may be used as a safety net, just as swap arrangements between the Federal Reserve Bank and other central banks were used after the collapse of Lehman Brothers in 2008–09.

The problem, again, is that RMB is not a fully convertible currency. Those countries that receive RMB would not be able to use the currency to pay for liabilities owed to countries other than China. But there seem to be other motivations at play. China's official reasons for creating an RMB-centered swap arrangement include promoting trade and investment. If importers in other countries cannot obtain RMB to pay for what they buy, the swap between the central banks can be activated to finance trade. Companies wishing to invest in China can thereby obtain RMB to pay for their investment. So the swap arrangement can be used to supplement the Chinese government's push for RMB invoicing and settlement.

The internationalisation of the RMB, if fully implemented with capital account liberalisation, has the potential to unite (most of) Asia as an RMB bloc. Trade invoicing, settlement and bond issues would all take place in RMB within the bloc. Countries would hold RMB assets as a part of their foreign reserves, and when a country falls into a liquidity crisis, the Chinese government would provide cash in RMB, either with or without IMF help. It may take several decades to get to that stage, but there is a clear trend toward it. **EAFO**

Takatoshi Ito is Professor of Economics and Dean of the Graduate School of Public Policy, University of Tokyo.

Financial scenarios for Asia and the world

ANDREW SHENG

THE Asian century is a foregone conclusion, but no-one has clarified whether it will be good or bad for Asia. The region has 60 per cent of the world's population and, according to Asian Development Bank estimates, will probably be responsible for half of global GDP and financial assets by 2050. Asia is too big to ignore and too diverse to be able to predict how it will shape this century.

Demographic patterns indicate that there will be at least three waves, each of over a billion Asians, attaining middle-income levels this century. The first wave will consist of 1.3 billion Chinese by mid-century, followed 10–15 years later by 1.3 billion Indians and then by 1 billion-plus in Muslim communities, stretching from Turkey to Indonesia. These groups will become extremely influential, as they will be in command of strategically important natural resources and, not least, nuclear weapons.

... the privileged position of the US dollar lasted only 25 years, from 1945 to 1971, when the US left the gold standard

No one has yet thought through what these predicted rises in income and the accompanying consumption trajectory would mean for climate change and competition for water and energy resources.

Since finance is a derivative of the real sector and the two have a complex feedback interaction, it is not easy to project the financial architecture of Asia and the world. So it is necessary to sketch some scenarios of how the Asian and global real economy might develop.

There are numerous possible scenarios for related global currency and financial outcomes, but three can be singled out.

The first scenario is for a glorious Asian century, where everything goes well for Asian economies, and Asia and the rest of the world prosper together. By mid-century the Chinese renminbi (RMB) and Indian rupee would join the yen as three important international reserve currencies, alongside the US dollar and the euro.

This prosperous Asia may transform the International Monetary Fund's Special Drawing Rights (SDR) into an important official central bank for clearing currency, so the leading central banks would hold their reserves with the IMF for the purpose of international clearing against each other. The IMF would become the central bank of central banks, with primary responsibility for

monitoring global financial stability and helping deficit or crisis countries to adjust. The SDR would not become a trade or investment currency, even though there is nothing to stop private sector funds from issuing products denominated in SDRs.

The second is an Asian disaster scenario, where conflicts combined with climate change-induced natural disasters send the region into stagnation, and, at the same time, the West remains militarily and economically dominant. In this case, the dollar remains the dominant reserve currency as the United States retains its position as the leading global economy. The euro remains the second-most-important reserve currency after painful reform and recovery from the euro zone crisis. Under these circumstances, the IMF

continues to be dominated by the West in shareholding activity, becomes more of a tough financial regulator and crisis manager than a central bank, and enforces the rules on emerging markets according to current norms.

The third scenario is of a world financial system just muddling through—the world goes into serious recession in the run-up to mid-century, despite quantitative easing, and emerging markets do not decouple from the advanced economies. As the advanced economies age, they become more inward-looking. Some go into hyperinflation because they cannot solve their debt burden. The result is a breakup of the euro zone and increasing protectionism, which also hurts the emerging markets' capacity to export. Unfortunately, a number of emerging markets also make policy

mistakes. Their fear of competition from other labour-intensive economies leads to global market fragmentation, partly in the name of macro-prudential regulation.

Under these circumstances, a strong IMF is needed as the international crisis manager. But since resources are constrained by a lack of leadership by the advanced and BRICS countries, the situation does not improve. In this scenario the dollar remains the dominant world currency, but its role is enhanced with the cooperation of one or two of the Asian surplus economies.

In all three scenarios, the RMB is a significant but not dominant reserve currency. There are at least two historical facts and one past lesson that support this view.

First, the US dollar took more than



Temptation on display at a Shanghai trade fair: by mid-century more than 1.3 billion Chinese will have attained middle-income level, and their higher income and consumption patterns promise to transform the world's financial architecture.

PICTURE: EUGENE HOSHIKO / AP PHOTO / AAP

Time to rethink the global rules for trade

PHILIPPA DEE

70 years to supplant sterling. It did so by the United States becoming the dominant military power after World War II, and developing superior financial markets that deliver superior US-dollar liquidity to global investors.

Second, the privileged position of the US dollar lasted only 25 years, from 1945 to 1971, when the US left the gold standard. From 1971 to 2007, the Triffin Dilemma—high foreign demand for a reserve currency which forces its issuing country to run a current account deficit—became ultimately a national burden. This was especially the case because it was difficult to impose a hard budget constraint on Wall Street to keep on printing shadow credit at public expense.

History shows that the euro and the yen challenged the dollar for currency dominance with disastrous consequences for their domestic economies. This happened not because the dollar was strong but because of the competitors' policy mistakes. For the RMB to attempt to do the same seems unwise.

In theory, the SDR may be the only logical choice for global reserve currency—by definition, the world as a whole cannot run by net current account deficit. But this is not going to happen for reasons of national self-interest.

This may be the Asian century, but the dollar is likely to remain the pivotal reserve currency. Though the United States currency can lose its dominant position, other economies cannot gain it. Asia's financial architecture will ultimately depend on which of these scenarios comes to prevail. **EAFQ**

Andrew Sheng is President of the Fung Global Institute and Adjunct Professor at Tsinghua University and University of Malaya.

PROSPECTS for trade in the Asian century appear good. After all, Asia has risen to its current position on the strength of its trade. Why shouldn't this trend continue?

Some immediate macroeconomic threats are obvious. Asian economies are not de-coupled from the rest of the world—a significant portion of Asia's exports still go to Western countries. This trade cannot 'bootstrap' the global economy when Western demand is languishing. But infrastructure spending by Asian countries could significantly aid global recovery. If spent to improve transport and logistics links, it could even boost trade in the longer term.

Some medium-term influences are also clear. Growth of real incomes and real wages in emerging Asian countries, including China, is beginning to exert pressure for structural change. Demand patterns will increasingly match those in rich countries, with a growing proportion of incomes spent on things that are mainly produced at home, such as health and education services. Rising real wages will also price these countries out of the unskilled-labour-intensive parts of manufacturing, which will move to poorer countries in Asia and elsewhere.

Ultimately, some countries that now export parts, components or

finished goods will instead export capital as they fund the relocation of manufacturing activity—much as Japan did a generation earlier. Trade may be no less important than it is now, but its geographic pattern may look a lot different.

The current trade rules, particularly those governed by the World Trade Organization, pose a hidden threat for trade in the Asian century. They are no longer adequate for current trade patterns, let alone to support short-term macroeconomic recovery or long-term structural change.

The rules were designed when trade was in goods, but trade is now in tasks. Thanks to declining transport costs and the information and communications technology revolution, the production of both goods and services is increasingly fragmented. This benefits small countries as well as small and medium enterprises, as they no longer need to do everything but can specialise in providing slivers of value added within a production chain that is now potentially global.

The fragmentation of production has changed the dynamics of trade protection. The current trade rules were designed for a trade negotiating game that balanced the interests of exporters (who wanted more market access overseas) and import-competing interests (who did not want to give up protection at home).



Laotian garment workers at their machines in Vientiane: rising real wages and real income will exert pressure for structural economic change.

When production is fragmented, local production does not compete with imports—it complements it. It is not surprising, therefore, that the world has seen significant unilateral liberalisation in areas such as electronics, where global production chains dominate. It is also not surprising that, in the face of the global financial crisis, border protection has risen only modestly.

The bigger trade problems are not at the border but behind it. Conceivably, there is no Doha Round settlement because it offers too little of commercial value—it is still focussed at the border. FTAs don't do much better. They are preferential, which means they also tend to focus on tariffs and other measures, such as rules on entry of foreign investment, that operate at the border.

Yet some of the biggest economic problems in Asia are caused by the poor performance of incumbent services suppliers in

transport and logistics, education and health, which are often state owned. Their dominance and lack of competitiveness is a drag on economic growth and a source of structural imbalances. Their performance can be a barrier to entry into regional production networks. Their crowding out of other domestic activity, including small and medium enterprises, is a key source of growing inequality.

Thus the reform priorities of emerging countries are shifting to behind-the-border regulatory reforms to ensure market contestability and to achieve public policy objectives more efficiently. Although the outcomes are critical for ensuring both infrastructure investment and trade rebalancing, the economics and politics of this agenda are deeply domestic. Will the existing WTO modus operandi—negotiated outcomes based on consensus, reciprocity, non-discrimination and a

single undertaking—help to achieve these outcomes? What changes to the global trade rules are necessary to facilitate these new developments?

To date, the WTO has been a vital global asset, creating and preserving the rules-based trading system that has produced the Asian century. But because production now takes place in regional and global networks, the at-the-border trade war has largely been won (with the obvious 'zombie' exceptions). If the WTO is to remain relevant in the Asian century, it needs revamping to deal with the behind-the-border agenda. This requires more than reform of the WTO's internal processes or governance—it requires fundamentally rethinking the rules.

EAFO

Philippa Dee is Adjunct Associate Professor at the Crawford School of Public Policy, Australian National University.

'Multiplex world': steps towards a new global order

KEN HENRY, HU SHULI, EVAN A. FEIGENBAUM AND AMITAV ACHARYA

EAFQ: How is the Asian century unfolding?

Ken Henry: The rise of Asia is reshaping the world. This reshaping has some way to run. And it is occurring against the backdrop of truly profound global challenges.

Asian growth has been ignited by a new wave of economic liberalisation, internally generated. That growth, and the development of new technologies to facilitate communications and trade, has transformed domestic economies and global markets.

As Asian economies have grown, hundreds of millions of people have been lifted out of poverty, new businesses have emerged and others have been transformed, and governments and societies have modernised and become more outward looking.

In just the past 20 years, China and India have almost trebled their share of the global economy, and increased their absolute economic size six times over.

Forty per cent of global economic activity now occurs in Asia. By 2025, that will rise to almost one-half. By then, one-quarter of the globe's economic activity will occur in China alone. Asia will have four of the 10 biggest economies in the world: China first, India third, Japan fourth and Indonesia tenth.

Today there are about 500 million



ABOVE: Ken Henry: How challenges to the sustainability of human activities are handled will have implications for people in all countries.

LEFT: Hu Shuli: The American presence in Asia will only grow as the United States extricates itself from the Middle East and Afghanistan.



people in Asia who would be regarded as being 'middle class'. By 2020 that's expected to rise to 1.7 billion people, and by 2030 to more than three billion, with Asia then accounting for about 60 per cent of global middle-class consumption.

Yet there are risks. Many countries, on all continents, are confronting challenges of water security, food

security, energy security, climate security, broad-scale ecosystem destruction, national and transnational terrorism, and population aging. It is legitimate to describe these challenges to the sustainability of human activity in both economic and security terms. How these interrelated challenges are managed will have implications for all people in all countries, and for all future generations.

EAFQ: How is China's rise affecting Asia?

Hu Shuli: China's rise has already had a profound impact on other Asian countries. That influence is

likely to continue. The way China's geopolitical relations with Asia evolve will be significantly determined by Sino-US relations. Economically, the ties between China and other Asian countries have been deepened through trade and investment, providing an important buffer against conflicts and easing tensions in regional relations.

From Beijing's standpoint, Washington's rebalancing strategy towards Asia has brought uncertainty to the region. The disputes over the Scarborough Shoal and the Diaoyu/Senkaku islands, as well other rows between China and its neighbours, can be understood in this context. Countries in the region have taken advantage of America's determination to be a key player in Asian security. They rely upon American engagement for their strategy.

The US presence in Asia will only grow now that the Americans are slowly extricating themselves from the Middle East and Afghanistan. This is a problem for China—its relationships with the rest of Asia, particularly its neighbours, have been disturbed. US officials and analysts like to describe the US-China relationship as one of co-operation and competition; although, in the context of China's relations in its neighbourhood, Washington and Beijing are clear rivals.

Still, economic ties between China and Asian countries remain strong. For instance, negotiations for a free trade agreement between China, South Korea and Japan have finally begun after a decade of preparation. Officials have a choice: if they work together to co-ordinate their policies, minimise friction and complement one another's competitive advantages, they could create a booming trade area that can compensate for the gloom in Europe and the United States; if they



Evan A. Feigenbaum: Groups that can solve real problems need to emerge in Asia.

focus instead on turf-building, regional development and domestic growth will be the worse for it.

China should also fully prepare for any crisis but spare no effort to strengthen regional ties to avoid any confrontation. Chinese diplomacy in the region will need to be more proactive to shore up the country's influence.

EAFQ: What are the central diplomatic challenges Asia faces?

Evan A. Feigenbaum: Two difficult strategic challenges will test the region's diplomats in coming years: first, the collision between economic integration and security fragmentation, and, second, the dominance of form over function in the institutions that could help to mitigate this debilitating dynamic.

The central strategic challenge in Asia is that economics and security are increasingly in collision. Put bluntly, two Asias, wholly incompatible, have emerged in stark relief. There is 'Economic Asia,' the Dr Jekyll—a

dynamic, integrated Asia with 53 per cent of its trade now being conducted within the region itself, and a US\$19 trillion regional economy that has become an engine of growth. And then there is 'Security Asia,' the veritable Mr Hyde—a dysfunctional region of mistrustful powers, prone to nationalism and irredentism, escalating their territorial disputes over tiny rocks and shoals, and arming for conflict.

Amid slow growth in the United States and protracted austerity in Europe, intra-Asian demand will likely become a more central driver of regional growth. Already, China has become the top trade partner for many of Asia's major economies, which increasingly provide economic-related public goods to one another while pursuing pan-Asian agreements on trade, investment and technical standards. But long-term strategic intentions, especially Beijing's, inspire deep anxiety. With the exception of China, all major Asian countries, though their economies are increasingly integrated within Asia, are tacking hard across the Pacific toward the United States for their security.

The region does not lack institutions that could help mitigate this dynamic. But regional groups in Asia mostly duplicate one another's roles. They have too many members, and mostly lack functionality or a comprehensive template to measure and systematically assess results. They have developed habits of dialogue, but social interchange and political rhetoric dominate. Lingering suspicions and historical anxieties remain. Asian concerns about maintaining 'face' have typically meant that the most sensitive topics, from human rights to territorial disputes, are avoided. The ASEAN Regional Forum (ARF) is perhaps the best

example of this. It is Asia's leading security forum, and yet all of the potential sources of major conflict are mostly off the table.

A more effective and purposeful multilateralism would begin with lessons learned. Asia's redundant existing mishmash reflects an underlying assumption that dialogue and process are beneficial in and of themselves. With most of the major groupings—ASEAN, ARF, APEC and so on—now decades in the making, groups need to emerge that can solve real problems by pooling real capabilities. So function will need to drive form, not the other way around. And function ultimately will need to be married to capacity, with those that have the greatest capacity playing the most significant roles. Asia's major multilateral institutions have proved to be almost irrelevant to practical problem solving. It would be wise for a group of like-minded countries to think through a modest but substantive operational agenda for the next East Asia Summit meeting to decide priority issues. Then, depending on the issue, leaders could ask that ARF or APEC, or another relevant body, follow up with practical actions. This would begin to inject greater relevance into regional institutions and more connectivity among them.

EAFQ: How is the Asian century changing the existing world order?

Amitav Acharya: Asia's rise is leading to a multiplex world order. This term describes a situation where unipolarity or US hegemony is ending, there are several great or emerging powers, but no one dominates or even leads.

'Multiplex', the dictionary tells us, is 'a complex that houses several movie theatres' and involves 'being or relating



Amitav Acharya: The emerging world will be one of 'diversity and complexity, not homogeneity'.

to a system of transmitting several messages or signals simultaneously on the same circuit or channel'.

In a multiplex world, we will have several producers and actors (states, regions, transnational groups) staging their own shows simultaneously. There is no single script or show running on any single world theatre, no single producer or actor (power) is monopolising our attention—this is analogous, for example, to the chaotic, overlapping web of multilateral institutions ('messy multilateralism') emerging. Sometimes we have the same show running in different theatres in the same complex, but more often there are different shows in different theatres in the same complex. The audience may not see all of them at the same time. It's a world of diversity and complexity, not homogeneity. It is not a picture of 'one world' but of 'many worlds'.

Back in the 1990s, the Japanese diplomat Yukio Satoh called the then-emerging multilateralism in Asia a multipolar approach, where bilateral, multilateral and ad hoc approaches

would co-exist. But the idea of a multiplex world or a multiplex world order is not just regional (although it might well describe Asian regional order today), nor is it only about multilateral institutions. It applies to the world environment as a whole, as a consequence of the shifting distribution of power. The multiplex idea is a much more apt and accurate way to describe the emerging world order and better than competing characterisations, such as multipolar, polycentric, nonpolar, neopolar, G-zero or post-American, worlds.

Welcome to the multiplex world that we shall live in. **EAFQ**

Ken Henry is the Executive Chair of the Institute of Public Policy at the Crawford School of Public Policy, ANU. He is Special Advisor to the Prime Minister of Australia and led the development of the Australian Government's White Paper, Australia in the Asian Century, released last year. He was Secretary to the Australian Treasury from 2001 to 2011.

Hu Shuli is Editor-in-Chief of Caixin Media.

Evan A. Feigenbaum is Vice Chairman of The Paulson Institute at the University of Chicago, and Non-resident Senior Associate for Asia at the Carnegie Endowment for International Peace. From 2001 to 2009 he served at the US State Department in several capacities related to Asia, including twice as a Deputy Assistant Secretary of State.

Amitav Acharya is Professor of International Relations, UNESCO Chair in Transnational Challenges and Governance, and Chair of the ASEAN Studies Center, American University, Washington DC.



Dilemmas of China's success

ROBERT A. MANNING

OVER the next decade, China will face a suite of daunting economic challenges more politically difficult than those it has grappled with over the past three decades.

China's new leadership must address an unsustainable status quo: a state-centric economic model that has exceeded the limits of utility; a steep environmental cost for its breakneck development since 1979; and an entrenched political elite whose legitimacy is increasingly being called into question by endemic corruption and a lack of both transparency and accountability. And these challenges operate in a fluid regional security environment shaped by Beijing's assertive behaviour in Asia, which has raised concerns among its neighbours from India to Vietnam.

In addition to its structural economic issues, China will have to

manage a new wave of urbanisation which is projected to add 350 million to its cities over the coming generation, bringing the total urban population to about one billion. By 2025 there will be 221 Chinese cities with one million or more people living in them. By comparison, Europe today has 35 cities with a population of over one million. This historically unprecedented urban expansion highlights China's dilemma at a time when robotics and the digital economy are redefining work. For example, FOXCONN, which employs 1.2 million Chinese and assembles some 40 per cent of the world's consumer electronics, has announced it will purchase one million robots over the next three years.

Chinese leaders must also deal with unprecedented forms of individual empowerment from a rapidly expanding middle class that harbours rising expectations and

festered resentment over corruption, environmental damage, and increasing inequality. This includes the 500 million Chinese citizens who use the internet, and the hundreds of millions who use Weibo, China's microblogging Twitter-like service, in a country that collectively owns over 700 million cell phones.

There are clear signs that China's leaders recognise the need for reform. The legitimacy of the Communist Party is based on performance, and more than three decades of double-digit economic growth have been the foundation for the success of this de facto social contract. But China's leaders know that its investment-driven export model is unsustainable. This was the premise of *China 2030*, a report released last year that was co-sponsored by the World Bank and the Chinese State Development and Reform Commission, a leading policy body. *China 2030* clearly

outlined that sweeping reforms aimed at creating a greater role for private markets, increasing competition and strengthening the rule of law will be necessary if Beijing is to realise its goal of becoming, 'a modern, harmonious, creative, and high-income society.' Importantly, the report argues that 'reforms of state-owned enterprises (SOEs) and banks would help align their corporate governance arrangements with the requirements of, and permit competition with, the private sector on a level playing field.'

Yet there have been few signs that the leadership has a strategy to implement such reforms, despite the fact that newly installed President Xi Jinping and Premier Li Keqiang, along with some members of the standing politburo, are viewed as reformers.

If Beijing does have a game plan for achieving its strategic goals, then it is certainly not an obvious one. Where does this leave us? Below are three alternative futures offered as a heuristic tool to think about possible outcomes of China's current strategic and policy options.

Harmonious world: In this best-case scenario, China allows the renminbi to become convertible, and begins over the next five years to strengthen the rule of law and move its financial system to a more market-based allocation of resources. Consumer-driven growth sustains a 6–7 per cent annual growth rate as China decreases its reliance on exports and increases social stability through political and judicial reforms targeted at opening up the political system and enhancing the rule of law, transparency and accountability. China also finds a new, more-stable and cooperative modus vivendi in East Asia with both the United States and its Asian neighbours. The US–China relationship plays a critical role in

If Beijing does have a game plan for achieving its strategic goals, then it is certainly not an obvious one.

securing this positive outcome for China.

Muddle through: This is a crisis-reaction rather than strategy-driven future, in which the leadership responds with limited effectiveness to environmental crises, a burst residential real estate bubble, corruption, increasing inequality and social discontent. China engages in reform by default more than by design. China takes tentative steps to enhance the rule of law, increase accountability of local and regional party officials, and gradually reforms the economic and financial system to enhance competitiveness, reduce the monopoly power of the SOEs, and, reluctantly and belatedly, moves to restructure the economy. This future is characterised by a reactive foreign policy that is a mix of nationalism, caution, and both cooperation and competition with the United States.

Middle-income trap: Pressures to sustain 7–8 per cent growth result in more-excessive and politically motivated lending by state banks to keep up the appearance of a growing economy, which in turn increases debt and continues unproductive investments. This proves to be counter-productive. The residential real estate bubble deflates, middle-class investors who put their savings into buying apartments are devastated, social unrest grows, and China's real

growth drops radically to the 2–3 per cent range as unemployment skyrockets. China falls into the middle-income trap, failing to move up the value chain in production to compete with advanced countries, while at the same time its higher wages make it uncompetitive with other developing countries. As China focuses increasingly on internal challenges to stability, it tends to view the outside world as a source of its problems and a strategic threat, thus stoking nationalism and increasing intransigence in its relations with other states and international fora.

One of the biggest obstacles to China realising a future close to a harmonious world is the network of entrenched vested interests of the elite in state banks, state-owned enterprises and PLA-affiliated interests arising as a result of its post-1979 reforms. There are, for example, reportedly 83 billionaires in the National People's Congress. Given expected roadblocks to a new wave of reforms, China is likely to drift from muddle through toward the middle-income trap initially. Attaining sufficient political momentum to overcome resistance to implementing reforms may require bottom-up pressure (allowed by the politburo) caused by a triggering event such as the deflation of its residential real estate bubble whose fallout would be calamitous. **EAFO**

Robert A. Manning is a Senior Fellow at the Atlantic Council's Brent Scowcroft Center for International Security and its Strategic Foresight Initiative. He served in the US State Department as a senior Advisor to the Assistant Secretary for East Asia and the Pacific (1989–93), on the Secretary's Policy Planning staff (2004–08) and on the National Intelligence Council Strategic Futures Group (2008–12).

The challenge of China's governance

KERRY BROWN

HERE have been significant tensions between party and state since the introduction of market reforms in China at the end of the 1970s. The leadership around Deng Xiaoping in the early 1980s attempted to pin down the responsibilities of the government and those of the ruling party, and these were loosely addressed in the new constitution issued in 1982. But over 30 years later, the ways in which the Communist Party of China is able to assert control over the government machinery are manifold. Put in the starkest terms, Xi Jinping is the most powerful man in China now, at least on paper—he heads the party and sits as number one on the Standing Committee. Li Keqiang, the premier and head of government, comes in at number two. This hierarchy tells us where the final power still really lies.

Defining the space where the party legitimately operates and where the government works is not an issue that will go away any time soon. There is a stark contrast in the ways the two bodies operate. The government, through its ministries and central and local bureaucracies, tries to perform its functions transparently, with fiscal accountability and to defined outcomes. But the party exists in a more nebulous space, and its lack of openness, the secrecy around how it governs itself and the ways in which it functions are increasingly problematic for effective governance

of the Chinese state.

In the leadership transition over the last two years, this conflict between party and government can be seen more vividly in the figures of former leaders Hu Jintao and Wen Jiabao. Wen's language from 2010 supporting more legal structures and greater democracy were taken as signs of latent support for a reform agenda at the highest level. But a more political reading of this would be to take heed of the immense wealth that Wen's family has accrued (the *New York Times* expertly exposed this late in 2012, though it was widely known in China long before). Wen's wife, children and even his mother have amassed a multi-billion-dollar fortune. In the light of Wen's financial position, there was some truth in the manifesto produced by over 1600 academics and intellectuals in China in 2011 attacking him for being venal, a closet Western lackey and a political hypocrite. Their

The issue of the separation of powers, however, no matter how it has been abused and avoided, is a persistent problem

most stinging phrase was simply to note that, in a decade as premier, not once had Wen mentioned Mao Zedong in a public speech.

For Wen, the political territory he covered was the State Council, the government organisation that contains all the central ministries and key administrative entities. Ensuring that the right patron was in charge of the council once he retired was crucial. In that sense, Li Keqiang, who had strong links with Wen, seemed a highly desirable successor. In the past few years there was growing support for Li from both Hu Jintao, his original patron, and Wen, a new admirer. Ironically, a man whose family is probably the wealthiest clan in modern China advocated attractive reforms. But Wen probably acted more from a sense of self-protection—supporting the government machinery in which he had his key patronage links—than from a real conviction that there needed to be a separation of party and state powers.

The issue of the separation of powers, however, no matter how it has been abused and avoided, is a persistent problem. Xi Jinping may make nice-sounding attacks on corruption and vested interest, but there is a wide acceptance that the only possible cure is to establish a balance of powers, greater scrutiny, and the placing of law and the implementation of rule of law above all institutions and power groups. And that, for all its complexity, boils down to constitutionalism. If there is one

part of the system, as it has evolved in contemporary China, that needs to be fixed, this is it. Legal scholars in Beijing joke that the current Chinese constitution, largely unchanged since 1982, is a sleeping beauty—a wonderful, aspirational document that offers the weakest possible legal safeguards when it is actually invoked.

It is in the constitution, finally, that the frontier between government and party will need to be spelt out. And Li Keqiang, a lawyer by academic training, will be the person who must try to engage in this immense negotiation of a new social contract for China. It is significant that Li occupies a dual role as member of the leading group of the Party, the Standing Committee, and head of the State Council, the highest government body. Thus, the elevation of premier from the third-ranking position in the last Standing Committee to the second this time round may well prove to be truly meaningful. The National People's Congress, and its gesture towards public participation in decision-making, was once seen as a potential route to reform, so maybe in the next few years we will see much greater effort going into strengthening government. At the end of this process the parameters of party activity and power should finally be set out. Li's elevation means that distant day may well have just got closer.

Rising to this challenge in the reform of governance, perhaps more than most things, will determine for how long the world can continue to rely on China as an anchor of the Asian century. **EAFO**

Kerry Brown is Executive Director of the China Studies Centre and Professor of Chinese Politics at the University of Sydney.

How different states pivot to Asia

IRVIN STUDIN

PIVOTS to Asia today are primarily China-driven. On any reasonable analytic account, therefore, the Asian century refers mainly to everything concerned with the economic and strategic rise of China over the past three decades.

While most non-Asian countries seem broadly aware of the need for some species of Asia- or China-driven pivot, the character and intensity of the pivot among countries around the world varies greatly, depending on at least four factors: geography (or borders); the history of relations with China and Asia; whether the state has a unitary or federal structure; and the talent of the state's political and strategic leaders. (A China-driven pivot may mean a pivot 'away' from China. The key analytic point is that the pivot is in reaction to China's rise.)

The geography factor turns largely on relative proximity (and flying times) to China and to other major economic and strategic theatres (the United States, Russia, Europe). The history factor turns on the degree of economic or strategic interdependence (and psychic familiarity or intimacy) formed in past relations between a state and China and the region.

As for the federalism versus unitary state binary, this is perhaps the least appreciated among all factors affecting pivots to Asia. Given that the

credibility of a state's China pivot often requires considerable educational investments, such a pivot is more difficult in federal than in unitary countries, given that federations are typically faced with the 'strategic paradox of federalism': to wit, foreign policy is a federal constitutional competence while education lies with states or provinces. This means that the national or federal government may declare a disposition or intention to pivot but that the efficacy of that pivot will, in practice, turn on the degree to which the 'upstream' machinery of state- or province-run education systems operates in support of this 'downstream' national goal. What if the states are unwilling or unable to deliver? What if, as in the case of Canada or the United States, this strategic paradox of federalism is hardly recognised in policy decision-making? In 2007 Canada declared a major pivot to the Americas without countenancing any supporting Spanish or Portuguese languages strategy (on which the provinces would have had to lead).

Finally, the question of talent or competence concerns the capacity of political and strategic leaders in specific governments, especially given complex geography and/or histories vis-à-vis China and Asia (and perhaps given complex internal structures of governance), to effectuate or negotiate the pivot.



Australian Prime Minister Julia Gillard and Chinese Premier Li Keqiang toast the relationship in Beijing on 9 April 2013. Australia's 'pivot' is 'arguably the most promising, strategically coherent and serious'.

The Asian game of the post-Soviet states is among the most involved and most interesting. Ukraine, Belarus, Georgia and Armenia are all famously 'dancing' as it were, between the Russian and European poles or gravities. The China pivot is plain to all of them conceptually but not at all easy to negotiate, given the geopolitical theatres in which they operate, and the fact that China is far less a part of the imaginations of these societies than are Russia and Europe. This means that, even though these are all highly centralised polities, their pivots—as between Russia, Europe and China—will still ultimately turn on the talent and industry of particular state leaderships. As a result, while Kiev, Tbilisi and Yerevan struggle to incorporate a serious Asia game beyond perfunctory state visits, their geopolitical reality remains conditioned by the Europe–Russia binary. Meantime, countries like Kazakhstan and, to a lesser degree, Belarus, both of which have joined a customs union with Russia (and are out of favour politically with Brussels), are increasingly privileging a Russia-Asia axis of orientation, principally at

the expense of a rich European game.

The Latin American–Asian game is peculiar in that it is as much Asian countries that struggle to incorporate Latin America into their geopolitical briefs (in short, Asian strategists in key capitals do not quite know what to do with Latin America, apart from Beijing's resource plays) as it is Latin American countries that have to date not been overly exercised by Asia. Geography—the tyranny of distance and, in particular, the absence of direct flights to Asia—and relatively thin bilateral histories with China have together conspired for immature pivots and relationships between the two continents. There is currently not sufficient strategic talent in even the leading capitals of Latin America to materially change this state of affairs in the near future.

FINALLY, the pivots or attempted pivots of the world's major federations in North America, Europe and Australia are worthy of study. Australia's pivot, while attracting some scepticism from Asian and Australian strategists alike, is arguably the most promising, strategically coherent and

serious. A considerable tradition of Asian 'pivotry' preceded the 2012 Australia in the Asian Century Gillard government white paper. A part of this tradition was former Prime Minister Kevin Rudd's twofold premise that, first, political and strategic elites could not be effective in Asia in the absence of linguistic competence in the continent's principal languages; and second, given that Australia's states ran the education file, constitutionally speaking, an Asian pivot could only work if the federal and state governments worked hand in hand—upstream and downstream of the Asian strategy, as it were.

By contrast, the larger, more strategically capacious federations like Canada, the United States and Germany, all of which are actively pivoting to Asia—albeit with 'partial' pivots, given that their geographies and histories dictate more global games than those of Australia—have not yet come close to exploring the connections between state or provincial responsibilities. They have instead been preoccupied exclusively with classical federal responsibilities relating to the military, diplomatic and international trade instruments of statecraft: move some military assets here, increase or shift diplomatic efforts there, and negotiate free trade agreements everywhere. For now, no conspicuous Sinophilic leaders have come to the fore in the political and strategic communities of these federations to make these pivots more credible to Asian observers and Beijing in particular. [EAFQ](#)

Irvin Studin is Editor-in-Chief and Publisher of Global Brief magazine, and MPP Program Director and Assistant Professor in the School of Public Policy and Governance, University of Toronto.

China's contribution to the global mitigation effort

ROSS GARNAUT

AS THE Chinese National Development and Reform Commission (NDRC) observed in its first survey of Chinese climate change policies in November 2012, 'China is one of the countries most vulnerable to the adverse impact of climate change'. This is one reason why it should come as no surprise that China has taken decisive action in recent years towards a more environmentally sustainable growth model.

China is a crucial part of the global climate change project because of its importance as a source of emissions and its economic and strategic weight. It matters also because it is likely to have comparative advantage in mass production of capital goods embodying low-emissions technologies over the coming decades. For example, large-scale production of photovoltaic units in China has lowered the cost of solar power generation all over the world, and similar developments are likely in other technologies.

At the Cancun Climate Change Summit in 2010, the Chinese pledged to reduce the emissions intensity of their economic output by between 40 and 45 per cent from 2005 levels by 2020. This was the largest departure from business as usual in terms of tonnes of emissions avoided by any country there.

China's 12th Five Year Plan (for 2011–15) embodies far-reaching measures to constrain emissions



PICTURE: AAP

Chinese power workers check solar panels. China's extensive domestic efforts mean that it is advantageously placed to contribute to international climate change efforts.

within these intensity targets. In the first year of the new plan, emissions continued to grow strongly. This was deeply discouraging for the international mitigation effort. But policies to give effect to the new plan began to bite in 2012. Together with economically driven structural change, this changed the emissions trajectory in 2012 to the extent that over-performance against the pledge seems possible and strengthening of the pledges is feasible in the context of increased global effort.

Within the electricity sector, accounting for over 44 per cent of China's emissions in 2010, demand growth slowed to 5.7 per cent in 2012. Overall demand had more than doubled in the previous decade. The slower growth in demand was in response to energy efficiency

and structural policies as well as a moderate easing of output growth. These factors are likely to keep electricity demand growth much lower than in the first decade of the 21st century, and bring within reach the 3.5 per cent annual increase in primary energy consumption necessary to achieve the electricity targets of the 2011–15 Plan.

While 2012 data is not yet finalised, so far there seems to have been almost no growth in thermal power generation. Output of all low-emissions energy sources of electricity grew rapidly: hydro-electric by 19.7 per cent, nuclear by 17.2 per cent, and wind by 35.8 per cent. Solar increased much more rapidly still from a low base.

A number of policies will contribute to maintaining the new momentum

in reducing emissions from thermal generation that became apparent in 2012. In particular, there is still some way to go in replacing high-emissions coal generation in small, inefficient generators with ultra-supercritical plants operating at the world's efficiency frontiers.

China is investing more heavily than any other country in technological development for carbon capture and storage of carbon dioxide waste from fossil fuel combustion. Deregulation of electricity and coal prices in 2013 accompanied by the removal of coal transport subsidies are likely to contribute to easing in electricity demand and to increasing costs of supply from the coal sector. Major investment in high-voltage long-distance transmission and in pumped hydro storage is leading to more complete utilisation of intermittent renewable energy capacity and to expanding options for new investment in renewables. The 12th Five Year Plan greatly increases financial commitments to energy efficiency and for innovation in low-emissions technologies including in the electricity sector.

The electricity supply and demand developments together may have caused zero growth in emissions from combustion of coal in electricity generation in 2012. This is a dramatic break from established trends and takes us way outside the conventional wisdom on development of the Chinese energy market. The current energy market adjustment seems to be another case of underestimation of the Chinese economy's capacity for rapid transformation in the reform era. Of course, the outcome will depend on the policy that emerges from continuing debates and political contests within China.

Industrial emissions, which are

largest in steel production, are experiencing much slower growth as a result of policy-enhanced slowing in the rate of growth of heavy industry, and by innovation to reduce emissions intensity. Forced closure of inefficient plants (32 million tonnes of steel capacity alongside 8,000 GW of coal electricity generation in 2011 alone), higher costs of electricity and other inputs, export taxes and restriction of investment in new capacity have slowed expansion in energy- and emissions-intensive activities. The goal articulated in the 12th Five Year Plan to reduce the energy intensity of steel production by a percentage point per annum is a realistic extrapolation of recent trends.

In transport, the heavy investment over the past decade in inter-city and intra-city rail will ease somewhat the growth of automobile traffic. Within the automotive sector, ambitious official targets for electrification are being strongly supported by a range of policies. The combination of rapid expansion of public transport led by rail, automotive electrification and decarbonisation of the electricity sector are likely to add up to unexpectedly early peaking of emissions from the transport sector.

China's extensive efforts at home make it well placed to contribute forcefully to the international climate change effort, where it can push for quality change in a variety of ways.

The 12th Five Year Plan greatly increases financial commitments to energy efficiency

First, it can share views on all aspects of the climate change challenge. These include views on industrial transformation—including China's experience in upgrading transmission grids to reduce energy losses, to connect energy resources to distant centres of demand, and to integrate intermittent electricity sources more efficiently into major grids. They include, as well, experience with mitigation policies.

Second, it can take the lead in initiating an independent global analysis of what constitutes a 'fair share' of the strong global mitigation effort that will be required to meet the two degrees objective.

Third, China can work to strengthen the pledges that the substantial economies have made to reduce emissions, and to ensure that international trade in entitlements remains a legitimate means of meeting emissions reduction pledges. This third area of cooperation is especially important, as the international community faces decisions over the next two years that will determine whether the two degrees objective remains within reach. **EAFO**

Ross Garnaut is Distinguished Professor of Economics at the Australian National University and Vice-Chancellor's Fellow and Professorial Fellow of Economics at the University of Melbourne.

This is a condensed version of the keynote presentation at 'The design and development of cost-effective market mechanisms for carbon emissions reductions in China: Economic modelling and international experience', National Development and Reform Commission/State Information Centre Carbon Market Beijing International Workshop, Beijing, 31 January 2013.

No simple scenario for uniting the Koreans

PICTURE: EPA / YONHAP / AAP



South Korean President Park Geun-hye addresses a joint session of the United States Congress on 8 May 2013, when she spoke of her hope of making North Asia a more harmonious region.

CHUNG-IN MOON

IT IS a daunting challenge to predict the future of the Korean peninsula in the Asian century because there are so many variables involved. But the key factor is clear: the peninsula's regional and international status and influence will be determined by the nature of inter-Korean relations. Whereas peaceful reunification would greatly enhance Korea's position, a continuation of the status quo, heightened tension and military clashes are likely to undermine its leadership in the region.

Yet the status quo—where the Korean peninsula remains divided—does not have to entail negative consequences. Although both Koreas might fail to achieve de jure unification, they can avoid military tension and conflict by promoting mutual exchanges and through cooperation, and so lay the foundation for eventual peaceful unification. Under this rather benign status quo scenario the South Korean economy would continue to grow and North Korea could grasp a new opportunity for opening and reform as well as economic revitalisation. The peninsula, though divided, would be at peace. That would allow both Koreas to play a significant role in shaping the Asian century.

A more disturbing scenario is possible. North Korea maintains its nuclear ambition and international efforts to punish the North through bilateral and multilateral sanctions

increase hostility between the two Koreas. The South strengthens its alliance with the United States and seeks further American assurance that it will be protected under the US nuclear umbrella. North Korea responds by intensifying its nuclear threats. Such a harsh confrontation revives the 'cold war divide' in the region and complicates regional security problems. Occasional military clashes deal critical blows to the South Korean economy with the 'Korea discount' and 'sell out Korea' dominating the response in international markets, while the North Korean economy continues to slide into deep stagnation and paralysis. The Korean peninsula would remain, in this scenario, a dangerous flash point in the Asian century.

Another scenario is that North Korea becomes so dependent on China as to lose aspects of its sovereignty—the 'Finlandisation' of North Korea. Mounting external pressures have already made North Korea increasingly dependent on China. As of 2012, China accounted for more than 80 per cent of North Korea's total trade, and economic ties between the two countries have expanded markedly. If this trend continues, North Korea could be functionally incorporated into China's northeast economic zone. Inter-Korean economic relations would suffer greatly and the chance of national unification recede. The North Korean economy would, however, be better off than under the second scenario, and South Korea could also sustain its economic growth at a moderate pace. But China's growing influence would overshadow the role and visibility of both Koreas.

National division might not be the inevitable destiny of Koreans. They could achieve national unification. Koreans could take Germany as a

China is not likely to let North Korea collapse internally and South Korea absorb the North

successful example of unification by absorption; a total merger of the two Koreas into a unified nation, through South Korea's takeover of the North, is possible. The complete internal collapse of North Korea is also plausible. If unification occurred under these circumstances, it would represent the ultimate triumph of South Korea's market economy and liberal democracy over North Korea's *juche* ideology.

Three factors could impede unification through collapse and takeover.

First, North Koreans, regardless of what the post-Kim regime looks like, are not likely to give up their sovereignty, through fear of losing material and positional values. Second, South Korea lacks both the economic and social resources to absorb the North. Given the fragile foundation of the South Korean economy, absorption could result in the collective destruction of both Koreas. South Korean youths are openly reluctant to bear the high costs of German-type unification. Finally, for strategic reasons, China is not likely to let North Korea collapse internally and South Korea absorb the North.

Unification by mutual consent could also be possible. Peaceful co-existence through confidence-building measures, arms control and reduction, as well as promoting exchanges and cooperation, could lead to de facto,

if not de jure, unification in the form of a union between the North and South. This is the most desirable scenario because it would be cheaper, relatively free from trauma and far more manageable than anything else. It would not be possible unless North Korea adopted a market economy and gave up its nuclear armaments. A Korea unified in this way would emerge as a major middle power in the region regardless of how it overcame division. Its population would number almost 80 million and it would have enormous economic and military capabilities.

Military clashes and even war cannot be ruled out. North Korea might unexpectedly make a pre-emptive military move on the South, or brinkmanship diplomacy could trigger a surgical strike on nuclear and missile facilities in the North by the United States and its allied forces. In either case, the end result would probably be the takeover of the North by South Korea and its allies. The human and material costs of war cannot be calculated and, devastated by war, Korea will play no significant role in Asia's future. **EAFQ**

Chung-in Moon is Professor of Political Science at Yonsei University and advisor to late President Roh Moo-hyun.

EASTASIAFORUM
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IN OUR NEXT ISSUE . . .

**Leading
China
where?**

Can Indonesia play a leadership role?

MARIA MONICA WIHARDJA

INDONESIA has become an unlikely star of the international economy, with its resilient growth in the midst of the US sub-prime mortgage and European sovereign and banking crises. But political, social and environmental conditions at home are not commensurate with the quality of Indonesia's relatively outstanding growth. If Indonesia is to contribute to the Asian century, it must first put its own house in order. And to assume a potential leadership role in the region and globally, Indonesia needs to develop its political institutions, secure an 'ocean-focused' development strategy that complements its status as an archipelagic nation, become a real champion of regional and global cooperation, and create a well-educated and competitive workforce and labour market.

Indonesia is facing many political and social issues. While domestic politics is relatively stable, constant cabinet reshuffling remains a part of political struggle on the ground. The very vulnerable population—almost half of Indonesia's total population, or almost 100 million people, are categorised as 'poor' or 'near poor'—are without a strong national social safety net. Adding to Indonesia's domestic woes are supply-side constraints, unsustainable and poorly targeted national health-insurance subsidies (*jamkesmas*), and energy subsidies. Furthermore, although expenditure on education has

By 2025 the demographic dividend, with more than 50 per cent of the population under the age of 30, will come to an end

expanded, there is no clear evidence of better-quality education, according to a recent World Bank study.

Essentially, Indonesia needs growth—but it must be quality growth. There are four main challenges Indonesia must confront if it is to achieve this.

First is building inclusive political institutions. Effective leadership matters, but civil-society organisations and other 'agents of change' (including local champions, business communities, academics and women) can also work politically to promote pro-poor policies under both good and bad leadership if they remain neutral. This has been proven to work at the local level, where local regulations helping the poor were passed in Semarang and Pekalongan following the establishment of Pattiro offices, a national non-government organisation, in both cities, where leadership quality differs. Mobilising the demand side of better public goods and services is just as important as

improving the supply side.

Second, as the world's biggest archipelagic country, Indonesia's development strategy must be more 'ocean focused' and maritime based. This is important to the region's strategic economic development and its security and defence. Sustainable development in Indonesia means more than just 'green growth' or 'blue growth'—Indonesia needs to better know itself as 'a continent of islands' or an archipelagic continent. As such, its development strategy needs to include issues concerning connectivity, food security, environmental degradation and climate change. Additionally, illegal fishing is rife partly due to Indonesia's limited patrol fleet and enforcement capacity. Indonesia is known for having a strong army but weak navy. To oversee Indonesia's ocean, there are only five patrol ships, which operate a mere 65 days a year. Without a strong navy, Indonesia's strategic position remains weak, a factor which may have an impact on the Asian region as a whole.

Third is capacity-building in government bodies which deal with international institutions and negotiations. Indonesia's increasing engagement in many regional and global fora, including ASEAN, APEC and the G20, make Indonesia a potential leader to drive the regional and global agenda. But Indonesia's domestic political interests often dominate negotiations. Trade negotiations assume mercantilist approaches and, as a country with a

big market, Indonesia unfortunately often takes a rather protectionist approach.

Indonesia needs to build working units within the government to better position itself in these regional and global fora, based on input from academics and think tanks as well as public consultation. The classic divide between the advocates of protectionism and those defending open markets has often created bureaucratic infighting. Identifying and appointing low-profile 'champions' in the government who can work independently from domestic political interests will help.

Fourth is investment in education. By 2025 the demographic dividend, which Indonesia currently enjoys, with more than 50 per cent of the population under the age of 30, will

come to an end. Indonesia will need to seriously invest in more quality education as a top priority; otherwise it will be 'trapped' with low-quality human capital and a working-age population with low comparative advantages to reap the benefits of globalisation. If the resource boom that Indonesia has been enjoying begins to fade, it will leave Indonesia with no choice but to move to more downstream industries that will likely need to rely on highly skilled labour and innovation. However, education is constrained by a range of factors including significant overlaps between central and local governments' assignments of responsibilities for pre-tertiary education, the absence of incentives for local government to align their education systems to national standards and the lack of

accountability mechanisms in the education sector. Total expenditure on R&D currently amounts to 0.08 per cent of GDP, significantly less than other emerging countries such as China, Brazil, South Africa and India, and lower than what would be expected for a country at Indonesia's level of development.

Addressing these challenges is essential to Indonesia's future economic prosperity, and will enable Indonesia to realise its leadership potential in the Asian century. **EAFC**

Maria Monica Wihardja is a researcher at the Centre for Strategic and International Studies, Jakarta, and a lecturer at the Department of Economics, University of Indonesia. She is Associate Editor at the East Asia Forum Indonesia Desk.

THE GETTING OF WISDOM

A dynamic new source of cultural, intellectual influences

JIEMIAN YANG

THE Asian century, or Pacific century, has become a catchphrase that emphasises economic dynamism and shifts in political power. But the cultural and intellectual aspects have rather been neglected.

In the coming 25–50 years, three trends in Asia are likely to develop in the context of continuous globalisation, evolving regionalism and the ongoing information revolution.

Asia will develop a greater sense of regional awareness and cohesion. The region is still compartmentalised into Northeast, Southeast, South, Central

and West Asia. But the region's current collaborative efforts—such as the ASEAN-Plus formula, the Shanghai Cooperation Organisation and the South Asian Association for Regional Cooperation—will gradually lead it towards a greater level of pan-Asian cooperation.

The global configuration of power will become more evenly distributed between established and emerging powers, and Asia will be a very important component of the latter. Asia will no longer be complaisant and content with its position as a less influential actor in the world economy and as a follower of Western models.

Rather, in both their bilateral and multilateral relations, Asian countries will call for a bigger say in making rules and setting agendas for regional and global affairs. In this sense, the growing influence of the G20 and the reform of the International Monetary Fund and the World Bank indicate Asia's increasing role in world affairs.

Asia will contribute more to the mainstream of world thinking. In the coming 25–50 years, Asia's status will change substantially from it being merely a recipient—or at most an adaptor—of Western culture. Asia has already made some great contributions in this regard. For instance, China,

India and Burma worked out the Five Principles of Peaceful Coexistence, and Southeast Asian nations have built up the ASEAN Way of consensus-making. With its traditional and intellectual cultures both experiencing a renaissance, Asia will provide the world with more public goods in the form of ideas, principles and values.

As well as contributing to the global economy and international security through these three trends, Asian nations will also provide the world with alternative models of regionalism. Pragmatism and inclusiveness will be two major features of the new Asian regionalism. Asia's pragmatism has helped its countries converge into an Asian community, from the ASEAN-Plus process through to a much broader membership based around building consensus. Unlike regional groupings such as the European Union, 'New Asianism' embraces such non-Asian members as the United States, Australia and New Zealand. This inclusiveness shows that Asia respects the history, current standing and future development of its members. By relying on incrementalism rather than coercion, New Asianism is also conducive to the peaceful transition of the international system and more effective global governance.

The Asian century will see Asia present a fusion of cultures to the world, unlike other regions which are often dominated by a single culture. Asia is renowned for its cultural and religious diversity and its ability to accommodate these many differences. In this fast-changing world full of immediate concerns and conflicts, the inclusivity of Asian cultures can play the bridging role between regions and populations in ways that geopolitics and geo-economics cannot.

The Asian century promises to



Asian culture's bridging role: South Korean singer Psy swings into action on the Today show in New York.

create new moral standards and values as a means to tackle future challenges. The universality and particularity of moral standards and values is a matter of perennial debate, and while it is difficult for the actors in these debates to convince others to change their mainstream moralities and values, it may be possible for them to agree on making new ones. For instance, Asian values attach greater importance to the non-material aspects of life, such as diligence, work ethics, family cohesion and consensus-making. These ideas will undoubtedly contribute to the eventual pooling of shared values, which in turn will help facilitate global affairs and international relations.

Finally, the Asian century will help the international community to crystallise a greater sense of wisdom. This will help us to approach the many global challenges we face from a broader perspective. Many regional bodies are based on economic, political or security concerns, and while they are certainly necessary, they are not sufficient in themselves to bring about the higher level of

international and regional community building needed to confront the challenges likely to occur in the next 25–50 years. Asian nations have much expertise and leadership that can be called upon in this regard, such as the rich traditional civilisations of China and India and the economic dynamism of countries such as South Korea and Singapore which can point the way to adapting to new challenges. And Asia's exceptional willingness to contribute to this new century will help it digest the wisdom of others and assimilate it into its own.

When talking about the Asian century, we should pay proper attention to long-term trends other than those involving material goods and physical security. Consensus building, shared values and convergent moralities will be essential as both Asia and the world strive for a better future. **EAFO**

Jiemian Yang is President at the Shanghai Institutes for International Studies.

Japan: free voice in a region where debate is stifled

BARAK KUSHNER

JAPAN and China have been vying to lead East Asia for the past hundred years, and while initially Japan seemed to surge ahead the game has changed. In the past few years Japan has been criticised for its economic ‘lost decades’, and its standing has suffered over its slow response to the 2011 tsunami and Fukushima nuclear accident. The lustre of the 1980s has dimmed. Over the same time period, Western interest in China has shot up with seemingly no end in sight. But we must ask ourselves, is the competition only about economic statistics and GDP? Japan can offer the world something equally valuable which China cannot yet—freedom in the media, scholarship and political debate.

While studying in China can offer tremendous benefits, such a pursuit provides returns essentially limited to subjects directly connected to China. The Chinese scholarly market focuses mainly on itself because it remains largely censored and essentially state-managed—it continues to suffer from political bias. On the other hand, Japanese scholarship is a major source of information about the world. It translates virtually twice the number of books that China does, yet its population is almost one-tenth of China’s. Japan both contributes to and draws from international education in a way that the current system in China does not. With these educational resources, Japan has

the potential to serve as a channel for interests other than those of the West (or China) in East Asia. This is especially the case now, as the region faces new challenges far different from those encountered when American dominance was established in the early years of the Cold War.

The problems with the Chinese education system can be demonstrated by the obstacles that academic Sergey Radchenko faced when he tried to introduce Western critical scholarship on China to his students at a British university campus in China. Radchenko encountered a wall when Chinese authorities refused his selections of English books in his courses. In his words, Chinese students will only partially take in critical information because ‘What they do know tends to agree with government-sponsored discourse on the pride and glory of China’s rise after

While in China historical debate remains anathema to the state, Japan is a society that allows for dispute and disagreement with the government

a century of humiliation by Western powers.’

Critics of the Japanese education system have also accused it of closed-mindedness. But its problems pale in light of the fact that Japan is an open democracy—all can freely publish, and the content of university courses are not state mandated. So, in recent years, many Chinese scholars have published their work in Japan when it failed to obtain approval in China.

While in China historical debate remains anathema to the state, Japan is a society that allows for dispute and disagreement with the government. This is vitally important in the region, a fact that often gets overlooked in the West’s zeal to prosper from Chinese economic growth. Japan has much to offer Asia and the world in media and scholarship because Japanese scholars are closer to and often in much more frequent contact with what is going on in East Asia. The writer and journalist Katō Yoshikazu is indicative of what Japan has to offer. He is part of a new breed of young Japanese who graduated from an elite Chinese university and writes in measured tones for the media in both countries in both languages, popularising the term *aiguozei* (patriotic thugs) to describe extremes in Chinese nationalism.

While his story also demonstrates the deep changes in China that have allowed Japanese to study and work there, the ability to freely pursue all topics in China remains a conundrum. For example, the Chinese Ministry

of Foreign Affairs Archives was recently closed again, supposedly for reorganisation but probably because a Japanese journalist uncovered an official document that undermined the Chinese position on its island disputes with Japan. A similar event happened in Japan some 20 years ago, when academic Yoshiaki Yoshiaki exposed some documents relating to the history of comfort women. But Yoshiaki's subsequent book on that topic put pressure on the Japanese government's stance on comfort women and, in some ways, forced Japanese society to revise some long-standing incorrect views.

Although Japan does not celebrate a culture of debate comparable to that in countries like the United Kingdom (where parliamentarians must defend themselves in Question Time and in the media), another example of how Japan fosters political discussion is shown by the publically available online *Diet Minutes*—something unthinkable in China and an example of just how far Japan has evolved since its imperial downfall.

Today, Japan, with its vibrant media and open political debate, can play a crucial role in East Asia—and this should not be overshadowed by, or dismissed because of, the rise of China. Japanese society is also capable of achieving more. Leveraging Japan's open institutions can produce more impetus towards fulfilling Japan's potential and encouraging discussion of important issues such as demographic-driven decline and immigration. East Asia needs Japan, and for more than just its economic purchasing power. **EAFC**

Barak Kushner is Associate Professor of Modern Japanese History in the Faculty of Asian and Middle Eastern Studies, University of Cambridge.

Prospects for Japan as a middle power

YOSHIHIDE SOEYA

AFTER World War II Japan virtually stepped down from the stage of power politics and accepted that two documents would be the pillars of its foreign policy: its postwar Constitution (particularly the 'pacifist clause,' Article 9) and the US–Japan security treaty. Both have fundamentally constrained Japan's freedom of action in international security and limited Japan's foreign policy options to those of a middle power. This diplomatic style allowed Japan to focus on postwar economic recovery, which eventually proved to be the key to the nation's rise as an economic power. But even as Japan achieved economic strength it maintained a restrained posture in dealing with political and security issues, and concentrated instead on cultivating economic and cultural relations with Asia and the world.

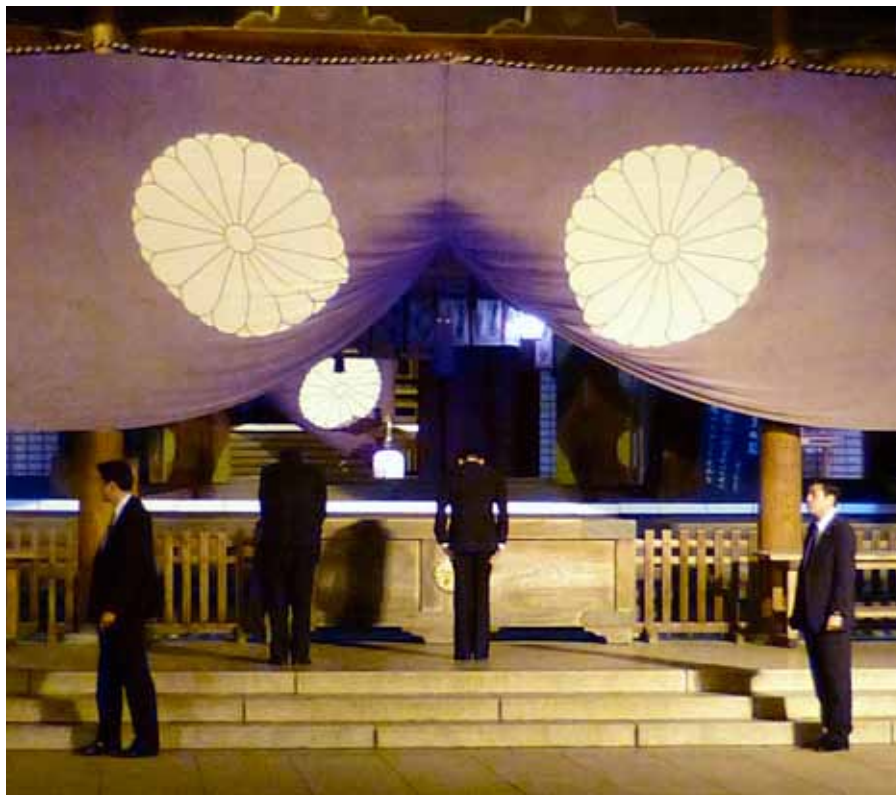
Japan must recognise that it will be a truly equal partner with other Asian countries in the Asian century

Japan's economic input to the modernisation programs of the Park Chung-hee regime from the mid-1960s was significant in South Korea's eventual economic success. Japan's official development assistance and foreign direct investment in Southeast Asia helped to accelerate the economic integration of the region. And Japan's full-scale support for the ambitious open-door and reform policies of Deng Xiaoping from the end of the 1970s was not insignificant in the eventual rise of China. In short, Japan played a critical role in constructing the foundations of the Asian century.

But these good old days for Japan are now clearly over. South Korea has caught up with or even passed Japan in some economic and cultural dimensions, and Southeast Asia is forming its own political, economic and cultural communities. The impact of the rise of China now goes beyond the region and extends into various corners of the globe. As a result, Japan is searching for a new mission and a new role in Asian diplomacy.

Some say that value-oriented diplomacy is the answer. In recent years, however, this has lacked a coherent theme that resonates across Asia. This was the product of a unique combination of two different considerations.

The first aspect dates back to the end of the Cold War, when the Japanese government started searching



Deputy Prime Minister and Finance Minister Taro Aso, center right, bows as he visits Yasukuni Shrine in April 2013—one of several visits by government members which caused protests by South Korea and China. Japan needs to 'cultivate various channels of communication with Chinese civil society'.

for a new rationale for the US-Japan alliance in the absence of the Soviet Union as a major threat. Protecting and promoting universal values was the answer. The main focus of this new foreign-policy orientation was global rather than regional. This has been sustained by central policymakers and bureaucrats who believe that Japan is or should be a global actor.

The second thread of value diplomacy originates from the mid-1990s when Taiwan embarked upon democratisation under the strong leadership of Lee Deng-hui, whom China attempted to intimidate with a series of military exercises. From this time on, anti-China conservative politicians and opinion-makers in Japan began emphasising democracy in their foreign policies. Their perspective is informed by somewhat

naïve pro-Taipei and anti-Beijing sentiments.

Universal values like democracy and respect for human rights are, of course, very important in and perhaps even central to promoting peace and stability in the Asian century. But, while Japan might have been right during the Cold War to assert that economic development should precede political democratisation in Asia, the critical question in the Asian century is how universal values will fit into the new Asian context.

The concept of middle-power cooperation might provide a clue. Japan must recognise that it will be a truly equal partner with other Asian countries in the Asian century. Equality in its partnership with ASEAN, for instance, was a key component of Japanese–Southeast

Asian diplomacy even in the 1970s. Today, it should be even more obvious that Japan is on an equal footing with many of its Asian neighbours.

More importantly for Japan's middle-power, value-oriented diplomacy, it must maintain and cultivate various channels of communication with Chinese civil society. But the current administration of Japan, led by Shinzō Abe, inclines toward containing China by means of 'alliances of democracies,' which in essence could be called the 'geopolitical use of values.' This encourages an unhealthy preoccupation with China and breeds regressive attitudes towards the history problem among some important members of the government, while anti-Japan sentiments in China run deep. Thus, China and Japan seem trapped in an emotionally charged vicious cycle.

Asia and Japan will continue to need the United States as the ultimate guarantor of security in the region. But middle-power cooperation has other advantages. If Japan adopts a middle-power attitude one of its main objectives will be to co-exist with China. The key to this middle-power approach is, therefore, to balance and integrate the hedging and engaging policies toward China as a coherent and shared strategy among middle powers in the region. The first step towards this goal is forming an epistemic community among Asian civil societies. To open up this new dimension of middle-power cooperation, there is no more natural partner for Japan than Australia. **EAFC**

Yoshihide Soeya is Professor of Political Science and International Relations at the Faculty of Law, and Director of the Institute of East Asian Studies, Keio University.



SHEKHAR SHAH

THE 19th century was thought of as belonging to Britain and the 20th century to America. Many now believe that the 21st century will be Asia's.

The sheer market size and growth potential of China and India place them at the centre of the Asian century. Over the past 20 years, these two countries have almost tripled their share of the global economy. When adjusted for purchasing power parity, the Indian economy is now roughly the same size as Japan's. One Goldman Sachs estimate suggests that India's economy will surpass the US economy by 2043. For long the world's second-

largest country, India's population is expected to pass China's in less than two decades.

Despite all this, India is likely to remain a lower middle-income country well into the Asian century, lagging behind its BRICS counterparts. India has the world's largest concentration of poor people: in 2010, more than 840 million Indians lived on less than US\$2 a day, and 400 million on less than US\$1.25 a day. By the time India becomes the most-populated country in the world, its already large challenges relating to urbanisation and the provision of adequate infrastructure, jobs, drinking water, and food for its citizens will have grown larger. India's size and its

Indian Congress Party workers celebrate victory in the 2013 Karnataka elections. India's prospects for success in the Asian century will depend on its political class providing far-sighted leadership.

rising middle-class power may have led many to rightly highlight its role in powering the Asian century, but ironically it is less clear how India's own poor people will be empowered to rise out of poverty.

This raises a number of questions. Located in the right place at the right time, how can India thrive in this Asian century? What opportunities will Asia's rise offer India? What opportunities will India's rise offer Asia? Most importantly for the

average Indian, how will the shift of economic and strategic power to Asia shape the massive economic and social transformation underway in the world's largest democracy? Already a lower middle-income country, how can India avoid the middle-income trap? More immediately, how can India regain the growth momentum it had generated in the mid-2000s, address its rapidly growing fiscal pressures, and reduce the unprecedented fragility of its current account deficit?

These are large and complex questions. It is important to ask them now because in a very real sense the world's expectations of India perhaps exceed India's expectations of itself. India's failure to address these questions will have far-reaching consequences, giving rise to a greater gulf between India's potential and its achievements, and making it that much harder for India to catch up with the rest of a rapidly rising Asia. Much will depend on the far-sighted leadership that Indian leaders do or do not provide in designing, implementing and evaluating the right policy frameworks to achieve the goal of 'faster, sustainable, more inclusive growth' that the Indian government's 12th Five Year Plan (2012–17) has set for itself.

Three scenarios are worth considering. The first and most favourable is a win-win situation in which India gains greatly from the rise of Asia, much as India's market size contributes to the Asian century. India successfully leverages its demographics and its trade and cultural proximity to Asia's economic centres to transform its workforce and its manufacturing and service sectors into a highly competitive, connected and innovative force through sound public policies, and investments in education, skills and infrastructure.

As India does well, so does Asia. In the second, less-welcome, scenario India muddles through. It meets some of the expectations of India's role in the Asian century but does not gain ground relative to other Asian countries and perhaps falls further behind. The third and least-desirable scenario sees the Asian century largely bypass India. Given the commercial, political and strategic relationships that India already has with the rest of Asia, this scenario is hopefully also the least likely. But the very fact that it is unlikely could breed domestic complacency and keep India away from gaining fully from the Asian century.

What will it take for India to make the first scenario a reality? Analysts have identified seven domestic pillars that aided the early and rapid transformation of Asia's newly industrialising economies: policies that supported free markets, science and technology, meritocracy, pragmatism, a culture of peace, rule of law and education. These pillars will require further refinement, as India will also have to address newer domestic challenges, including global warming, the provision of clean energy and water to its citizens, and the threat of corruption and public ineffectiveness,

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which appears to have worsened in recent years.

On the external front, India's trade and investment relations with Asia will play a major role, not just within Asia but also in its relationships with North American, European and African markets. India has already signed nearly 20 regional trade agreements and is currently negotiating several more. As hopes dim for a successful multilateral trading regime, India must expend its energies not just in signing bilateral agreements but also in helping to bring about an FTA in groups such as the ASEAN+6 or the Regional Comprehensive Economic Partnership arrangement.

To enhance public awareness of the immense advantages and significant risks that India will face in the Asian century, India's National Council of Applied Economic Research in New Delhi (NCAER) is exploring a multi-year research program on India in the Asian century. The research program will focus on identifying opportunities in the short, medium and long term to increase the economic and other net benefits to India from the global economic and strategic shift to Asia. Short-term actions are those that India could take in the next five years, while medium- and long-term actions are those that could be implemented before 2025. An important part of this project would be to foster joint work with Asian partner institutions. If India is not to miss the boat in the Asian century, there is much work to be done. [EAFQ](#)

Shekhar Shah is Director-General of the National Council of Applied Economic Research (NCAER), New Delhi. He is grateful to Dr Rajesh Chadha, Senior Fellow at NCAER, for the many useful discussions on the topic.



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