

The Broad Trends Shaping Asia

Tobias Harris, SENIOR VICE PRESIDENT, TENEO

Bob Herrera-Lim, MANAGING DIRECTOR, TENEO

Gabriel Wildau, SENIOR VICE PRESIDENT, TENEO

Since World War 2, U.S. influence in Asia has depended on its ability¹ to deliver public goods, ranging from security relationships, to governance institutions and economic growth initiatives. The U.S. has provided technology and capital and allowed access to its markets. In addition, the U.S. fostered efforts to expand international trade and cross-border investment, as well as reforms that emphasized free markets and economic stability, while also providing a framework for its leadership.

“China has shown an increasing desire to provide regional and global leadership across various areas, as seen in the creation of the Asian Infrastructure Investment Bank and the Belt and Road Initiative.”

However, three factors have broadly changed this dynamic over the past three decades. The first and most visible one is the rise of China — first through its role in global supply chains, then as a consumer economy, and now increasingly as a provider of technology and capital. China has also shown an increasing desire to provide regional and global leadership across various areas, as seen in the creation of the Asian Infrastructure Investment Bank and the Belt and Road Initiative. Beyond their direct impacts on economies, the latter signal to leaders and elites across the region China’s institution-building capability — arguably the next crucial component in China’s ability to influence Asia.

The second factor is U.S. action, which in many parts of Asia is attributed to Washington’s excessive focus on the Middle East and the global war on terror. China’s rise was, therefore, coupled with U.S. disengagement — at least from the Asian point of view.

¹ Often in this document we refer to the U.S., though in several instances, this designation is a simplified phrase that includes not only the U.S. government but also the different players in what we would consider the U.S./Western system such as corporations, NGOs, and key investment and multilateral organizations and institutions.

A third factor is the weakened appeal of Western-linked ideas such as globalized trade, unfettered cross-border financial flows, and laissez-faire capitalism. The financial crisis in both the U.S. and Europe – the bulwarks of capitalism and globalization – the collapse of the WTO’s Doha Round, and rising concern over wealth inequality have all chipped away at the prestige of U.S. ideas and institutions.

These trends will generally continue for the near term, although political changes in the first half of this decade may still gradually shift the trajectory of Asian geopolitics over the medium term. Any U.S. administration will face significant domestic constraints in terms of being able to shift policy – which will be evident to Asian leaders as well. In addition, although China faces growth and governance risks that lower its longer-term economic outlook, its clout is firmly established, at least for the next

few years, both as a market for foreign goods and as a source of investment and technology for others. All of these changes will take place while the region’s economic profile changes. Production will no longer be concentrated in southern China or Thailand, at least for East Asian consumption. The middle class will grow outside of the traditional centers of production and finance. Both trends will have significant effects on society, including driving demands related to governance and the environment.

“The financial crisis in both the U.S. and Europe – the bulwarks of capitalism and globalization – the collapse of the WTO’s Doha Round, and rising concern over wealth inequality have all chipped away at the prestige of U.S. ideas and institutions.”

Key Investment Decisions

Globalization and trade will continue to be seen regionally as important drivers of growth and prosperity. Should the U.S. continue to pursue what countries in the region see as nationalist and transactional trade and economic policies, then they may continue to focus more on intra-regional trade. Companies will generally seek to

avoid taking sides in the U.S.-China rivalry and to maintain access to both markets, but for some companies – and perhaps whole industries – this balance will be impossible to strike. These companies will be forced into tough choices about which market they value most.

“Countries that have traditionally favored free markets and avoided ‘picking winners and losers’ will reluctantly embrace policies inspired by China.”

Industrial policy will become increasingly important in the West. Countries that have traditionally favored free markets and avoided “picking winners and losers” will reluctantly embrace policies inspired by China, such as corporate subsidies and state investment funds. This trend will create risks and opportunities for companies.

The broad change in the region’s economic profile, such as the unbundling of supply chains concentrated in China and Thailand and the continued rise or evolution of middle-class consumers, will generate significant demands for reforms in governance and investment in connections between economies.

Given the U.S.’ diminished credibility, governments in the region will be cautious in how they adjust their policy towards the next administration. The U.S. remains the most significant factor in regional geopolitics; the decisions it makes about its political, economic, and military role will influence the choices of every other power, including

China. The Trump administration had at times appeared to call for decoupling from China as part of a “New Cold War” – going beyond military competition, trade sanctions, or market access, to incorporate excluding Chinese students from U.S. universities and canceling other person-to-person exchanges. But the administration has also been inconsistent in its approach to the U.S. alliances and other regional institutions in Asia that would be a critical part of a coherent containment strategy.

A series of U.S. actions aimed primarily at allies and partners in the region undermined trust in the U.S. Trump’s decisions included withdrawal from the Trans-Pacific Partnership, the imposition of steel and aluminum tariffs, the threat to impose automobile tariffs on Japan and other allies, and the surprise suspension of the joint military exercises with South Korea. The possibility of new initiatives like the withdrawal of some troops from South Korea would deepen uncertainty about the U.S.’ presence in the region and undermine deterrence.

“The Trump administration had at times appeared to call for decoupling from China as part of a ‘New Cold War.’”

Japan's Balancing Act

The Covid-19 crisis marked the end of a period in which the Abe administration tried to balance between growth-friendly stimulus in the near term and the pursuit of fiscal sustainability over the medium term. This approach, which generally avoided politically risky budget cuts, helped reduce the budget deficit and stabilize the debt-to-GDP ratio before 2020. In 2020, the Abe government had budgeted historically large sums of money in response to the Covid-19 pandemic, most of it backed by new government bonds. The result is that the newly elected Prime Minister Yoshihide Suga, who succeeded Abe in September 2020, and subsequent leaders will likely face the same infighting between fiscal hawks and “growth firsters.”

While Japanese companies are unlikely to decouple from China, the diversification that began with the “China-plus-one strategy” in the early 2010s will likely continue, not only for geopolitical reasons but due to cost factors, new trade and investment rules, and the emergence of new fast-growing economies in South and Southeast Asia. As part of its response to the Covid-19 recession, the Abe government offered subsidies for firms that wanted to shift production from China to

Japan or elsewhere in Asia; new Prime Minister Yoshihide Suga signaled he wanted to expand this program after the number of applications greatly exceeded the funds budgeted.

Japanese companies will continue to seek profit opportunities in developing countries with younger demographic profiles than Japan.

Japanese foreign direct investment – including cross-border M&A, infrastructure projects, and other activities – will continue to provide profit opportunities for investors in fast-growing emerging markets. Consolidation within Japan's industrial sectors as demographic decline picks up pace will also continue to create opportunities for foreign investors, likely with less competition from Chinese investors due to new investment controls.

Abe's foreign policy had been premised on the idea that Japan has no alternative to a close partnership with the U.S. to guarantee its security in a rapidly changing Asia. Abe repeatedly took significant political risks – bringing Japan into TPP, pushing for constitutional reinterpretation to permit the exercise of the right of collective self-defense, gambling on a close relationship with Trump – to safeguard the U.S.-Japan relationship

and keep the U.S. engaged in the region. Changes in the trajectory of U.S.-Asia policy will therefore be felt most immediately in Tokyo. There may be signs that Japan is already bracing for a more restrained U.S. role in the region and is therefore preparing to lessen its security dependence on the U.S.

The surprise decision in June to suspend deployment of the Aegis Ashore missile defense system (purchased as part of a large package via the U.S. foreign military sales program) has led to a new debate over whether Japan should have independent strike capabilities that would allow it to counterattack against missile bases in neighboring countries. The Japanese government has already decided that its next-generation fighter will be developed indigenously.

These decisions, coming after nearly a decade of defense spending increases (which were preceded by a decade of cuts), a doctrinal shift to focus on the flexible defense of Japan's

southwestern islands, and the acquisition of new equipment and new capabilities in advanced domains (cyber and space) suggest that Japan enters the 2020s as a more capable military power than it has ever been during the postwar era.

That is not to say that Japan is prepared to break out of the U.S.-Japan alliance; Tokyo would still prefer to use its new capabilities within the alliance. Nevertheless, Japan will increasingly hedge against a rapid U.S. withdrawal from the region not only by regional powers, particularly Australia, India, and Vietnam. Domestic constraints – including lingering anti-militarist sentiment and the postwar constitution, budgetary restrictions, and demographics (which may already be limiting the Self-Defense Forces' ability to attract recruits) – will all hinder Japan's efforts to become a larger military power, leading to a continued emphasis on building partnerships across the region.

India and Convergence

Shared geostrategic priorities have led to a closer relationship between the U.S. and India. However, economic and security reforms will be important to continue the strengthened

cooperation. These relations have improved significantly over the past two decades, as their security interests have converged. The U.S. sought to preserve its clout in South Asia,

while India aimed to increase its ability, at least relatively, to protect its security and influence in the region in the context of an increasingly more powerful and influential China, while still satisfying its development objectives.

In fact, Indian Prime Minister Narendra Modi, recognizing the value of U.S. support, set out immediately after winning office to strengthen the relationship between the two countries, both at an official and personal level. Modi has invested heavily in his relationships with other leaders – from Trump and former U.S. president Obama, to Japan and Southeast Asia. He has sought to develop a network of relationships from Tokyo to Jakarta that emphasize a democratic orientation vis-à-vis an authoritarian China.

Within the past few years, the U.S. has reciprocated, significantly broadening its defense relationship and highlighting the value that it placed on its emergent and improving relationship with New Delhi through its “Indo-Pacific” strategy. The Trump administration allowed India access to defense-related technologies with a “strategic trade authorization,” which was a step further than its designation as a major defense partner under the Obama administration.

However, while Washington’s nationalistic approach to trade and immigration issues grate economically – both key issues for the Indian economy and people – they are so far insufficient to alter the broad positive trajectory of the relationship. New Delhi remains mindful of the U.S.’ seeming near-term erratic behavior on key issues such as Afghanistan and China’s growing political strength. And this is the greatest risk to the relationship – that a U.S. failure to consider India’s immediate issues could cause India to again emphasize its policy of “strategic autonomy” or non-alignment, instead of the evolving strategic partnerships of the past decade.

India’s tradition of “strategic autonomy” makes it unlikely that the U.S.-India relationship will be upgraded to a more formal treaty partnership over the coming decade, notwithstanding Indian fears of China’s burgeoning military power and assertiveness in India’s neighborhood. However, Modi’s “Act East” policy – which has mandated investments in India’s maritime security capabilities and closer relationships with ASEAN and major regional powers, especially Japan – will remain the guiding principle of Modi’s foreign and security policies.

New Delhi has often had an easier time working with other Asian powers like Japan than with the U.S. and is likely to continue to look for sympathetic partners across the region. Relations with Australia, which have heretofore lagged behind other regional partnerships, could be upgraded over the coming years. Security ties will continue to be supplemented by foreign aid and investment

links with Japan and other powers, as India seeks to avoid dependence on Chinese capital Investment Impact. India has made significant substantial progress in liberalizing its approach to foreign investment, but strong domestic interests continue to advocate protection that limits U.S. exports and investment opportunities.

Southeast Asia and South Korea

Southeast Asian countries will seek to avoid clear alignment with either the U.S. or China. Governments will seek to preserve the benefits of trade and investment relations with China. The region's governments and the powerful local elites within them recognize that while they may be apprehensive of Beijing's intentions, they may also face substantial opportunity losses if they alienate themselves economically from China. Southeast Asia will generally want to avoid being seen as choosing sides, to avoid the political and economic complications that it would generate. However, this may lead to nationalist policymaking and slow regional integration.

South Korea is a well-governed, stable, prosperous democracy, all of which could

enable it to play a leading regional role. However, despite these strengths, South Korean leaders will be hindered by long-standing constraints, including demographic decline, export dependence, and the ongoing threat posed by North Korea. The ruling Democratic Party of Korea (DPK) will be the favorite to retain the presidency when Moon Jae-in's term ends in 2022. It could benefit from the inability of conservative forces to appeal to the bulk of younger voters who feel left out of South Korea's chaebol-dominated economy. If the DPK continues to hold the presidency, it may be able to make headway on structural economic reforms to combat inequality and promote transition to new growth opportunities in information technology and clean energy.

Even if South Korea enjoys domestic political stability for most of the decade, its leadership will still face structural challenges that could inhibit its ambitions. Its fertility rate is the lowest in the world, and its population may have already peaked.

Meanwhile, any transition to a new, more inclusive growth model will struggle with the continuing dominance of the chaebol, which would be the likely beneficiaries of industrial policies to encourage new growth sectors. Finally, South Korea's export dependence not only leaves Korea vulnerable to global economic shocks but also susceptible to economic pressure from China. Economic dependence on China could complicate Seoul's foreign policy choices. South Korea has already been largely absent from discussions about a "Free and Open Indo-Pacific" and would at best be a reluctant participant in a bloc of democracies aimed at countering China's influence.

If the U.S. were to downgrade or end its alliance with South Korea and reduce its role in the region, it is more likely that South Korea would seek to play a balancing role between China and the group of middle powers centered around Japan and Australia than

joining their ranks outright. If the progressive bloc remains in power until the latter half of the decade, tensions with Japan could remain a persistent feature of Korean foreign policy, even more so if Japan continues to rearm and reduces its dependence on the U.S.

The single biggest constraint on South Korea's global role will remain North Korea, which will command an outsized share of the government's attention and remain the primary focus of its national defense. The North Korean threat means that, not unlike Japan, Seoul will work to keep the U.S. engaged in regional security, but the progressive bloc's determination to move towards deeper economic integration and eventual reunification with the north will also lead the Korean government to continue to agitate for sanctions relief that enables it to pursue inter-Korean economic cooperation. The investment climate in South Korea is unlikely to change dramatically. While stable government and investment in new growth sectors may create new profit opportunities, South Korea's export dependence and the continuing threat of a new crisis with North Korea could lead to periodic selloffs.

Conclusion

The outcome of U.S.-China competition will heavily influence the fortunes of all countries in the region. China's increasingly assertive foreign policy has sparked alarm throughout the region. Beijing's tendency for strident diplomacy and its use of coercive economic measures to exert geopolitical pressure may ultimately end up undermining Beijing's soft power. Most countries want the U.S. to continue to serve as a check against rising Chinese influence, both economically and militarily, even as they continue to pursue benefits from trade and investment links with China. But if Washington proves unwilling or unable to play this leadership role, or if U.S. leadership takes the form of pressuring Asian countries into a thorough rejection of a China alliance, Asian countries may feel they have little choice but to accept a China-led regional order. A kind of benign stalemate

in which neither Washington nor Beijing are able to reliably enforce compliance will be unsatisfactory to hardliners on both sides. But by forcing both governments into a continuous competition for support and influence, stalemate may serve as a check on the excesses of both sides. As such, it may be the best outcome the region can hope for.

“Most countries want the U.S. to continue to serve as a check against rising Chinese influence, both economically and militarily, even as they continue to pursue benefits from trade and investment links with China.”
