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## Ten Trends That Will Shape Asia in 2014\*

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A fraught 2014 lies ahead for Asia. Political risks will rise, security tensions will increase, and skepticism will continue to grow about whether major Asian governments—especially in Beijing, Tokyo, New Delhi, and Jakarta—are sufficiently committed to growth-conducive reforms.

Ten trends will shape this more volatile Asia, yielding risks, opportunities, and patterns that will influence the next twelve months and beyond.

### 1. Asia Drives Demand

First, the good news: Asia's relationship to the world economy is changing in dramatic, and positive, ways. For decades, G7 countries beat a path to Asia's door—buying Asian exports and investing heavily in Asian economies. But Asia has become a major factor in the advanced economies' own growth stories. And where others have long consumed goods from Asia, it is Asians who are now investing and consuming more from overseas.

For an illustration, take the United States: American demand for Asian goods has powered export-led sectors across the region since at least the 1960s, from Japanese and Korean microelectronics to Thai rubber to

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Vietnamese textiles. But Asians are now major consumers of all things American, including corn and soybeans (for their animal feed), pork (for their tables), and natural gas (for their power plants). Increasingly, they are buying stakes in U.S. companies and resources too. If, as many argue, the prospects are finally brighter for the U.S. economy, it is in part because Asia has become a contributor to several pillars of the recovery, not least U.S. domestic energy production, agricultural exports, and high-tech innovation.

This trend will continue and grow in 2014, as Asia consolidates its role as a demand driver for the world economy.

## 2. Security Fragmentation Threatens Economic Integration

But here's the bad news: Asia is becoming more prosperous and economically integrated, yet the central strategic challenge in Asia today is the collision between economics and security.

Over half of Asia's trade is now being conducted within the region, powering a \$20-trillion-plus regional economy. But the same countries that are trading, investing, and growing together are beset by security tensions and dysfunctional diplomatic relationships. Asia's major powers are mistrustful and prone to nationalism. Their strains are increasing over the sovereignty of tiny rocks and shoals in the East and South China Seas.

This contradiction between economic integration and security fragmentation will sharpen in 2014. Asia's economic dynamism and integration are being put at risk because of debilitating security competition and sharpening political disputes.

A central factor is China. Bluntly put, Beijing's long-term strategic intentions inspire deep anxieties. So, as a hedge against China's growing strategic weight, many Asian countries are deepening defense and political coordination with the United States and each other.

China has become the top trade partner for many of Asia's major economies. And it will continue to play a major role in powering the growth of other economies in Asia, including erstwhile strategic rivals like Japan, South Korea, Vietnam, and Australia. Yet, economic interdependence alone cannot serve as a conflict-mitigating mechanism. After all, economic interdependence did not make war in Europe obsolete in 1914.

### 3. The Contested Commons

These tensions are likely to play out not just in disputes over territory but in the global commons as well. Beijing's November declaration of an air defense identification zone (ADIZ) in the East China Sea raised hackles and will likely be followed in 2014 by similar declarations around China's maritime periphery. Yet the debates over China's actions raise broader questions about how competing sovereignty claims in Asia may touch public goods and the global commons—airspace, cyberspace, and the high seas.

Beijing and Washington in particular seem to be talking past each other—China talks mostly about sovereign rights and claims; the United States talks largely about international rights and customs. And these differences will compound existing tensions over the cyberdomain.

So, quite apart from contested sovereignty claims between China and its neighbors, disputes will intensify in 2014 over issues of the commons—rights of passage, freedom of navigation, and diverging interpretations of customary international law.

Many countries have already framed their positions on these disputes around divergent perceptions of laws and norms. Take Beijing's new ADIZ: At a summit in December, Japan and ten Southeast Asian countries avoided mentioning the zone directly but called, in coded language, for "freedom of overflight and aviation safety in accordance with universally recognized principles of international law." Meanwhile, Beijing defended the zone by declaring that it "will not affect the freedom of overflight, based on international laws."

### 4. Japan's Pivot to Asia

With a competitive eye on China, expect Tokyo to further reinvigorate its Asian diplomacy in 2014. Just one year into his tenure, Prime Minister Shinzo Abe has traveled Asia relentlessly, courted India, and pledged \$20 billion in new aid and loans to Southeast Asia.

It is too easy to overstate the novelty of this. Tokyo has a long history of vigorous pan-Asian diplomacy. But Abe's effort takes on special resonance in the face of intensifying strategic wariness between Tokyo and Beijing.

Tokyo will look to expand its toolkit, leveraging project finance, trade, aid, people-to-people exchanges, and even security cooperation. How

deeply this resonates in Southeast Asian countries, which have long sought to foster balance between Beijing and Tokyo, will be especially telling of whether Abe is getting traction in his effort to use China as a foil to boost Tokyo's ties in Asia.

Japan's approach to investment bears watching in the coming year, particularly if another round of anti-Japan boycotts and protests erupts in China. Thus far, talk of a "hedge" has not led to a serious rethink of China as an investment destination for Japan, Inc. But investments may begin to flow out of China to other destinations in Asia if tensions escalate in 2014.

One challenge will be for Tokyo and Washington to stay coordinated. Each in its own way looks warily at a rising China. Yet Japan's pan-Asian diplomacy, especially on economic ideas like Asian monetary integration, has at times put it at odds with the United States—a trend that could resume in 2014. Japan is a robust U.S. ally with a powerful sense of trans-Pacific identity, yet it has incubated a variety of pan-Asian regional ideas that have unsettled past U.S. administrations.

#### 5. North Korea's Great Unraveling?

The December execution of Jang Song-thaek, the uncle of North Korean leader Kim Jong-un, and the ongoing purge of his patronage network have highlighted internal divisions and raised underlying questions about the stability of the regime. The risk of instability will grow in 2014.

Pyongyang has a penchant for provocations and in recent weeks has begun to hurl new threats and invective at South Korea. Both Seoul and Washington fret that Pyongyang lacks escalation control. And worse, the North has plenty of provocative options, including another nuclear test, long-range missile tests, or conventional attacks around or beyond its disputed maritime border with the South. Conventional attacks would be especially destabilizing because they would raise questions about whether the conventional deterrence that has kept the peace on the peninsula for six decades is eroding under the shadow of Pyongyang's nuclear capability and a reckless young leader.

Such provocations would pose tough choices for everyone in Northeast Asia. For its part, Beijing is Pyongyang's closest partner but would hardly welcome actions that destabilize the region—or bring Seoul, Washington, and Tokyo into closer alignment. China has shown scant appetite for coercing North Korea, while Seoul and Washington have bet that Chinese leverage could limit Pyongyang's behavior and restrain

the worst provocations. But many viewed Jang as Beijing's man in Pyongyang, so, in the wake of his execution, China's influence over the North is more questionable than ever.

Meanwhile, the ghosts of history have bedeviled U.S. efforts to encourage security collaboration between South Korea and Japan. China's rise looms in the background, but Seoul has been careful not to lean too far toward Tokyo. In fact, America's Northeast Asian allies, despite a robust trade relationship and a powerful shared interest in countering North Korean threats, could not sign even a straightforward intelligence-sharing agreement in 2012 to enhance cooperation in the face of this common threat. If a more volatile North Korea in 2014 can't bring these two U.S. allies together for security coordination and contingency planning, what will?

Washington will be working hard, mostly behind the scenes, to help its allies overcome their differences. Beijing will likely be looking to forestall this, betting that Seoul's tensions with Tokyo over history and territory will ultimately limit their cooperation.

## 6. The Future of the U.S. Rebalance

It has been no easy ride for the Obama administration in Asia. First, its critics charged it with paying too little attention to the region while China "ate America's lunch." Then, the administration initiated a supposedly game-changing "pivot," or "rebalance," to Asia that put America back in the game. Finally, in November President Barack Obama missed a regional summit and the criticism picked up again.

Washington must make choices in 2014 that will test traditional U.S. roles in Asia in new ways. In the postwar period, the United States became the principal provider of security-related public goods in Asia through alliances and forward-deployed military forces that have helped to keep the peace. And the United States has been the principal provider of public goods in the economic realm as well, not least because demand from American consumers has helped to power export-led growth in Asia.

In recent years, the U.S. role as Asia's principal security provider has been reinforced, but Washington's allies in particular will be anxiously watching to see how it reverses the debilitating effects of sequestration on its defense posture and whether it makes long-range investments in new capabilities. Meanwhile, as U.S. economic weight shrinks in relative terms, it is unclear whether the U.S. role is sustainable without

a significantly increased American economic profile to balance its enhanced security profile, for instance through the kind of leadership that would help bring global and regional trade agreements to conclusion.

## 7. A Convergence of Models?

Indeed, a raft of regional preferential trade agreements now compete for attention in Asia. These include, but are not limited to, the U.S.-backed Trans-Pacific Partnership (TPP) and the pan-Asian Regional Comprehensive Economic Partnership (RCEP), which does not include the United States.

Many see the TPP and the RCEP as competitive. And in recent years some in Beijing, in particular, have looked warily at the TPP, viewing it as part of a U.S. containment strategy. But things may change in 2014, as China has begun to take an interest in the TPP. Chinese reformers view external pressure, such as the pressure that the membership requirements of the TPP would provide, as a way to promote change at home, much as membership in the WTO forced economic and institutional changes in the late 1990s.

This does not mean that competition between models will evaporate overnight. For one, the gap between TPP requirements and China's domestic arrangements is huge. And even the current TPP negotiating parties have not forged agreement on tough issues like the treatment of state-owned enterprises.

But if the TPP is concluded in 2014, it will set a new competitive standard in Asia. Major countries, including China, will need to adapt as the agreement begins to affect their economies.

## 8. China's Economy: To Market?

China's reform efforts have become more vigorous because its growth model, which has depended on the twin pillars of investment in fixed assets and exports, has begun to run out of steam.

To that end, Beijing ends 2013 having adopted a sweeping economic reform agenda that includes new commitments to financial liberalization, the repair of China's social safety net, protections for rural property rights, and greater reliance on market forces. Beijing has committed to increase the role of the market in the economy—for example, by boosting the formal role of private capital.

But reforms that aim to give the market a more decisive role cannot



succeed unless the state begins to shed some of the functions that have made it a pervasive force in the economy. This will be a pivotal reform challenge in 2014. Chinese leaders have declared war on “vested interests” that, they say, are obstructing market reforms. Yet the biggest vested interest in the Chinese economy is the state itself, which plays an outsized role in areas, like price controls, that would be better left to the market. In the coming year, Beijing will debate and struggle with the state’s relationship to the economy, especially the way that prices and interest rates are determined.

The biggest changes will likely come through financial reforms, with significant moves toward market-based prices and steps to begin liberalizing deposit interest rates. The biggest struggles, meanwhile, will be over restrictions on internal migration and the subsidies provided to state-owned firms.

## 9. The Push and Pull Over Reforms

Washington and Beijing won’t be the only capitals to face intensified scrutiny of their economic policies in 2014. Antsy global investors and angry domestic voters will push and pull a number of Asian governments in competing directions.

In India, tax, insurance, and land acquisition reforms have stalled, investor confidence has sunk, and a pending national election seems unlikely to yield any scenario conducive to bolder initiatives. In the absence of concerted national action, pressure will rise on India’s states to enhance their role as local laboratories for growth-conducive reforms.

Tokyo confronts skepticism that the prime minister’s economic agenda—Abenomics—can deliver a long-term growth strategy that will return Japan to sustained economic health.

Investor confidence will be tested in Thailand, where political conflict continues, and Indonesia, where slowing growth has been managed primarily through monetary policy, not policy reforms.

In Malaysia, the government’s popularity has taken a hit as it cuts subsidies, hikes tariffs, and moves to introduce new consumption taxes to address its fiscal deficit. Although the aim is a stronger economy, the government’s efforts will squeeze consumers.

## 10. Central Asia in Flux

New economic and strategic pressures will also emerge in continental

Asia in 2014. Landlocked Central Asian economies will be tested amid the U.S. withdrawal from Afghanistan, new Chinese investment and infrastructure initiatives, Russia's efforts to extend its preferential customs union, and Iran's uncertain trajectory.

To date, enthusiasm for economic cooperation has been far greater outside the region than among Central Asian states themselves. Yet cooperation is important because these landlocked economies rely on surrounding powers like Russia and China for the transit of goods and resources, raising transaction and transportation costs.

In 2014, questions about leadership succession and other political risks in Uzbekistan, Kazakhstan, and elsewhere will intensify the pressure on these governments to deliver more enduring economic gains. But with U.S. and European attention on the region likely to recede after the withdrawal from Afghanistan, these governments will have fewer outside partners. So they will increasingly need to look to their own neighborhood if they are to overcome their weak history of cooperation. Macroeconomic fundamentals and enhanced cross-border trade and investment could become more important as governments seek to deliver balanced growth and foster economic opportunity.

### A Testing Time

For two decades, Asia has defied the gloomy predictions of those who believed that its future would resemble Europe's conflict-ridden past. Like Europe before 1945, Asia is beset by territorial disputes, powerful nationalisms, and a long history of war and conflict. But Asian countries have managed throughout the post-Cold War period to grow and prosper together while keeping their disputes in check.

The question is how long that positive trajectory will last. Posing tough new tests to this effort to construct a shared future, the year to come will prove a trying one for Asia.

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