# IMPLICATIONS OF THE FINANCIAL CRISIS ON AMERICAN, CHINESE, SOUTH KOREAN, AND JAPANESE SOFT POWER IN EAST ASIA
## /Workshop Agenda/

22-24 OCTOBER 2009| CHICAGO, ILLINOIS, U.S.A.

## Thursday – 22 October 2009

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| **6:30p.m.** | **Check-in and wine reception** |
| **6:55p.m. – 7:05p.m.** | **Opening Remarks: Marshall M. BOUTON**, President, The Chicago Council on Global Affairs and **Sook-Jong LEE**, President, the East Asia Institute |
| **7:05p.m. – 8:50p.m.** | **Dinner and Keynote Address: Ashley J. TELLIS**: "Managing the Security Implications of the Economic Crisis in East Asia" |

## Friday – 23 October 2009

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| **7:45a.m.** | **Registration and breakfast** |
| **8:30a.m. – 11:40a.m.** | **Session I: *The Effects of the Financial Crisis on U.S. Soft Power*** Moderator: **Young Sun HA** |
| **8:30a.m.** | **Thomas WRIGHT** opens the workshop and outlines proceedings |
| **8:40a.m.** | **Part I: Why the Financial Crisis Matters for Soft Power in Asia** **Ellen FROST** memo presentation: "Recent Economic Trends: Implications for Post-Crisis Power Relations in East Asia" |
| **8:50a.m.** | **Yinhong SHI** memo presentation: "Why the Crisis May Have Strategic Consequences for the U.S. Role in East Asia?" |
| **9:00a.m.** | **Commentary and Discussion** |
| **10:20a.m.** | **Break** |
| **10:45a.m.** | **Part II: The Future of U.S. Influence in East Asia** **Jackie NEWMYER** memo presentation: "U.S. Policy in East Asia after the Financial Crisis" |
| **10:55a.m.** | **Commentary and Discussion** |
| **11:30a.m.** | **Session Adjourns** |
| **11:40 a.m.** | **Lunch** |

**12:10p.m.** **Keynote Address: Douglas BEREUTER**: "The Exercise of Soft Power and Public Diplomacy by a Nongovernmental Organization: The Experience and Programs of The Asia Foundation"

**1:05p.m.** **Lunch Adjourns; Afternoon Session Begins**

**1:10p.m. – 4:20p.m.** **Session II: *The Effects of the Financial Crisis on Chinese Soft Power***
Moderator: **Harry HARDING**

**1:15p.m.** **Part I: China and the Financial Crisis**
**Xiaoming ZHANG** memo presentation: "China and the Financial Crisis"

**1:25p.m.** **Mingjiang LI** memo presentation: "The Effects of the Financial Crisis on China's Strategy"

**1:35p.m.** **Commentary and Discussion**

**2:55p.m.** **Break**

**3:20p.m.** **Part II: U.S. and Regional reactions to China's New Direction**
**Sukhee HAN** memo presentation: "What Will Be the Long Term Impact of China's Strategic Shift on its Influence in Asia"

**3:30p.m.** **William OVERHOLT** memo presentation: "The Financial Crisis and Chinese Soft Power"

**3:40p.m.** **Commentary and Discussion**

**4:20p.m.** **Session Adjourns**

**6:15p.m. – 8:15p.m.** **Dinner and Keynote Address; Byung-Kook KIM: "**Soft Power and East Asia's Divided Nations"
Hosted by the Korean Consulate of Chicago

## Saturday – 24 October 2009

**7:45a.m.** **Breakfast**

**8:30a.m. – 10:15a.m.** **Session III: *Regional Repercussions-South Korea***
Moderator: **Nobuhiro HIWATARI**

**8:35a.m.** **Dong Sun PARK** memo presentation: ""The Effects of the Crisis on South Korea"

**8:45a.m.** **Chaesung CHUN** memo presentation: "South Korea's Views on East Asian Security"

**8:55a.m.** **Commentary and Discussion**

**10:15a.m.** **Break**

**10:40a.m. – 12:25p.m.** **Session IV: *Regional Repercussions-Japan***
Moderator: **Steven CLEMONS**

**10:45a.m.** **Motoshi SUZUKI** memo presentation: "The Effects of the Crisis on Japan"

**10:55a.m.** **Andrew SHEARER** memo presentation: "U.S. and Regional Views of Japan"

**11:05a.m.** **Commentary and Discussion**

**12:25p.m.** **Lunch**

**1:30p.m.** **Closing remarks: Marshall M. BOUTON** and **Sook-Jong LEE**

**The *Soft Power* workshop is generously supported by the Korea Foundation and the Korean Consulate General in Chicago.**

# Implications of the Financial Crisis on American, Chinese, South Korean and Japanese Soft Power in East Asia

**Confirmed Participants (United States and Asia)**
Douglas Bereuter, *Asia Foundation*
Marshall Bouton, *Chicago Council on Global Affairs*
Rachel Bronson, *Chicago Council on Global Affairs*
Chaesung Chun, *Seoul National University*
Steven Clemons, *New America Foundation*
Paula Dobriansky, *Kennedy School of Government, Harvard University*
Aaron Friedberg, *Princeton University,* (tentative)
Ellen Frost, *Peterson Institute for International Economics/ National Defense University*
Peter Geithner, *Harvard University*
Young Sun Ha, *Seoul National University*
Sukhee Han, *Yonsei University*
Harry Harding, *University of Virginia*
Nobuhiro Hiwatari, *Institute of Social Sciences, University of Tokyo*
Paul Herman, *National Intelligence Council*
Byung-Kook Kim, *East Asia Institute and Korea University*
Sook-Jong Lee, *East Asia Institute and Sungkyunkwan University*
Mingjiang Li, *S. Rajaratnam School of International Studies, Nanyang Technological University*
Barry Lowenkron, *MacArthur Foundation*
Raja Mohan, *S. Rajaratnam School of International Studies, Nanyang Technological University*
Jackie Newmyer, *Long Term Strategy Group*
William Overholt, *Kennedy School of Government, Harvard University*
Dong Sun Park, *Ambassador for International Economic Cooperation, Republic of Korea*
Andrew Shearer, *Lowy Institute for International Policy*
Yinhong Shi, *Center for American Studies, Renmin University of China*
Mathew Stumpf, *MacArthur Foundation*
Motoshi Suzuki, *School of Government, Kyoto University*
Ashley Tellis, *Carnegie Endowment for International Peace*
Thomas Wright, *Chicago Council on Global Affairs*
Dali Yang, *University of Chicago*
Xiaoming Zhang, *School of International Studies, Peking University*

**Session I: The Effects of the Financial Crisis on U.S. Soft Power**
**Part I: Why the Financial Crisis Matters for Soft Power in Asia**

## RECENT ECONOMIC TRENDS: IMPLICATIONS FOR POST-CRISIS POWER RELATIONSHIPS IN EAST ASIA

Ellen L. Frost
Peterson Institute for International Economics

**Key Points:**

- The financial crisis has hit East Asia hard, especially its highly globalized coastal areas and manufacturing sectors. But the region is weathering the crisis better than most and growth is picking up.
- China, not the U.S., is the "locomotive" for East Asian recovery, but the quality and sustainability of the stimulus are dubious. China's recovery will probably not help other Asians as much as the pre-crisis boom in China-centered production networks.
- The U.S. has taken a black eye and the popularity of free-market policies has waned, but the political leverage stemming from China's economic power is still limited.

### 1. Financial Crisis Hit Globalized East Asians Hardest

Once the financial crisis erupted, initial data from East Asia were devastating. In January 2009, Singapore, ranked number-one in economic globalization by the World Economic Forum, recorded a 40% fall in exports and a 29% drop in manufacturing output compared to the same period in 2008. Idle container ships lay anchored at its port, hitherto the world's busiest. In the first six months of 2009, Taiwan's exports fell 34.2% and South Korea's 22.7%. In the first two quarters following the collapse of Lehman Brothers, Japan's GDP shrank by well over 10% on an annualized basis. China, whose dependence on trade doubled between 1998 and 2008 (from 30% of GDP to as much as 60%), suffered an equally calamitous plunge in export volume as Western demand withered. Growth rates everywhere slowed down or went into reverse. Only China and Indonesia have escaped a recession (defined as two consecutive quarters of negative growth).

Unemployment data were equally alarming. The number of jobless rose sharply in Malaysia, Singapore, Taiwan, Hong Kong, Thailand, and Japan. (In South Korea, state-owned and publicly listed companies cut wages instead of jobs, limiting the rise in unemployment.) In China, an estimated 20 million workers lost their jobs in 2008. China expert Pieter Bottelier estimates that in 2009, as many as 48 million Chinese, including recent graduates, may be competing for less than 7 million new jobs. Everywhere in the region, employment in manufacturing contracted more severely than jobs in services and agriculture.

BUT…

### 2. East Asians Are Weathering the Crisis Better than Most

Despite these blows, the ADB estimates that developing Asia is expected to grow by 3.9% in 2009 and 6.4% in 2010. This is still well below the 9-10% of pre-crisis years, but it is encouraging. Restocking inventories has begun. 2009 growth estimates for the East Asian sub-region (China, Hong Kong, South Korea, Mongolia, and Taiwan) have been revised upward, from 3.5% to 4.4%. The growth forecast for 2010 has been raised from 6.5% to 7.1%. The 2009 growth estimate for the

Southeast Asia sub-region (the ASEAN countries) is 2.5%, far lower than the 6-7% of recent years but still positive.

As for individual countries, Indonesia is a star performer; its growth rate of 4% is the third highest of the G-20 counties and is expected to rise to 5% or more next year. The IMF predicts that in 2010 China will grow at around 9%. South Korea's growth will be in the 2-4% range (compared to minus 1% in 2009), and even Japan's growth will be above zero, possibly reaching 2% (compared to minus 5% in 2009).

There are a number of reasons why East Asia is weathering the crisis relatively well. Stimulus packages, generally larger than the G20 average, were implemented promptly. Banks' balance sheets are in much better condition than they were in 1997-98. Financial institutions largely avoided the risky financial instruments peddled by Wall Street. There was no real estate bubble to speak of. High levels of household savings, combined with the government's strong fiscal position and ample foreign exchange reserves, cushioned the worst effects of the crisis. Relatively open trade and investment policies remain in force, and consumption is growing.

### 3. China is the "Locomotive" – But Doubts Remain about Stimulus

China responded to the crisis promptly with a stimulus package equal to 5-7% of GDP. The central bank pumped liquidity into the system; in the first 8 months of 2009, yuan-denominated lending by China's banks rose by 8.15 trillion yuan ($1.65 trillion), a level that exceeds even that of the U.S. Bank loans in first three months of 2009 exceeded the entire 2008 level. The stimulus package focuses heavily on investment, especially expanding infrastructure and retooling factories.

Despite this "giant chugging sound," doubts have arisen about the quality of China's stimulus. Some argue that two-thirds of the money would have been spent anyway. A more serious criticism is that the focus on investment worsens the imbalance between consumption and investment; the level of personal consumption in China (about 38% of GDP) is growing, but it is still far lower than in other major economies and exacerbates global imbalances. A large share of the stimulus is going to state-owned enterprises, adding to overcapacity in heavy industries like steel and petrochemicals. Commitment to environmental cleanup is uneven; the choice of investment targets demonstrates again that the government's growth target of at least 8% still trumps environmental protection. Only a small share goes to energy conservation, health, education, and future-oriented industries. Finally, widespread corruption could siphon off some of the stimulus funds. On Transparency International's 2008 "Corruption Perceptions Index," China ranked #72 out of 180 countries surveyed (#1 is best).

Until the financial crisis hit, the main sources of rising prosperity in East Asia were China-centered production networks, the majority of which were established by foreign-owned companies or joint ventures. Their output was destined for Western markets. These networks stimulated a region-wide division of labor and fueled rising exports of manufactured components from the rest of Asia to China, especially in the electronics and telecommunications sectors. Until recently, half to two-thirds of China's exports consisted of imported parts and materials, mostly from Asia. (The label "Made in China" is highly misleading.) But with Western demand at a low ebb, China's imports from the rest of Asia fell by some 80% between mid-2008 and 2009 and have only picked up recently.

Compared to production networks, China's stimulus package is unlikely to fuel growth in the rest of the region to the same degree. The focus on developing China's relatively poor interior regions is entirely justifiable, but such a priority puts East Asian exporters at a geographical and logistical disadvantage. The products needed to raise standards of living in the remote interior can be manufactured easily and cheaply in China. Moreover, there are reports that local officials are imposing "Buy-China" provisions and other forms of protectionism on government procurement projects. Finally, China's stimulus money targets investment, not the promotion of consumer spending that might attract imports from the rest of Asia.

## 4. Implications for Economic Power

The paradox of globalization is that economic power is linked to engagement with the world economy. The deeper the engagement, the more limits that governments face when they try to influence the behavior of other governments.

There can be no doubt that the financial crisis has boosted China's economic prestige and undermined confidence in U.S. financial leadership. According to a CSIS poll conducted as the crisis was building, East Asian elites predict that in 10 years China will be "strongest in overall national power in the Asia region" and the "most important country" for their nation. (Chinese and Japanese elites, however, named the United States.) Just as Japan's long stagnation is a source of disappointment, China's role as regional locomotive is widely appreciated. China's new prominence lends force to efforts to restructure the voting shares of the IMF and other international institutions and helped spark the shift of gravity from the G8 to the G20.

The implications of China's economic achievements for power relationships should not be exaggerated, however. China's attempts to apply economic coercion against Taiwan have generally failed. Only when a vital issue arises (the status of Tibet, for example) has Beijing explicitly pressured other Asian governments. Despite loose talk about a "Beijing Consensus," the appeal of some sort of "China model" – however it is defined -- is limited. Indonesia's impressive political and economic achievements point in a quite different direction. The Chinese themselves acknowledge their numerous social and economic problems and insist that each country must find its own development strategy. China's greatest leverage arises from simply being big and dynamic.

Given the causes and consequences of the crisis, it would be understandable if the reigning mantra in Asia became "resist globalization, practice mercantilism, keep currencies undervalued, and accumulate large foreign currency reserves." That is a risk. Bashing a strawman version of the "Washington Consensus" is in fashion. The fallout from Wall Street has already tarnished the image of market-driven capitalism. In South Korea and Japan, for example, support for free markets has dropped 15 percentage points. Meanwhile, China's central bank governor has proposed curtailing the role of the dollar as an international reserve currency and relying more on Special Drawing Rights (SDRs). Premier Wen Jiabao followed up with a plea to Washington to "guarantee the safety of China's assets." But this talk is mainly finger-wagging. As Chinese experts themselves have pointed out, there is no near-term alternative to the dollar.

Just as the 1997-98 crisis spurred East Asians to step up efforts to achieve closer integration and deepen Asian regionalism, so the current crisis appears to be having the same effect. In May 2009 ASEAN + 3 announced a $120 billion regional currency stabilization fund, integrating and building on a series of bilateral swap agreements. (Some key details remain murky, however.) Japan's new leader has announced support for pan-Asian groupings and may undertake new leadership initiatives in the region.

Cross-Strait relations are similarly in motion. The combination of the financial crisis, China's economic resurgence, and the China-ASEAN free-trade agreement (scheduled to go into effect in 2010) is propelling Taipei to step up negotiations on a China-Taiwan Economic Cooperation Framework Agreement (ECFA) with Beijing and to seek an arrangement comparable to China's free-trade agreements with others in the region.

The United States and its Asian friends and allies should welcome not only the nascent East Asian recovery but also the trend toward intra-Asian integration. On balance, they coincide with U.S. interests. Every government in the region, including China's wants the United States to remain deeply engaged in Asia, at least for the foreseeable future. What worries them is America's economic future. From their perspective, a vibrant U.S. economy is a strategic imperative for the region. Accordingly, East Asia's implicit message for Washington's policy-makers is, "Physician, heal thyself!"

## Session IV: Regional Repercussions-Japan

### IMPLICATIONS OF THE GLOBAL FINANCIAL CRISIS FOR JAPAN

Andrew Shearer
Lowy Institute for International Policy

Japan underwent the fastest and deepest plunge of any of the world's major economies following the September 2008 collapse of Lehman Brothers and the ensuing global economic crisis – the country's deepest recession since the Second World War[1]. Despite prompt measures by authorities[2], output is projected to fall by around 6 per cent in 2009, reflecting a collapse of exports and tighter financial conditions.[3] This contraction comes on top of two decades of economic stagnation.

Key reasons for the severity of Japan's downturn include the drag of steeply rising energy and raw materials prices before the crisis, an economy heavily dependent on manufactured exports (hobbled with a currency which has appreciated both against the US dollar and the Yuan), and political uncertainty.[4] Japan's economic outlook remains weak. The tentative recovery evident in the April-June quarter of 2009 is likely to slow once fiscal stimulus is withdrawn in fiscal 2010. Growth is projected to remain below 1 per cent during 2010.[5]

***Regional perceptions***

Despite Japan's status as the world's second-largest economy (at US dollar rates) and its many national strengths, political and economic sclerosis has seriously eroded national self-confidence and Tokyo's regional influence. As a result of unresolved historical legacies and sometimes maladroit diplomacy, Japan often has not reaped the credit it deserves for its significant aid and economic contribution to East Asia. China's dramatic rise, coinciding as it does with Japan's stagnation, has reinforced Japanese uncertainty and strategic anxiety.

Tokyo often struggles to translate Japan's substantial economic power, responsible international role and diplomatic resources into durable soft power and commensurate regional influence. During the 1997 Asian financial crisis Beijing received considerable regional kudos for not devaluing the Chinese currency. By contrast Japan's decision during the current economic crisis to allow its currency to appreciate has received almost no attention. The Chicago Council's 2008 poll *Soft Power in Asia* [6] showed that perceptions of Japan are very mixed across the region despite its considerable soft power assets.

Japan's regional dilemma is highlighted in the recently released 2009 Lowy Institute Poll[7]. Japan is regarded more positively in Australia than in many other regional countries, registering a warm 66° (compared with China at 53°). Japan remains vitally important to Australia – its largest export market and third-largest source of foreign direct investment (behind the United

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[1] Junichiro Takeuchi, 'Japan in the Economic Crisis', in *Japan Economic Currents: A Commentary on Economic and Business Trends*, Keizai Koho Center, Japan Institute for Social and Economic Affairs, No. 74, September 2009.
[2] The Bank of Japan's policy interest rate was 0.1 per cent at the end of 2008 and the government has announced four stimulus plans amounting to 4.7 per cent of 2008 GDP, higher than the OECD average of 3.9 per cent: OECD, *Economic Survey of Japan, 2009*, Policy Brief, September 2009.
[3] OECD, *Economic Survey of Japan, 2009*.
[4] Takeuchi, 'Japan in the Economic Crisis'.
[5] OECD, *Economic Survey of Japan, 2009*.
[6] Christopher B. Whitney, Project Director, and David Shambaugh, Senior Project Consultant, *Soft Power in Asia: Results of a 2008 Multinational Survey of Public Opinion*, New Results and Analysis, 2009 Edition, The Chicago Council on Global Affairs, pp. 18-20.
[7] Fergus Hanson, *The Lowy Institute Poll 2009: Australia and the World: Public Opinion and Foreign Policy*, Lowy Institute for International Policy, Sydney.

States and the UK). Yet only 6 per cent of Australians polled regarded Japan as the most important economy to Australia (by contrast 63 per cent said China and 27 per cent the United States). Few Australians are aware that Japan is Australia's most important regional diplomatic ally and an increasingly important security partner. The difficulty of gaining traction even in such a favorably disposed country as Australia highlights the extent of Tokyo's diplomatic challenge in regional countries where the war-time past is rawer and national interests are less convergent.

***End of an era***

The new center-left Democratic Party of Japan (DPJ) government would almost certainly have been elected even without the economic crisis. The scale of the DPJ's August 2009 victory reflects widespread public disenchantment after half a century of virtually unbroken rule by the Liberal Democratic Party (LDP). It represents a deep desire to change a model of government regarded as having failed rather than a vote of confidence in the DPJ, its leaders or its policies.

Prime Minister Hatoyama and his new government have laid out a very ambitious agenda which, if implemented in full, would transform Japan. But they face difficult challenges.

***Governing***

The election confirmed the success of DPJ eminence grise and former leader Ozawa in forging the party into a political force. The abject state of the previous government allowed the DPJ to campaign on a platform comprising mostly vague statements of intent rather than detailed policies, and already there are signs the government will be pragmatic and selective when it comes to implementation. But only a handful of senior members of the government have executive experience, and scope exists for divisions between the social democratic wing of the party and the moderates who hold sway in cabinet. It remains to be seen whether the DPJ can demonstrate the competence necessary to entrench itself as a viable long-term alternative to the discredited LDP (and also whether the LDP can rehabilitate itself in opposition). The government's first major test will be how successfully it translates aspirations such as clean government, devolution of authority to the regions, subordination of Japan's traditionally powerful bureaucracy to elected authority, and a more independent foreign policy into detailed measures in the process of putting together its first December budget.

***The economy***

Breathing life into the economy will be the DJP's most important task. Sustaining the weak recovery under way will require reforms to stimulate private domestic demand, including labor market reforms and measures to boost productivity in the non-manufacturing sector. The financial system is inflexible and inefficient at allocating capital and requires urgent reform. Japan's domestic reform failings have accentuated an unhealthy export dependence and are a major factor in its declining international influence. With a post-crisis budget deficit projected at 10 per cent of GDP in 2010 and gross public debt approaching 200 per cent, sustaining the confidence of financial markets will require a robust medium-term fiscal consolidation plan. Japan's rapidly ageing population will mean lower output and increased pressure on government spending, necessitating reforms to health-care in particular. The government's economic policy direction remains unclear, however, with contradictory campaign positions favoring both reduced taxation and increased social welfare spending.

***The US alliance***

The DJP's election platform called for a more equal alliance relationship with the United States, and among its more explicit commitments were undertakings to review the US-Japan Status of Forces Agreement, revisit the current plan for realigning the US military presence in Japan (including the removal of US forces from Okinawa) and end the Japanese Maritime Self Defense Force refueling mission in the Indian Ocean. Japan will be less likely to commit forces to international operations absent a UN mandate, and there are distinct signs of foreign policy naïveté among novice DJP Diet members: according to a recent Kyodo News survey, more than 60 per cent of Lower House DPJ members want Japan to leave the US nuclear umbrella.[8] Japan's share of the cost of shifting US forces from Okinawa will become an issue given growing fiscal pressures.

For these reasons the US-Japan alliance will be more difficult to manage, at least in the short term until the DJP consolidates its hold on government at the Upper House elections in July 2010. Ultimately, however, the DJP is likely to be mugged by reality. Japan's difficult strategic circumstances and Ozawa's inherent pragmatism are likely to prevail. There are already signs that the government is softening many of its campaign positions on foreign policy, and the defense minister recently reaffirmed Japan's commitment to cooperation with the United States on missile defense. Japan's regional partners will not thank the DPJ if the realignment of the US military presence in Japan stalls and disrupts broader US force posture changes in the region.

***Relations with East Asia***

The DPJ is committed to placing greater emphasis on Japan's relationships with its neighbors in Northeast Asia. So far this has been reflected in Hatoyama's promise not to visit the controversial Yasukuni war cemetery, his proposal to develop an East Asian Community excluding the United States and the recent China-Japan-South Korea summit. Japan's trade and investment links with China are growing strongly, and the diplomatic relationship has improved markedly since Prime Minister Koizumi left office. DPJ efforts to deal more forthrightly with Japan's war-time excesses hold out the promise of further improvement in Japan's ties not only with China but with South Korea and Southeast Asia. But Japan and China remain natural strategic competitors. This, and Japan's continuing dependence on the United States for extended deterrence, is likely to constrain Sino-Japanese intimacy.

***Japan and the world***

Traditionally Japan has played an active role in multilateral diplomacy, particularly on disarmament and climate change. The DJP government is committed to a more active position on nuclear disarmament and to aggressive (and probably unrealistic) targets for carbon emissions as a way of emphasizing Japan's international leadership credentials, but any progress on either is likely to be slow. Japan remains a leading financial power, but the recent replacement of the G7 by the G20 leaders' meeting –with China occupying a prominent place – will dilute Tokyo's influence and signals an end to the period when it could represent Asia in the world's most powerful financial counsels.

***Conclusion***

Japan has been standing still or going backwards for two decades. Its share of world output and of world trade has been falling steadily: its share of total world exports has fallen more than that of any other G20 country over the last 20 years. In some respects this is a natural consequence of the maturing of Japan's phenomenally successful growth model. But Japan needs to change. Its short-term economic prospects are weak and it faces major medium and long-term policy challenges, both domestically and internationally. At least up until now, political paralysis has prevented Japan from putting in place the economic and other reforms necessary to restore its international competiveness and confidence. Until this happens Japan will continue to lose ground, and inevitably a burgeoning China will loom as the main comparator. The Japanese people will be desperately hoping the new DPJ government can succeed where its predecessors largely failed, as will Japan's international partners. Both will need to keep up the pressure for reform.

[8] See http://search.japantimes.co.jp/cgi-bin/nn20091011a1.html.

**Session I: The Effects of the Financial Crisis on U.S. Soft Power**
**Part I: Why the Financial Crisis Matters for Soft Power in Asia**

## WHY THE CRISIS MAY HAVE STRATEGIC CONSEQUENCES FOR THE U.S. ROLE IN EAST ASIA?

Shi Yinhong
Renmin University of China

*"I will cover minor and major human settlements equally, because most of those which were important in the past have diminished in significance now, and those which were great in my own time were small in the past. I will mention both equally because I know that human happiness never remains long in the same place."* --Herodotus, *The Histories,* 1.5.

*"It was not we* [Themistocles, the maker of strategy for the triumph of the Greek small city-states against the mighty Persian Expedition, allegedly says] *who accomplished this* [the Greek victory over Persians at Salamis]*, but the gods and heroes, who did not want to see a single man ruling both Asia and Europe."* –Herodotus, *The Histories,* 8.109.

The philosophy declared by Herodotus, the Father of History, has been often proved through history, including this time of global financial crisis and recession. Though the concrete causes are numerous and complex, but no one denies that it initially broke out in the United States and spread from the United States. Moreover, so few people refute the almost common-sense proposition that this superpower had been the single most important perpetrator of the crisis. So Asians do blame America for the crisis, though many of them (including the PRC Chinese) are aware that they themselves should have their own part of responsibility, including had been enjoying and benefiting from America's financial, commercial, military, and ideological unhealthy "overstretch" for so long that they have contributed substantially to the "spoiling" of the United States as well as of themselves.

In this context, the further relative decline of both American hard and soft power, a decline following that primarily due to George W. Bush's blunder wars and foreign policies and China's dramatic economic rise during his years in the White House, is inevitable. At present, the global financial crisis and economic recession has been widely regarded as a historical turning point, really ending the already too long "Post-Cold War" era and ushering in a new period of world politics. For, first of all, there has been a major development described by an American scholar as "the financial death of the U.S. Empire." America's huge and nearly perennial financial deficits, whether federal, or local governmental, or corporative, or even individual, come from almost all the major dimensions of the operation of American "democratic welfare empire," or to say with some major reservations, from the contemporary American way of life. In the words of the above American scholar, words exaggerated but still sound plausible, "the myth of US omnipotence likely is shattered forever…. Over the last six years [i.e., 2002-2008] the US has tossed away its moral superiority, diplomatic indispensability, and military infallibility. Now it has lost its economic security. Washington is broke."

In a sense, the even more profound impact of the financial crisis and recession the world has faced since September 2008 is something psychological and intellectual. The political cultural and value belief system in the world has been strongly influenced thereby. Stapleton Roy, former U.S. Ambassador to China and currently director of the Kissinger Institute at the

Woodrow Wilson International Center for Scholars, deeply sensed or predicted this impact. He said in a conference in Washington, D.C. in early October 2008 that the financial crisis was "catastrophic," that 2009 would be a defining moment in history, that the idea of the universal superiority of free-market capitalism and western liberal democracy was being severely challenged internationally, and people began to seriously doubt whether these were the best ways to deal with the severe problems of the world.

Ambassador Roy is only a little earlier in that sense than many others in the U.S., Europe, and Asia. There has indeed been a broader discrediting of the so-called Anglo-Saxon economic model (or "Washington Consensus" in its political economy dimension) within Asian countries, no doubt broader than during the decade before the global financial crisis. In China, this discrediting is unquestionably much stronger than in most other East Asian countries, especially because the comparative self-confidence in China's own spectacular economic achievements achieved substantially through depending upon China's own way of doing things besides its adaptive "borrowing" from the West.

China even in a large degree discredited the above model or Consensus much earlier, for since late summer of 2003 (the earliest according to some Chinese researchers) China's top leaders have emphasized an increasing conviction that *lazier fare* market economy, obsession with GDP growth only, and undifferentiated integration into the economic globalization, all so prominent in China's drastic economic rise at the cost of social justice, balanced development, and environment protection, are unsustainable and increasingly dangerous, reflecting a large part of the Chinese public's resentment or even anger. What happened in the U.S. and much of Europe and elsewhere only further convinces the Chinese top leaders, some "uncorrupted" Chinese intellectual elites, and larger part of the Chinese people to go a national way substantially different from the Anglo-American model and its "Chinese" version, while still keeping the native and foreign positive experiences of market economy and its healthy social implications.

Is there a crisis of confidence in U.S. national power in East Asia? In the context of some initial indications of a near future recovery of U.S. economic prowess these weeks or months, together with promises of change made by a very energetic and charismatic new President Barack Obama, "crisis" seems to be an overstatement in Japan, ROK, etc. But there are doubts, more serious than before. America's up-to-now very remarkable incompetence for years in making North Korea denuclearized or even convincingly deescalate its nuclear and missile armed endeavor, as well as in overcoming the Afghanistan and even Pakistan quagmires have strengthened them, while "the Japanese political revolution" made by victorious Democratic Party headed by now Prime Minister Hatoyama partly reflects them. Looking further into the future, governments and peoples across the Pacific may naturally doubt a financially much weakerAmerica, to say nothing about the increasing influence and strength of China as a huge rising great power (even a peaceful one), could remain in the same extent as in the past *the* leader and protector in the region. The structure of power and role can change, and is really changing, though the existing degree and direction of this change are necessary debatable. For China, because of its greater independence and magnitude, "confidence in U.S. national power in

East Asia" is not a relevant concept. China has determined to cooperate with U.S. in East Asia widely but still selectively, while it has been objectively or even in some cases subjectively "eroding" U.S. power and preponderance, sometimes at least in quite effective and low-cost ways. The most important among a few major developments in this respect since the financial crisis is in the areas of China's much increased regional financial role, the expanding regional function of its national currency RMB, and the substantial steps with greater prospect in regional multilateral economic cooperation or even integration.

International politics are relative, and most of the governments and informed people in East Asia sense more strongly than ever before the decrease of U.S. power and the increase of China's. International politics are dynamic, so relative decline of one and relative rise of another are not unchangeable, or certain and determined. International politics are a sort of comprehensive game, with their hard power and soft power aspects in numerous sub-field, and both the United State and China (together with other players) have their respective advantages and disadvantages, so that assessment of the overall game performance and balance of strength is definitely a complex matter. Often it depends more on open-ended observation, experienced intuition, and common sense.

## U.S. POLICY IN EAST ASIA AFTER THE FINANCIAL CRISIS

Jackie Newmyer
Long Term Strategy Group

· *How is U.S. policy toward East Asia likely to change—economically, diplomatically, and militarily?*
· *Will the U.S. model be challenged by an Asian alternative? and*
· *Even if the U.S. were to develop proper multilateral political institutions, do Asians expect the U.S. to muster the resources necessary to remain a key player in East Asia?*

The argument of this memorandum is that reports of the demise of U.S. preeminence in East Asia are premature. As a primary matter, while economic developments are important, it is unlikely that fallout from the financial crisis will be the exclusive driver of U.S. policy in the region for the foreseeable future. Other factors that will count include diplomatic relationships and regional strategic developments – for instance, trends in defense policy and nuclear proliferation – and American choices about how to respond. While it is natural to focus on immediate challenges and negative developments, attention to the financial crisis should not come at the expense of recognition of underlying fundamentals.

To follow the lead of the questions above and focus on the impact of economic factors first, it is worthwhile to note that basic trends in growth are favorable for the United States. By contrast, Japan's economic growth rate has for some time been lower than that of the United States and is likely to remain so. At the same time, China's economic growth, which has been much higher than that of the United States, is likely to slow in the face of demographic trends associated with the one-child policy and a decline in the amount of growth generated from rural-to-urban human capital flows as the rural proportion of the Chinese population continues to drop. As Morgan Stanley's Stephen Roach and other economists have noted, China's stimulus spending has been focused mainly on production and reviving exports, not fostering a domestic consumption market that might allow for continued growth as wages rise and gains available from changes in the labor force decline.

Aside from demographic issues that are likely to afflict Japan and China but not the United States, several other factors relevant to longer-term economic trends merit consideration. One such factor is innovative capacity, an area where the United States seems to remain a global leader. While other countries have been able to adapt and improve on new technologies pioneered in the United States, and to develop innovations of their own in particular areas, overall, the United States continues to be at the center of new developments in high technology, bio-technology, and other realms, as measured by patents awarded, Nobel Prizes won, and the ability of U.S. universities and research institutes to attract talent.

A second factor is the potential for economic disruptions arising from domestic instability, another area where the United States seems to have an advantage, at least relative to China. While the possibility of significant unrest in China remains hard to measure, it is a wild card that cannot be ruled out when considering China's economic potential, as recent events in Xinjiang appear to demonstrate. More speculatively, South Korea may over time incur costs associated with developments in North Korea that are difficult to predict but nonetheless worth bearing in mind.

A third, related factor is the allocation of government spending and its impact on national growth prospects. Here, the trends are less clear, but the United States already spends a record one fifth of GDP on healthcare. If that figure stays relatively stable or declines as a result of healthcare reform, while other countries see their healthcare costs rise in line with the American precedent and the senescence of their populations, this is likely to have an impact on relative economic growth rates.

Moving beyond economic issues, other trends in the international environment are likely to affect U.S. policies in Asia. For instance, the current modernization of the Indian and Chinese nuclear arsenals, together with developments in Southwest Asia and the Middle East, may lead to proliferation in East Asia. There will be dangers associated with the transition to a world in which there are more nuclear actors with bigger arsenals and a range of delivery systems. The United States will be concerned with managing this transition, but the burden will likely fall on local actors most threatened by the possibility of a nuclear exchange. Already, an increase in Chinese naval capabilities has been tied to proposed increases in Indian and Australian naval capabilities. Over the coming decades, to the extent that local powers will be engaged in balancing with one another, this may leave the United States with a different role in the region, but there is no reason to assume that the U.S. role in East Asia will be less important than it is today.

To conclude, claims about declining U.S. influence in East Asia in the wake of the financial crisis may be overblown. At the same time, there is a case to be made that the character of the American role in the region will change as a result of broader geostrategic developments and U.S. choices about how to respond.

# CHINA AND FINANCIAL CRISIS

Xiaoming Zhang
Peking University

## Does China wholly blame the United States for the crisis or is the blame shared?

In China, the US has been blamed for the crisis, mostly, if not wholly. It is the US where the financial crisis originated and then spread to the other parts of world. The US financial policy is one of the main targets for the Chinese critics. Many Chinese commentators argued that the US-style "debt economy" reflected by low interest rate, low saving rate, and high consumption, should be blamed for causing the crisis. The other main target for the Chinese critics is the international financial system, or the Breton Woods system, which was designed and has been dominated by the US and her partners in the West. The global financial institutions, such as the International Monetary Fund (IMF) and the World Bank, have long been dominated by the US and Europe and poorly adapted to the changing global economic geography. Further more, the US dollar has long been occupying a privileged place in the international financial system by serving as the chief foreign reserve currency which tends to result in over supply of the dollar in the world market.

On the other hand, as some Chinese economists pointed out, in a globalized world, the blame for the current financial crisis should be shared by other countries or economies, including China. Professor Zhang Weiying, the dean of Guanghua School of Management at Peking University, recently commented that we could not understand the real causes of the financial crisis unless we take the Chinese economy into consideration. According to Zhang, the swelling foreign exchange reserve in China has been providing the US with money supply which could be poured into un-limited investment. Some other Chinese analysts argued that the Chinese economic practice of high saving rate and low consumption also contributed to the global financial crisis, although China should not bear the main responsibility for the crisis.

## What lessons will China learn from the crisis and will these lessons resonate in the rest of the region?

Generally speaking, China has been much less affected by the crisis, in comparison with most of the developed countries in the world, partly because the Chinese financial system is still relatively closed as Renminbi (RMB), the Chinese currency has not fully become an international currency, and it is only convertible under the trade account, not under the capital account. But the Chinese economy did suffer a lot from the financial crisis. Firstly, as an export-oriented country, China has been experiencing a slump in its export, especially in its exports to the US and the other major developed countries. And the trade protectionism practiced by some countries (especially the US) after the outbreak of the crisis, has led to trade frictions between China and her major trade partners, or even possibly a trade war in the near future. Secondly, the drop in export resulted in a large number of layoffs in those export-oriented factories or companies in China, especially in the costal areas. The Chinese central government and local governments have to deal with the issue of unemployment in an appropriate way, in order to avoid social unrests. Finally, largely due to trade surplus, China became the largest foreign exchange reserve holder in the world (currently $2000 billion) before the crisis, but the safety of the vast foreign exchange reserves is also currently at stake. Since China has placed the bulk of its foreign exchange reserves in the low-yielding U.S. Treasury securities, quantitative easing of the U.S. Federal Reserve could inflate the value of those assets.

But the crisis also taught the Chinese some lessons which might help China find a way to the economic sustainable development. The crisis made the Chinese know that a high dependence and reliance on foreign trade and international market would result in economic fragility. Many Chinese economists therefore advocated for the expansion of Chinese domestic market. In fact, shortly after the outbreak of the crisis, the Chinese government decided to pursue proactive fiscal and moderately easy monetary policies in order to expand the domestic consumption. The 4-trillion-yuan ($586 billion) economic stimulus program was comparable to 14 percent of the gross domestic product in 2008. Through its massive stimulus and strong lending program, China has contributed to the early signs of a global recovery by keeping its growth rate up, as World Bank President Robert B. Zoellick said in Beijing on Sept.2, 2009. Further more, as some Chinese economists argued, the financial crisis provided China with a great opportunity to restructure its economy and change the way of economic growth which would make China a more creative, competitive and eco-friendly country. Finally, the crisis taught the Chinese a lesson that, in a globalized and interdependent world, international cooperation is critical to the sustainable development of an individual country's economy. China has played an active role at the G-20 summit meetings and will be expecting more input during the restructuring of the international financial system after agreeing to buy the first $50 billion of the IMF new bonds as the IMF is in dire need of resources to help it support member nations as they battle to rebound from the global financial and economic crises. During the crisis, China also signed currency swap agreements with some countries totaling 650 billion yuan (US 95.5 billion), which would help the countries concerned (most of them are China's neighboring countries in East Asia) to overcome the economic difficulties and help to lay a foundation for the RMB internationalization.

China is probably going to be the first country to get out of the global economic recession. Zoellick projected in September 2009 that the Chinese economy would grow by nearly 8 percent in 2009. The World Bank raised its forecast for China's economic growth in 2009 to 7.2 percent in June from an earlier forecast of 6.5 percent. The good performance of China in the financial crisis might enhance the Chinese confidence in the so-called "Chinese model" and increase China's soft power globally and regionally.

## THE EFFECTS OF THE FINANCIAL CRISIS ON CHINA'S STRATEGY

Mingjiang Li
Rajaratnam School of International Studies, Nanyang Technological University

The financial crisis is no doubt a turning point for China's international relations. In the past year since the financial crisis unfolded, We have seen a few unmistakable signs of China re-adjusting its international strategy to be more proactive in various international affairs and at the same time indications that Beijing also intends to maintain the continuities in many aspects of its foreign strategy.

For the former, we can point to various Chinese proposals with regard to international financial issues, the increasing role of the Chinese currency, various financial and economic assistance programs to some of the less developed countries, the more aggressive acquisition moves of Chinese state-owned energy companies, the reportedly dramatic expansion of Chinese media's influence in the world, China's more heavy-handed approach to the EU with regard to the Tibetan issue and to the US with regard to arms sales to Taiwan.

For continuities in China's foreign policy, we can look at China's refusal of the G-2 concept, reluctance to exert pressure to North Korea and Myanmar to the full extent, lack of support to Kevin Rudd's Asia-Pacific Community concept, lukewarm enthusiasm in the BRIC grouping, suspicion towards Japanese proposal of an East Asian community, and ambiguous postures on issues concerning climate change.

At present, it is not crystal clear whether and how China is going to overhaul its international strategy. What is certain is that decision makers and analysts in China have begun to ponder and are still debating on these issues. To develop more meaningful understanding of the effects of the financial crisis on China's international strategy, we need to ask these questions:

1. What has been China's strategy in the recent past (or most notable aspect of its strategy)?
2. What factors have shaped China's erstwhile strategy?
3. How the financial crisis has had and will continue to have impacts on those Chinese considerations?
4. How will Chinese decision makers re-calculate their national interests in the aftermath of the financial crisis?

China's international strategy in the past two decades has been described as "low profile" [*tao guang yang hui*]. This "low profile" strategy can be observed in many respects, for instance, largely following the established international regimes, striving for stability in relations with major powers, downplaying sensitive issues (territorial disputes), reassuring the rest of the world of its peaceful rise, and maintaining a stable regional neighborhood. But it is important to note that China has always been very active and never hesitated in protecting and pushing for its core national interests, including keeping certain level of international influence, the Taiwan issue, the Tibetan issue, human rights issues, and energy supply.

China maintained its "low profile" strategy largely because of international structural factors and domestic weaknesses. In the post-Cold War era, China was an ideologically alienated power; the strategic apprehensions towards China among major powers and regional states were not conducive for an assertive strategic posture. Plus, a proactive international strategy would require China to invest a lot of its resources in international politics and overhaul some of its doctrines in foreign policy, which China was clearly unprepared to do. Domestically, in the past two decades, the mounting socio-economic problems hardly allowed China to take on a more influential role in international politics.

Has the financial crisis fundamentally changed those circumstances? The answer is no. Not only the crisis has not changed those circumstances, Chinese decision makers now worry that the rest of the world is developing too high expectations of China in dealing with global challenges, for instance, climate change, etc. A noticeable group of Chinese analysts have expressed their concerns that China might fall into this "trap". Sober-minded Chinese leaders will be aware of the imperative of domestic economic growth and the urgency of meeting popular expectations of various welfare programs. In addition, it seems that the effect of "path dependence" of Chinese foreign policy makers is also likely to serve as a significant constraint on any major innovation in China's international strategy. Mounting domestic social unrest, now coupled with the challenges in Tibet and Xinjiang, is also likely to keep Chinese leaders busy and make them more inward-looking. Political imbroglios among the top leadership will be another constraint for China to develop any new grand international strategy.

While the preceding strategic posture is unlikely to change anytime soon, it is important to note that, first of all, the financial crisis (together with the Olympics and National Day celebrations) has provided extra confidence to Chinese leaders. The fact that the Chinese economy was able to withstand the financial earthquake and recover faster than many other major economies will be source of pride on the part of Chinese leaders. The outside world has also been impressed by the continuous growth of the Chinese economy in the crisis. Second, China is likely to attempt to strive for a larger say in economic, trade, and financial issues at the global and at the regional levels. Many Chinese moves already attest to this Chinese intent. The perception of China being the new engine of economic growth in East Asia will be further enhanced.

In conclusion, Chinese international strategy is unlikely to experience any major transformation in the coming years. However, with its new-found financial wherewithal (forex reserve), China may find itself in a better position to maneuver in international and regional politics with more options to further protect and push for its core national interests.

**Session II: The Effects of the Financial Crisis on Chinese Soft Power**
**Part II: U.S. and Regional Reactions to China's New Direction**

# WHAT WILL BE THE LONG TERM IMPACT OF CHINA'S STRATEGIC SHIFT IN ITS INFLUENCE IN ASIA?

Sukhee Han
Yonsei University

The unexpected experience of the 2008 global financial crisis has given rise to the expectations of a potential tectonic power shift from the US to China. Starting with the burst of the bubbling US domestic real estate market, the crisis has immediately spilled over to the international financial market. By witnessing the sudden paralysis of the decades-endured US-based international financial system, the world has begun to suspect the liability of the US leadership, its credibility, and its capability. Given its international standing as the sole superpower for almost two decades, the fact that the US has lost its capability to deal independently with the current financial crisis has inflicted profound damages on its leadership in the world and its credibility as the world's financial manager. Simultaneously with the decline of the US, China as an emerging power has expanded its role in managing a variety of international issues, including climate change, WMD(Weapons of Mass Destruction), the Israeli-Palestinian conflict, and the Pyongyang's nuclear threat. The global financial crisis *inter alias* has been one of the most representing issues that reflects China's rise and its growing contribution to the international financial system.

As indicated in the term "G2," both the US and China have been the most important leading states to manage international affairs since the beginning of the 21st century. However, China has presented a dual attitude to its status as G2. On the one hand, China seems to have enjoyed its upgraded status in the international stage and to have gained the confidence that China is able to be a superpower surpassing the US. But on the other hand, China has been very cautious to identify itself as G2. Chinese leaders believe that Western identification of China with G2 is nothing but an extension of the traditional containment policy. Chinese argue that China, despite its fast and efficient development for three decades, is still far behind the level of development to be considered G2. Thus, they believe that the G2 discussions in the West are intentional restraints of China's further growth, because it promotes natural sense of challenge against the growing power. In contrast to its cautious ambivalence toward the issue of G2, however, China seems to be seeking the power transition by openly challenging US leadership. As the biggest dollar holder, China has criticized the US for its mal-management of the international financial system, suspected the US for its excessive dollar-printing, and challenged the dollar as the reserve currency. Although it declined to reveal its hidden intention yet, it is not a secret that China wants to replace the current American Dollar with the Chinese Yuan as the reserve currency.

But in the East Asian regional stage, China seems to be far behind the status of the US to cause a potential power shift from the US to China. In particular, in the field of security, China cannot compete with the US. Given the global military environment at present, no single state including China can challenge the US. Even the combined military budgets of four great powers—Russia, Japan, China, and the EU—cannot surpass the amount of the US's. Considering the current situation, a power shift is beyond China's capability. In a sense, China's overt criticism toward US alliances in East Asia seems to be its only challenge against the US supremacy in the region. China has complained the US alliances are symbols of the remaining Cold War structure. Instead, China has emphasized the value of multilateral institutions. As a way to maintain regional security, China has preferred multilateralism to the alliance system. But the majority of regional leaders still believe that the US alliance system has been the major buttress to keep the existing regional balance of power. Regardless of China's preferences, the US alliances will remain intact in the region and, from this perspective, the global financial crisis has caused scanty changes in the East Asian regional balance of power.

Similar consequences have been found in the responses of China's neighboring states. Despite the US's decline and China's rise, these states have not changed their traditional support for the US. For them, the US is still a robust great power even if it is declining, while China, due to its future uncertainties, remains far behind the proven superpower. Reflecting the diplomatic situation in the region, a number of China's neighboring states have adopted the policy of hedging, in which they maintain close relationships with both the US and China, simultaneously. It is not conducive to their national interests, if they get access to one power at the cost of the other. In other words, these states continue to cooperate with the US especially in terms of military and security, while they expand their economic interactions with China. The major reason that these neighboring states still pursue a hedging strategy is that China has failed to give these states a sense of trust. As a growing power, China has succeeded in developing its economic and military hard power, but it is lacking in the soft power interactions with its neighboring states.

In the long run, many states in East Asia expect China's assertiveness in its diplomacy. Despite its consistent growth, China still is not following the conventional path of development. Instead, it continues to be committed in following the Chinese characteristics of socialism under which both socialist politics and market economy are symbiotically implemented. Given the cacophonies of China's market socialism, China's interactions with its neighboring states are increasingly assertive. In order to diplomatically address this assertiveness, China is generally recommended to adopt a soft power strategy. In order to make China's soft power felt among the citizens in the neighboring states, China has to democratize itself some time soon. Given its obduracy, however, China has thus far declined to democratize, and failed to enjoy the trust from the neighboring states. For their safety and their interest in maintaining the status quo, these states would rather keep the strategic balance between the US and China: strengthening their comprehensive relationship with the US, while expanding their economic relations with China.

## THE FINANCIAL CRISIS AND CHINESE SOFT POWER

William H. Overholt
Kennedy School of Government, Harvard University

China was better positioned to respond to the global financial crisis than key neighbors, and it was the most decisive large country in responding to that crisis. Hence it has been reaping the benefits, both economic and diplomatic. There will be some economic hangover later.

China's coast was hit hard by the crisis, with 20 million jobs lost according to official statistics and likely a far larger number in actuality, because it had emerging economic stresses that coincided with the crisis. China had been slow to move out of low-end export industries and adopt policies that would move it up-market. A combination of high and rapidly escalating inflation, spreading bankruptcies, and departure of foreign investment preceded the crisis. Beijing began to implement stressful policies, such as currency appreciation and a new labor rights law, just in time to have the painful social consequences multiplied by the financial crisis. The collapse of foreign demand eliminated inflation but drastically escalated the loss of jobs and of potential foreign direct investment.

Despite these problems, China's immediate, massive fiscal and economic stimulus revived its economy faster than any other. Programs begun long before the crisis, to develop the interior and to build domestic demand there, provided a crucial offset to the coastal crisis. Chongqing, world's largest city and the center of gravity of the effort to develop the West, has been growing its GDP at a 15.5 percent annual rate in the wake of the crisis.

China's decisive response to the crisis made it the principal partner of the U.S. in responding to the global crisis. Europe, India and Japan could not match China's decisiveness. The U.S. saw Sino-American cooperation as essential and therefore was particularly quick to repudiate campaign rhetoric about currency manipulation and other conflicts, while emphasizing common interests. This enhanced a long-emerging trend toward Sino –American cooperation on a wide range of the most crucial regional issues, including North Korean nuclear development, terrorism, crime, drugs, open trade and investment, and genetically modified crops.

The rapid recovery of China's economy made it a vital lifeline for neighboring economies, including most notably Taiwan. A flood of Chinese money reflated the Taiwan and Hong Kong stock markets, raised Hong Kong property prices to stellar levels, and began to stimulate other Asian economies. This contributed to a warming of relations with numerous countries.

The soft power consequences of the crisis are influenced by other coterminous developments. Specifically:

Beijing and Taipei shifted the balance of their relationship from one based primarily on military and diplomatic competition to one based primarily on economic cooperation. While this was a shift in the balance, not a move from black to white, the shift was transformational. It facilitated a concomitant shift in U.S. military priorities, including a reduction of U.S. expenditure on high tech weaponry that previously had been justified by calculations of a "China threat." This further enabled a broad diplomatic warming.[1]

Japan, China's principal regional rival, accelerated its rapid decline in U.S. perceptions and regional and global influence. The four post-Koizumi administrations in Japan have been uninterested in vitally needed economic reforms and new Prime Minister Hatoyama has denounced globalization and made it clear that he sees the U.S. as the principal source of disruptive globalization. While the decade started with the Armitage Report, which recommended deemphasizing relations with China and putting Japan and Japan experts at the center of U.S. foreign and security policies, by the end of the Bush administration the U.S. military was fed up with 15 years of inaction on promises regarding Futenma Air Base, the State Department was fed up with Japanese opposition to Sino-American policies on North Korea, and there was widespread despair about Japan's political immobilization and unwillingness to reform its economy. Hatoyama proposed to further disarm Japan while distancing Japan somewhat from the U.S., thereby doubly weakening Japan's strategic position. The consequence of this was a reversal of the Armitage Report: increasingly the U.S. paid lip service to Japan's primacy while doing business mainly with China. The phrase "G-2," referring to Sino-American joint leadership, remained politically incorrect but increasingly accurate.

The new Obama administration in the U.S. was less inclined than the early Bush administration to emphasize the "China threat." Notably, its new security policies were guided by Secretary of Defense Robert Gates, who had become an advocate of spending less on high-tech China-targeted weaponry even while serving the Bush administration. Under Obama, defense contractors had less political clout; their lobbying for over $100 billion of annual China-justified military expenditures was a principal driver of the China-focused military strategy under Rumsfeld. On the economic side, under a strong president with a powerful mandate, there was less necessity to defer to Congressional emphasis on currency manipulation and economic conflicts than had been the case under a weak Bush presidency—notwithstanding some new, highly political U.S. tariffs on Chinese tires.

Changes in the U.S. and Japan led China to reassess its attitude to U.S. alliances and military presence in Asia. Traditionally, during the reform period, the balance of Chinese strategic opinion had been that U.S. bases and alliances contributed to stability and therefore were a net positive for China—notwithstanding considerable ideological public rhetoric to the contrary. The advent of a U.S. national security policy dominated by Cheney and Rumsfeld, and of a Japanese foreign policy dominated by the Abe-Aso right wing and highlighted by revisionist history and visits to the Yasukuni Shrine, changed that predominant view. The U.S.-Japan alliance became an alliance of the far rights in the two countries, and the servant of a Japanese view that the way to keep Japan up in global influence was to leverage the U.S. to keep China down. The 2 + 2 agreement of February 2005 formally brought Taiwan under the U.S.-Japan alliance. China concluded that, after all, U.S. bases and alliances were predominantly a threat. All this changed back as the Obama administration adopted a less militarized policy toward China, Aso sought to reduce tensions with China, Hatoyama sought China's cooperation in an Asian system that would reduce U.S. dominance, and the Ma administration in Taiwan reduced cross-Straits tensions. By mid-2009 Chinese foreign policy advisors were once again saying that U.S. bases and alliances in Asia contribute to stability and are a net positive for China. The parallel amendments of U.S. strategy and Chinese strategic assessments make U.S.-China strategic relations far less of a zero-sum game.

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[1] For an example of the warmer tone, see for instance Deputy Secretary of State James Steinberg's speech, "East Asia and the Pacific: Administration s Vision of the U.S.-China Relationship," to the Center for a New American Security" on September 24, 2009.

Finally, a mutual drive began to converge U.S. and Chinese policies on climate change. Long-term interests are identical: the planet must be saved. Short and medium term interests diverge sharply. The gap was too large to bridge overnight, but Chinese intellectual leaders began to speak of an era when the U.S. would develop decisive environmental technologies, China would finance them, and Chinese imports of such technologies would begin to narrow the trade gap. Speeches by Obama and Hu at the September U.N. conference on climate change reflected a determination to reach out toward one another.

Notwithstanding those auspicious trends, the two militaries remained mutually distrustful, trade and intellectual property issues remained contentious, Americans continued to be alienated by China's lack of human rights and democracy, and a protectionist Obama decision on tire imports (termed economic "vandalism" by *The Economist*) threatened to set off a mini-trade war. China faces significant, but not crippling, future problems created by bad stimulus projects, asset inflation, and persistent inability to replace lost jobs unless the private and service sectors, badly damaged in the crisis, are vigorously revived.

With those qualifications, China's economic, diplomatic and strategic influence are rising, China's tensions with Japan and the U.S. are declining, and old rival Japan's influence is declining radically not because of Chinese strategies but rather because of self-inflicted Japanese wounds.

The big loser, gratuitously, in China's rise is not the U.S. but Japan. As Prime Minister Hatoyama seeks to roll back globalization, and LDP strategists remain determined to keep China down and limit Sino-American cooperation, one is reminded of King Canute trying to push back the tides. Parallel to China's rise, South Korea is gradually leveraging its somewhat more open economy and its good relationship with China to nibble away at Japan's lunch. Samsung's gradual encroachment on Sony's turf and Hyundai's catching up with Honda in the automobile quality rankings are a microcosm of a broader economic and strategic trend. During this period neither China nor South Korea took any action designed to reduce Japan's stature. Japan did this to itself.

While it is clear that China's effective crisis response has greatly enhanced its stature in Asia and beyond, it is not yet clear whether China's leadership will be willing to accept the social stresses and loss of political levers entailed by the necessity to shift the balance between the job-creating SMEs, service companies, and private sector firms that have been so badly damaged in the crisis and the job-losing SOEs that have been the primary beneficiaries of stimulus. On this policy choice hinges the sustainability of China's soft power gains.

**Session III: Regional Repercussions-South Korea**

## SOUTH KOREA'S VIEW OF EAST ASIAN SECURITY

Chaesung Chun
Seoul National University

Although the geopolitical implications of the financial crisis are still unclear, there is a widespread concern in South Korea and East Asia that the grand security strategy of the United States might change at least for the time being. As is well known, major policy agendas of the Obama administration are overcoming the financial crisis, dealing with complex domestic issues, solving the Afghan dilemma, and coping with climate change. Under the situation where clear picture of President Obama's foreign policy doctrine and strategy is yet to be established, possible decrease of defense resources due to the financial crisis might affect the future overall strategy and East Asian security policy.

During the post-Cold War era for almost twenty years, the US grand strategy has evolved from the selective or overall engagement to the strategy of primacy under the Bush administration. There is still a debate what should be the US security strategy from now on. Neo-conservatives argue for clear and ideological strategy to consolidate the US leadership, whereas the liberal institutionalists focus more upon the role of international institutions and multilateral engagement. The change of strategic view will be followed by overall defense policy, regional strategy, and alliance policy. So far the strategies of "balance" and "hybrid warfare" are suggested for the overall defense policy.

The financial crisis, it seems, adds one more difficulty in determining the unclear future of the US security strategy. The gap between strategy and resources has been continuously illuminated in criticizing former Defense Minister Rumsfeld. With the financial crisis, possible solution might be the downsizing of strategy to fit decreasing level of military spending.

In the short term, South Koreans are concerned about the future alliance policy of the Obama administration. After experiencing fundamental changes under the Bush administration with the strategic concept of "military transformation," new strategic concepts in the future will have great impact on the ROK-US alliance. The financial crisis does not raise doubts about American commitment and intention about the alliance, but about capability. New agendas which will require the assistance and more commitment of the alliance partner such as counter-terrorism might complicate South Korea's role in Afghanistan. More involvement in economic issues and domestic affairs might lead the US administration to pay only scant attention to critical issues for South Korea such as North Korean nuclear crisis. In the face of possible power succession in the North, dealing with North Korean nuclear crisis is an impending issue. South Korean administration's suggestions of the so-called "grand bargain" may attain low level of support from Washing to for its plausibility, but also the difficult position of the US government in dealing with the financial crisis.

In the long run, South Koreans question the future power distribution of East Asia, especially the relationship between the United States and China. It is clear that power transition has been happening in East Asia, possibly departing unipolar architecture of security structure. Heated debate about the possible decline of the US is a vital issue for the future of South Korean strategy. Lacking multilateral security cooperative mechanism, South Korea has depended upon the role of the United States as the stabilizer and balancer. Weakening role of America, and the changing role and capability of the ROK-US alliance will cause fundamental debate about the strategic components of South Korea. The debate between declinists and the proponents of "the US as the default power" is not to be solved in the near future. Also whether China will continue its economic and military growth in the future is yet to be determined. Financial crisis to reveal structural problems of American system of maintaining its economy weakens South Koreans' belief in the American system to some degree. It contributed to destabilizing expectations about possible scenarios about US-China bipolarity, multi-polarity, or hopefully more cooperative multilateralism. In any case, the current South Korean security strategy will be under reexamination if the US leadership will be weakened in the future.

Uncertainty, then, coming from the impact of the financial crisis, or some other mechanisms leading to weakening of the US leadership such as the rise of China, rise of the rest, or weak points of the US itself such as infrastructure, public schools, and political system, is a concern to South Koreans. It is a structural problem that with the US leadership weakening, the security network composed of "hub and spoke" system of bilateral alliances, the role of American balancer, and the role of the United States to engage with China and Russia will fundamentally be altered. In this case, each security issue will be under slow but important changes which are critical to South Korea: the North Korean nuclear issue, the future of North Korea, peace mechanism on the Peninsula, South Korea's relationship with Japan and China, and multilateral security cooperation.

American soft power, in contrast, still holds effect in South Korea especially in the area of security. The belief of South Koreans in the role of the US in maintaining stability is firm, and the values that the US represent in security affairs, such as counter-terrorism, nonproliferation, and the maintaining of liberal democracy coincides with South Korea's core values. The joint vision of the ROK-US alliance announced in June, 2009, emphasized the future of the alliance as based on common values and mutual trust. With the Obama administration, there is general expectation that America will continue to perform it role as stabilizing the regional politics with close coordination with alliance partners. The cooperative stance of Washington in dealing with the financial crisis in G-20, and in coping with climate change has had a positive impact on South Koreans' perceptions of the US role. Decline is a relative game. If the US power declines, the next leadership should have not just hard power, but also soft power, legitimacy, and common values with South Koreans. In that sense, the US still wields considerable power upon South Koreans' perception.

# THE EFFECT OF THE CRISIS ON JAPAN

Motoshi Suzuki
School of Government, Kyoto University

· *What are the expectations in Japan of the depth and duration of the financial crisis? How does the Japanese response compare to that of other countries in the region?*
· *What lessons will Japan learn from the crisis?*
· *What are the implications of Japan's election for Japanese foreign policy, and by extension for soft power in the region?*

The 2008 financial crisis will continue to plague the Japanese economy at least till late 2009 or early 2010. In this fall, a weak recovery is slowly emerging with the risk of a double-dip recession. The economy has already been suffering a deflationary spiral with falling prices and corporate profits as well as the unemployment rate reaching the record high level of just under 6 percent—intolerably high by the Japanese standards.

As for recovery policy, the government's hands are tied: Japan is rapidly reaching the upper limit of fiscal expansion: it owes largest public debts among industrialized nations, major part of which accumulated to tackle the previous economic crisis following the burst of the asset babble in 1991. Under the aging population, the repayment burden of large public debts will be transferred to future generations, worsening long-term growth prospects. Yet, facing with the pressures for fiscal expansion from the current generation and the international community, the government has undertaken limited expansionary measures, while trying to avoid the same old mistake: the expanded public sector economy generated market distortions that resulted in the severe economic stagnation. Thus, the government's current recovery measures implemented through supplementary budgets focus on personal spending stimulus, private employment maintenance, and environmental protection. The effects of the recovery package are expected to be transitory because markets do not expect the budgets to be sustainable without significant tax increases.

With respect to a long-term growth strategy, Japan has been caught in a dilemma. The first economic crisis in the 1990s taught that the industrial policy, which had provided Japan with high growth from the 1950s through the 1980s, was no longer a viable growth strategy at the age of economic globalization. As the United States and Great Britain showed in the 1990s, a neoliberal approach, including a small government, deregulated economy, low corporate taxes, and strategic R&D, is most effective in attracting freely moving capital and human talents under globalization. In contrast, the second economic crisis in 2008 originated in the neoliberal market economies is giving the opposite lesson. Many Japanese citizens have come to believe that the structural reforms implemented by the Liberal Democratic Party (LDP) government in pursuit of a neoliberal market economy have worsened their living conditions and widened the income gaps between the rich and the poor. While both the industrial policy and the neoliberal approach have been discredited, the new government of the Democratic Party of Japan (DPJ) that defeated the LDP in the August 2009 general election needs to propose an alternative comprehensive growth strategy.

Another lessen derived from the current crisis is that the Japanese economy is connected deeply with economies of other East Asian countries. Since the American and European economies are likely to remain sluggish for several years to come, a viable recovery strategy for Japan is to expand economic ties with emerging markets in Asia that have continued to grow despite the global financial crisis by exploiting their underleveraged financial systems and insatiable domestic demands. This is a reason why the Hatoyama DPJ government has proposed the creation of an East Asian community, which, however, requires *soft power* in resolving the following questions:

An East Asian community is likely to involve not a single, but multiple agenda over trade, investment, exchange rates, development, the environment, etc. Thus, a first question for the negotiators is to exploit issue linkage and come up with an attractive institutional design that will benefit all of the concerned parties on an equitable basis.

A second question hinges on how an East Asian community will fit with the existing frameworks of regional cooperation. On international money, East Asian countries have invented the Chiang Mai initiative within which central banks of contracting states agree to swap their foreign reserves to deal with an exchange rate crisis that threatens not only the country of origin, but also its economic partners through chain reactions, as in the 1997 East Asia currency crisis. On international trade and investment, there exist bilateral FTAs and Asia Pacific Economic Cooperation (APEC). Whether an East Asian community will supplement or complement the existing institutional arrangements is a difficult question to resolve because members and approaches vary across the arrangements.

A third question concerns with whether an East Asian community will accept participation by non-East Asian countries. If it does not, a strong objection will come out especially from Washington, as in the case of APEC. The Hatoyama government will face a difficult task of balancing the multilateral approach with the bilateral one.

Finally, an East Asia community confronts the most difficult question regarding the underlying principles or core values that will constitute the community: the value question will quickly raise disagreements among East Asian states holding different political philosophies and strong respect for national sovereignty. Thus, an East Asian community is unlikely to take the EU approach of pooling and limiting of national sovereignties. It will be an entity that aggregates the members' national sovereignties with severe limits on the extents of integration and coordination.

The negotiators for building a community require a large dose of *soft power* to resolve these questions, while keeping high expectations under control.