The dislocations caused by the global financial crisis have highlighted the economic relationship between Asia and the West. It remains to be seen whether efforts to deal with the current crisis are only sowing the seeds of the next crisis.

William H. Overholt, a leading American expert on Asia, argues that stark choices facing Asian politicians from Japan to China and India to South Korea will ultimately shape the future relationship between Asia and the West.
THE GLOBAL FINANCIAL CRISIS cannot be isolated or blamed on one region over another. It is a consequence of Asia’s relationship with the West and a cause of the reshaping of that relationship. It results from the confluence of vast Asian and Middle Eastern liquidity — high Chinese savings, near-zero Japanese interest rates and petrodollars — combined with increasingly laissez-faire Western bank regulations, corrupt rating agencies and a bias — embodied in the policies of former US Federal Board Chairman Alan Greenspan — toward re-inflating busted markets but never popping market bubbles.

The root causes of the problems are persistent. The needs of the Chinese people for high savings to educate their children and to offset the country’s lack of a social safety net, along with the Chinese economic system’s suppression of personal consumption ensure that high savings will endure for decades. The Japanese government’s incompetent management of its economy has required near-zero interest rates to avoid collapse for a period that is already stretching toward two decades, with no end in sight. The vast yen “carry trade” — where investors borrow in yen to take advantage of low interest rates, then sell those yen for foreign currency to take advantage of higher interest rates — and the prevalence of yen-based mortgages from Hong Kong to Iceland is at least as important a source of excess liquidity as the excess savings of China, South Korea, Taiwan and Singapore. Likewise, US and EU dependence on Middle Eastern and Russian oil ensures persistent petrodollar accumulation. Western financial mismanagement is in principle more quickly remediable, but it remains to be seen whether fundamental reform or political theater in the form of attacks on executive pay and hedge funds that are not central to the problem will predominate.

More deeply, the crisis results from financial globalization combined with fragmented national management of markets and money supply. In theory, rational management of a financially globalized system could be attained through some form of global currency (a proposal made by British economist John Maynard Keynes in the 1940s) or a global central bank, but so far there is no indication on either side of the Pacific of any willingness to consider sacrifices of sovereignty of a degree that would resolve the contradiction between globalized finance and fragmented national financial management.

Therefore, just as the bailout from the 1997-98 Asian financial crisis and the bursting of the tech bubble of 1999-2000 presaged the current crisis, the bailout from the financial crisis of 2008-09 may presage the next bigger tumble. If so, the next round a decade hence will surely reshape relations between the Eastern liquidity providers and the capital-thirsty West. Crises sharpen choices.

On both sides of the Pacific all the significant powers face historic choices that are not caused by the financial crisis but are sharpened and accelerated by it.

The US must reform its financial and economic management or risk both its role as the dominant arbiter of Asian geopolitics and the hegemony of the dollar as the global store of value and unit of trade. Already Asia is evolving toward a more multipolar world, rather than the post-World War II world where the US was supreme because everyone else had been crippled. The time when the US Navy can dominate the beaches of Fujian is already passing. But whether this trend eventually shifts the balance merely along Asian beaches depends on economic choices that are hardly predetermined.

Likewise the role of the dollar remains to be determined. Looking at the financial and fiscal mismanagement that has characterized Washington in the first years of the current century, and at the $9 trillion of federal fiscal deficits projected for the next decade, pundits extrapolate the collapse of the dollar. But if the Japanese and European economies remain more sluggish than the US, vast capital flows from Europe and Japan into the more vibrant US economy could well sustain the dollar’s relative value for a considerable period. Politicians will choose.

Japan will either opt for much more fundamental reform, including marketization at home and globalization of trade and investment, or else see its decline accelerate. Japan’s economic decline is caused by a political system dominated for decades by a few reactionary interest groups — agriculture, retail, construction, property and banking. The gradual rise of strong, competitive, international-
The US must reform its financial and economic management or lose much of its role as the dominant arbiter of Asian geopolitics and the hegemony of the dollar as the global store of value and unit of trade.

China’s rapid economic rise is spreading its influence, as Japan’s rise once did. But hubris, complacency and interest group power, along with demographics, killed Japan’s rise and they could kill China’s too.

ized Chinese banks contrasts starkly with weak, provincial, uncompetitive Japanese banks, but that is a microcosm of Japan’s future so long as the current interest group structure dominates. It remains to be seen whether the recent election victory by the Democratic Party of Japan (DPJ), which replaced nearly 50 years of uninterrupted rule by the Liberal Democratic Party (LDP), will change things. In principle, Japanese voters’ distaste for a structurally corrupt system should allow a new system to emerge, but so far the DPJ appears to be just as dominated by the old interest groups, especially agriculture, as the LDP. DPJ leader Yukio Hatoyama’s denunciations of globalization and of former Prime Minister Junichiro Koizumi’s postal reforms could actually imply faster Japanese decline.

Russia must decide whether to learn the Asian lesson that modern geopolitical influence flows from economic power. Japan through the 1980s, China, South Korea, and India have shown that rapid economic growth quickly endows a country with prestige and influence. That growth comes from putting economic priorities ahead of military and territorial ambitions, from enhancing domestic and international competition, from being open to foreign technology and management and from investing heavily in infrastructure. China exemplifies such priorities, while Russia is doing exactly the opposite, dribbling away its resources in efforts to partially reconstruct its old empire, nationalizing rather than privatizing, reducing competition and restricting foreign investment rather than encouraging the inflow of foreign capital and technology. That path leads not to Russian resurgence but to flailing decline.

China’s rapid economic rise is spreading its influence, as Japan’s rise did a generation earlier. But hubris, complacency and interest group power, along with demographics, killed Japan’s rise and could kill China’s too. China has momentum but it faces momentous choices. In less than a decade its demographics will become more like Japan’s, with the demands of an ageing population placing increasingly intolerable pressures on the economy. Current Chinese leaders have been less willing than their predecessors to accept the social stress of market change. The great, successful thrusts of Chinese modernization have become obsolescent. Rising labor costs mean that exporting shoes and toys must give way to other forms of employment. The future lies with higher value-added manufacturing and services provided by small, medium and private enterprises, but today’s leadership likes the control that accompanies state enterprises and central management of capital markets, and it fears the social stress that comes from abandoning bottom-end manufacturing.

India’s dynamic post-1993 growth leads many Indian leaders to speak in private of dominating Asia. Economic improvement has indeed strengthened India’s international stature and improved millions of lives. But reform has been stagnant for the past five years. India’s growth has been extremely uneven and elitist compared to China’s. India’s service industries do not generate jobs the way China’s manufacturing does. Huge parts of India are left out, malnourished and illiterate while graduates of its best universities and executives of its globalizing businesses thrive. To continue rising, the Indian government must deliver education, roads, ports and water. Its democracy must spread benefits to an impoverished population that remains worse off than sub-Saharan Africa. Otherwise, the globalization that further rapid
India’s growth has been extremely uneven and elitist compared to China’s. Huge parts of India are left malnourished and illiterate while graduates of its elite universities and executives of its businesses thrive.

South Korea continues to have a cultural resistance to globalization, as indicated by the riots against US beef that damaged Lee Myung-bak’s early presidency.

growth requires will prove incompatible with the needs of hundreds of millions who are unequipped to compete in a globalized world. The results of the recent Indian election — which repudiated regional fragmentation and sectarian divisiveness in the face of a global crisis that once seemed certain to undermine the Congress Party-led government — create the potential but not the certainty that India will continue its rise indefinitely.

Finally, South Korea will either be squeezed between neighboring giants Japan and China, or it will leverage its relationship with China to eat Japan’s lunch. (An alliance with Japan against a rising China would automatically preclude Korean unification and therefore is not an option, unless China misbehaves.) Hyundai’s feat in catching up with Honda in global quality/reliability ratings, and Samsung’s challenge to Sony’s dominance of the quality television market, could provide templates for beating Japan. South Korea’s effective response to the global crisis facilitates that outcome, possibly with South Korea absorbing the North in the process. But South Korea continues to have a cultural resistance to globalization, as indicated by the riots against US beef that damaged Lee Myung-bak’s early presidency. But it has been globalizing more successfully than Japan. A million immigrants from places like Central Asia are internationalizing South Korea’s once-insular labor force at a pace that would be socially taboo in Japan.

PRELIMINARY INDICATIONS
In the wake of the financial crisis, US hegemony is giving way to greater multipolarity. The US Navy can no longer dominate everywhere, but the US remains by far the first among equals. US strategists agonize over how to cope with the rise of China, but across the spectrum of great issues — North Korea, terrorism, crime, drugs, trade and investment liberalization — the US has formed effective partnerships with China. It has had greater difficulty coming to terms with the decline of Japan. The two-decade period during which Japan has been economically stagnant and politically immobilized shows no sign of coming to an end, and the rise of the DPJ could exacerbate that era rather than end it. The revival of Japan appears to require deep political restructuring. China’s more prestigious role is enhanced both by its decisive response to the global financial crisis and by the shift of cross-Straits diplomacy from an emphasis on military-diplomatic confrontation to economic cooperation and diplomatic moderation. If Taiwan’s current diplomacy and economic policies continue, its economic dynamism will revive. South Korea is eating at least part of Japan’s lunch, gaining in international stature, and further increasing its leverage over a North that has been further weakened by the economic crisis, deepening Chinese disillusionment and an uncertain leadership succession. India continues a steady improvement in its international stature that does not challenge China but consolidates its dominance in the subcontinent; over the coming generation the Indian government may or may not learn how to deliver the basics of infrastructure and education and it may or may not overcome elitism sufficiently to prepare the impoverished masses of northern India for globalization.