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Economic integration and the new strategic environment in East Asia

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Introduction

The Russian invasion of Ukraine in early 2022 shook the foundations of the post–Cold War settlement in Europe and threw a wrench into the recovery from the COVID-19 economic downturn. It also posed larger questions on the intertwined nature of national security and economic policy. A concerted effort by the United States, Europe and other allies like Australia, Japan and Singapore have isolated Russia, cutting off what was the world's eleventh largest economy from much of the world economy. Most significant, perhaps, has been the freezing of Russia's dollar reserves, held in banks around the world. This has prevented Moscow from mounting any serious attempt to defend the rouble, which has essentially lost convertibility. A sustained sanctions regime could throw the Russian economy back to Soviet-era isolation and stagnation.

The leverage that has been exerted against Russia would not have existed in the absence of a deeply integrated global economy. Without economic interdependence, the only way in which a coalition could have intervened to deter military action in Ukraine would have been militarily, a course of action that could easily have led to nuclear exchange. The geopolitical value of global interdependence has been amply demonstrated. For some, however, the calculus may seem different: the ability of the sanctions coalition to impose steep economic costs on Russia may lead them to wonder if they, too, are vulnerable to concerted action. As several of the case studies in this book demonstrate, however, these fears are largely misplaced. What distinguished the international reaction to Russia's war of aggression in Ukraine from other recent attempts to use economic coercion was that it was *coordinated* as well as concerted: multilateral and not unilateral. This is not to say that unilateral economic coercion cannot impose costs on targeted country, only that those costs are usually severely circumscribed by the operations of global markets, which enable the targets of coercion to find alternative suppliers or purchases for most goods and services.

The COVID-19 pandemic shook a world that was already undergoing profound change. The most significant geopolitical shifts have been the rise of China, and, at the same time, an increasingly inward-looking United States. Growing strategic competition between the two powers has drawn attention to the possibility that such competition may spill over into other domains. The concept of 'economic security' has gained new intellectual ground in a number of countries across the region, while shortages throughout the pandemic have led to calls for a rolling back of the internationalisation of economic production that has characterised the global division of labour in the past several decades. This has taken the form not only of internationalisation of *value* chains, in which production processes are split across international borders, often crossing multiple international borders—but also increasingly complex international *supply* chains, which encompass value chains as well as all the procedures required to deliver goods to the final consumer. These have come under major stress during the pandemic, with bottlenecks in production as well as in logistics due to lockdowns and other workforce disruptions. The major disruptions to the world economy stemming from the sanctions regime placed on Russia have only heightened the sense for many that global economic interdependence is a weakness to be managed, not an opportunity to be seized.

The economic logic of deeper integration, though, remains as compelling as ever for the region. China's transition to a high-income economy will drive growth and structural change across the region. The diversity in levels of economic development across the Asian region will ensure that China's economic transition generates opportunities, particularly in labour-intensive manufacturing, for low and middle-income economies in the region, allowing them to climb global value chains centred on China, progressing from supplying only the most basic and generally labour-intensive production inputs at the beginning of their growth trajectory to more complex and capital-intensive components as they develop. For Asian developing economies, these opportunities are too valuable to be squandered by taking sides in the strategic rivalry between China and the United States. The strategic impetus behind the founding of the Association of Southeast Asian Nations (ASEAN) was to provide collective leadership that could keep Southeast Asian nations from aligning too closely to either the communist bloc or the West. A similar logic is likely to appeal to the region even if geopolitical tensions between China and the US continue to rise. The conclusion of two major plurilateral deals, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership and the Regional Comprehensive Economic Partnership, provide new institutional platforms that join existing arrangements like Asia-Pacific Economic Cooperation (APEC) from which an agenda of deeper economic integration can be pursued.

Even before the pandemic and the Russia–Ukraine war, the geopolitical environment in which an integration agenda could be pursued was not as propitious as it has been in recent decades. The election of President Trump signalled a major inward turn in the United States. The protectionist implications of his 'America First' rhetoric were realised in a range of trade-restricting measures that mainly, though by no means exclusively, targeted China in sectors in which China was increasingly out-competing the United States. More broadly, Trump represented an American retreat from US participation in the rules-based global order—one reversed only partially by the Biden administration. Trump withdrew his country from the Paris Climate Accord, blocked progress in cooperative forums like APEC and the G7, and gravely damaged the authority and effectiveness of the lynchpin of global trade: the dispute settlement system of the World Trade Organization (WTO). While President Biden has re-joined the Paris Climate Accord, his administration has largely followed Trump's lead in stonewalling the WTO. Commerce Secretary Gina Raimondo has described the protection of the US steel industry as a question of 'national security', indicating that Trump's rhetorical and practical marrying of protectionism and national security politics is likely to considerably outlive his presidency.

The decay in the multilateral system has opened up space for some countries to attempt to use market power to exert geopolitical influence on smaller economies—though, unlike with the sanctions on Russia, the fact that coercion has been unilateral rather than plurilateral has considerably blunted their impact. China, for example, showed its displeasure at Australian calls for a World Health Organization inquiry into the origins of the COVID-19 pandemic –interpreted in Beijing as a direct insinuation of guilt and a threat to sovereignty—by imposing restrictions on a number of key Australian exports. Though, in most cases, Australian exporters were able to quickly adjust by finding alternative export markets, the case demonstrated China's willingness to deploy economic coercion for strategic ends. In 2019, Japan removed South Korea from a whitelist of countries to which sensitive products, including key inputs into Korean microchips, could be exported without authorisation. This was widely seen as retaliation for a ruling in the South Korean Supreme Court that several Japanese companies, including Nippon Steel and Mitsubishi, must pay compensation for the use of forced Korean labour during World War II, contrary to a 1965 treaty between the two countries. In both cases, the attempts to use and politicise trade controls as a geopolitical lever were not overwhelmingly successful. South Korean firms, with active support from the government, have invested heavily in domestic production capabilities to circumvent the need for Japanese inputs.

America's actions under President Trump weakened the multilateral system upon which East Asia depends. But even prior to the election of President Trump in 2016, that system had been in a state of neglect, with the United States increasingly disregarding its principles and allowing its institutions to decay. The growing gap between the global system and the global reality of changing economic power and issue areas has been a key source of stress and tension. An early manifestation of stress in the system was the patchwork of bilateral, regional and global arrangements that substituted for comprehensive multilateral reform, undermining its efficiency and effectiveness. These arrangements have the benefit that progress can be made on issues that have been neglected within multilateral arrangements, but they come at the cost of attention and diplomatic energy being directed towards more comprehensive solutions at the global level.

In global finance, for example, the rise of emerging economies has not been reflected in the governance of the International Monetary Fund (IMF). IMF quota reforms, most recently in 2015, have helped reduce these gaps but progress has been slow and piecemeal. Combined with inadequate IMF resourcing and a perceived mishandling of financial crises by the IMF, the failure to achieve necessary institutional reform has led to the creation of competing institutions and mechanisms: the Chiang Mai Initiative Multilateralization and numerous development banks at the regional level, and bilateral currency swap lines at the bilateral level. This fragmentation has seen the share of the Bretton Woods institutions in the global financial safety net fall dramatically, from 80 per cent in 1980 to less than 35 per cent in 2020.

Elsewhere in the system, the problem is that the existing framework has not kept up to date with changes in the global economy over the past few decades. A large share of international economic interactions in the twenty-first century, like services trade, foreign investment and digital trade, are more or less unaddressed by existing multilateral disciplines. If they are covered, it is in bilateral, regional and plurilateral agreements that, while they serve a valuable role in deepening economic integration, do not have the same global reach as the WTO.

Economic shocks, like the Great Depression, the global financial crisis (GFC) and the COVID-19 pandemic, commonly result in a turn towards protectionism. But there is often a delay. The Smoot-Hawley tariff increases in the United States came relatively swiftly after the crash of 1929, but the most damaging tit-for-tat protectionism took several years to spread to the rest of the world (Eichengreen and Irwin 2010). After the GFC, it took some years before President Trump's 'America First' agenda became popular enough for him to win a presidential election. It is very likely that the next decade will see more pronounced protectionist sentiment around the world, if the policy reaction to the Spanish flu of 1918 is any guide: after the last major pandemic, countries that had suffered more deaths from the flu raised tariffs faster and higher (Boberg-Fazlic et al. 2021).

The economic foundations of the peace in Asia

In the depths of WWII, a new economic architecture was conceived that would help to provide economic security to the postwar world. The failure of the settlement at Versailles after WWI, and, in particular, the slide towards protectionist imperial blocs in the interwar period, convinced major thinkers in the United States that the country's economic interests would be best served by a formalised and institutionalised version of the mostly non-discriminatory liberal trading order of the late nineteenth century. In exchange for American aid, the Allied powers agreed to commit themselves to what we now know as the multilateral system, overseen and managed by international institutions: the World Bank, the IMF, and what was then the General Agreement on Tariffs and Trade (GATT) and is now the WTO.

The major accomplishment of this system was to disentangle, to a great degree, economic and security considerations. In particular, the new disciplines limited the ability of states to deploy the classic tools of economic statecraft—sanctions, punitive tariffs and quotas, and export controls, for example. Unlike the concurrent 'arms race' between the Soviet Union and the United States, which resulted from a prisoner's dilemma-style pessimistic logic, there was a real and fruitful disarmament when it came to the tools of state economic coercion, at least within that part of the world governed by the multilateral system. By and large, the hegemony of the United States in the security sphere contributed to stability in East Asia without detracting from the positive-sum game of economic integration.

The exceptions, to a large extent, prove the rule: the multilateral system did not end up being as comprehensive as originally intended; the Cold War did see the world splinter into economic blocs, though these were much more lopsided than the interwar imperial blocs; in 1960, total exports from the Soviet-led Comecon trade bloc were less than half those of the European Economic Community alone (Kaser 1996), and very much less than total GATT-covered trade. With the exception of explicitly communist countries, Asia was part of the multilateral order. Australia, New Zealand, India, Sri Lanka, the Republic of China and Pakistan were all founding members of the GATT, while many other major regional economies were quick to join: Indonesia in 1950, Japan in 1955 and Malaysia in 1957. The countries that rejected the multilateral order, particularly North Korea and China (until the rise of Deng Xiaoping) experienced poverty and stagnation.

In Asia, the Cold War became hot in two major theatres: the Korean War and the Vietnam War, both of which pitted combatants within the multilateral order against combatants in the Comecon sphere (both North Vietnam and North Korea were observers). At the end of the period of *konfrontasi* between Malaysia and Indonesia, the formation of ASEAN in 1967 signalled a new spirit of peaceful cooperation in the region. The members of ASEAN wanted to avoid complete alignment to any of the major regional powers, as other organisations, particularly the Southeast Asia Treaty Organisation had been seen as compromised by overtly tying themselves to a superpower. This principle of non-alignment was embedded in the Zone of Peace, Freedom and Neutrality Declaration of 1971, which explicitly declared Southeast Asia to be a region that should be free from interference from other powers. The early years of ASEAN focused more on political rather than economic cooperation, but, in the 1970s, as the failures of national import substitution industrialisation were becoming obvious, the benefits of economic cooperation and liberalisation began to shape ASEAN's direction more directly. Two major reports on the Southeast Asian economy advocated trade liberalisation, albeit with very different motivations. A UNESCAP report, much influenced by Latin American efforts, suggested that trade liberalisation within ASEAN itself would create a regional market for import-substituting industries, making investment in heavy industry more profitable (Shimizu 2004). In contrast, the Asian Development Bank (ADB) report *Southeast Asia's Economy in the 1970s* strongly advocated an outward orientation, with export-sector liberalisation leading the way in broader economic reform (Drysdale 2017). Over time, the wisdom of the ADB's recommendations became obvious, as the diversity in culture, language, economic and political systems and levels of economic development meant that a form of economic regionalism that was open to the rest of Asia, and the rest of the world, would yield faster growth in Southeast Asia than one that, like European efforts at regional integration, emphasised discriminatory liberalisation.

The increasing economic integration in the region has had security payoffs. One is very simply the link between economic development and military capability. There is a strong correlation between GDP and defence spending, with most countries' military budgets remaining fairly constant as a proportion of national income. The rapid growth in the region has therefore led to a substantial increase in defence capabilities. More important, though, is that the increasingly intertwined nature of economic interactions in the region raises the cost of conflict. A study by the Organisation for Economic Co-operation and Development (OECD) suggests that, in the event of a general global retreat from integrated global value chains, Southeast Asia would suffer an immediate 10 per cent decline in income (OECD 2021). This is a lower-bound estimate of the cost of major geopolitical conflict in the region that spilled over into economic disintegration. Importantly, this scenario would inflict costs on *all* players. Economic integration is not, and has never been, a zero-sum game. Because of the imperative of economic growth in the region, none of the countries in ASEAN are likely to willingly choose to align with either the United States or China.

The challenge for the region in the medium and long-term is to preserve the spirit of this open order in a world that is becoming increasingly polarised between major powers, but in which, importantly, the most important and most dynamic parts of the economy are unavoidably international in nature and require strong, clear rules to guide market participants.

Different countries and governments conceive of security differently. The countries of ASEAN view economic integration into the global economy, including, importantly, its large neighbours, as a source of national security. That is the basis for the broader Asian ideas of collective and cooperative security. At the other extreme are some countries, like North Korea, that take the narrow view of military security above a broader conception of security that includes economic security, or prosperity. Japan in the late 1970s developed the idea of comprehensive security that was a broader conception of security, explicitly including economic integration, given its constrained military and self-defence. This book generally takes national security to include defence of the sovereign state but also the defence of economic interests, its citizens and institutions. Economics and security do not need to be trade-offs but can be complementary, and the chapters in this book examine how countries in East Asia, collectively and some individually, are navigating that challenge.

Balancing economics and security in East Asia

This volume examines the new set of circumstances, with economics and security increasingly entangled with US–China strategic rivalry, complicating international policy choices and threatening the multilateral rules-based economic order on which East Asian economic integration and cooperation is built. The first two chapters set out the nature of the problem, develop a conceptual framework that brings prosperity, national security and social cohesion together in the national interest, and examine how international cooperation can help countries preserve their international policy options. The volume then looks at the economic and strategic policy choices and pressures Australia, Japan, Indonesia, Malaysia and Vietnam face, before drawing conclusions for collective regional action and the implications for the global order.

In Chapter 2, Gordon de Brouwer describes an approach to national policymaking that goes beyond the idea of a 'trade-off' between economic growth and national security. De Brouwer suggests that policymaking must focus on three dimensions of the national interest—prosperity, security and social wellbeing—and then identify and mitigate risks to each of these in a practical way. De Brouwer applies this framework to four key policy issues facing the region: infrastructure, foreign investment and the role of foreign firms, the regulation of dual-use technology and the recovery from COVID-19. In each case, he argues, there are ways to mitigate national security risks that do not threaten prosperity or social wellbeing.

In Chapter 3, Shiro Armstrong outlines a conceptual framework for thinking about the interplay between security issues and economics, predicated on the principle that zero-sum logics apply only rarely to the intersection of economics and security. Mixed interests in this area are common. Armstrong cautions against the return of zero-sum framing in the international sphere in the context of increasing strategic rivalry between China and Japan. Armstrong points out the dangers of introducing security logic into economic policy: national security spending tends to be by necessity of the 'command and control' type, with priorities set and resources allocated by bureaucratic fiat. The focus on 'dual-use technologies' and, in the context of the COVID-19 pandemic, on supply chain resilience—and, in particular, on the idea of 'reshoring' or 'friendshoring' production—risks rolling back the primacy of market forces in large swathes of the international economy in favour of a protectionism that is married to national security objectives. Armstrong argues that this would have major deleterious impacts on both global economic prosperity and, in the long-term, national security as negative feedback loops kick in. Finally, and importantly, Armstrong demonstrates that the multilateral system offers protection for national sovereignty for small and middle powers, preserving policy space that would be encroached upon by the major powers in the absence of rules governing international economic interactions. The multilateral sanctions on Russia in response to the invasion of Ukraine help to make the clear distinction between unilateral sanctions that almost always backfire in the medium term, if not immediately, and those that are coordinated, which can bring real costs to countries that egregiously violate global norms.

In Chapter 4, Adam Triggs and Peter Drysdale examine the challenging global environment Australia finds itself in and how this has made its economic and strategic choices difficult. The chapter reflects on Australia's transition from a closed, inward-looking, protectionist economy to a more open economy after WWII. Australia's postwar growth strategy was built on integration with Asia in particular. Triggs and Drysdale make it clear that Australia's economic openness has been a source of strength. They emphasise that the policy choices to open the Australian economy to global capital and people flows have underpinned the country's specialisation and strong comparative advantage in mining and resource goods, agricultural produce, education and professional services. This economic openness has buttressed Australia's economy against economic shocks and lifted its prosperity. They highlight that openness has brought strong productivity gains and lowered the cost of living for Australians. Triggs and Drysdale also point out that Australia's international engagement has been aided and enabled through its active participation in multilateral frameworks, including the G20, Asia-Pacific Economic Cooperation and WTO. The chapter details how tensions between the United States and China have made it difficult for Australia to manage its relationships with both countries, before moving on to consider Australians' attitudes towards openness and how debates over the sources of Australia's security have played out in the country. Triggs and Drysdale scrutinise the argument that Australia should divert its trading relationships away from China and Asia towards the Five Eyes intelligence sharing countries: Canada, New Zealand, the United Kingdom and the United States. They argue that this is based on a misunderstanding of both how markets work and the role that Australia's domestic policies and institutions play in managing economic prosperity, liberty and international integration. The chapter argues that Australia's prosperity and security cannot be traded off in a binary fashion. Australia must not retreat from openness and international engagement, but, rather, attend to national weaknesses that affect the integrity of its government and the resilience of its markets, their regulation and governance.

In Chapter 5, Shiro Armstrong and Shujiro Urata analyse the response of Japan to a new strategic economic environment. Traditionally tightly aligned with Washington on the security plane while integrated in the East Asian economy, Japanese policymakers have had to grapple with a number of new challenges, including Chinese assertiveness and a new US approach of 'managed' rather than free trade with Asia. The machinery of the Japanese Government has changed to reflect this new environment, with economic and national security issues being brought together within the Japanese bureaucracy, and the establishment of an economic team within the National Security Secretariat. The concept of 'economic security' has been further embedded within the policymaking space with the creation of the Economic

Security Division within the Ministry of Economy, Trade and Industry. Economic security policymaking has emphasised managing risks around technology. A number of policy decisions suggest that this new focus on economic security could result in a rolling back of economic liberalisation. Japan has tightened the screening regime for foreign investment, further restricting what was already an unwelcoming environment for foreign direct investment. It has also imposed export controls on what it deems to be sensitive goods, targeting South Korea in particular with controls on chemical inputs to semiconductor manufacturing—a decision that has largely backfired, leading to investment in South Korea to replace the chemicals it can no longer import easily from Japan, with no obvious improvement in the Japanese semiconductor industry. As Armstrong and Urata argue, it is very far from obvious that the large economic costs of a new focus on 'economic security' as an organising concept will be outweighed by any benefits to national security. Re-emphasising Japan's traditional reliance on the open regional order, though, requires proactive efforts on the part of Japanese diplomacy to renew and reinvigorate that order.

Indonesia is the largest economy in ASEAN and one of the fulcrums of geopolitical competition in the region. As Yose Rizal Damuri, Rocky Intan and Dandy Rafitrandi argue in Chapter 6, Indonesia's traditional approach has been characterised by the principle of *bebas aktif*—that is, a 'free and active' nation that proactively defends its sovereignty and avoids conflict with major powers. The authors argue that this approach may come under strain as geopolitical competition between China and the US heats up. Indonesia's interest lies in containing the economic spillover of this competition as much as possible, while pushing ahead with regional economic cooperation—an approach that can be seen in Indonesia's role in forging the ASEAN Outlook on the Indo-Pacific in reaction to the US's attempt to wedge ASEAN with its Free and Open Indo-Pacific statement.

In Chapter 7, Shankaran Nambiar considers the political economy of Malaysia's complicated relationships with major regional powers. He argues that weak national institutions have resulted in unnecessary difficulties in addressing the security–economics nexus, with Malaysia committing to some China-backed infrastructure projects that it does not need and cannot afford, a situation that required untangling, but at a cost to the political relationship with China. This could have been avoided by more stringent public policymaking that made full use of the relevant institutional capacity. Nambiar recommends a fundamental rethinking of the institutional framework of policymaking in this area.

Thanh Tri Vo and Duong Anh Nguyen argue in Chapter 8 that Vietnam's national interest dictates that it maintain neutrality with respect to major powers, and that this militates in favour of a strategy that centres ASEAN as a buffer between it and both China and the United States. Vietnam has enjoyed spectacular economic growth over the past three decades, and this has been predicated on its increasing integration into the regional economy. At the same time, a number of security questions, and, in particular, the South China Sea issue, have complicated relations with the major powers. By participating actively within ASEAN, and strengthening its role as a cooperative body, Vietnam is able to pursue both an ambitious economic growth agenda as well as securing its national strategic interests.

In Chapter 9, Peter Drysdale, Dionisius Narjoko and Rebecca St Maria describe the role of ASEAN in managing asymmetric power relations in the region. The ASEAN model, they argue, is a significant Asian institutional innovation that effectively marshals countries of very different levels of economic development, political systems and cultural backgrounds to achieve cooperation and regional integration. The ASEAN way is sometimes criticised for being slow moving, but this, the authors argue, is one of the reasons for the organisation's historical success. ASEAN will be forced in the coming decades to confront major policy dilemmas, and this will require the grouping to take a more proactive role in shaping the region than it has to date. ASEAN's collective leadership will be necessary to shape and guide the direction of Asian integration against a backdrop of increasing geopolitical competition in the region.

In Chapter 10, Peter Drysdale, Amy King and Adam Triggs provide an analytical history of the origins of the global postwar order. They argue that British and American thinkers devised a framework that was designed to ensure both economic prosperity and security by binding members into a set of rules to govern economic interactions. The global system was contested from the beginning and was forced to evolve to accommodate new economic realities, such as the rise of Japan, which prompted the creation of the ADB. They point to new stresses in the global order, which have led to the construction of new and competing institutions and mechanisms, like bilateral swap lines and plurilateral trade agreements. While the election of President Biden means that the United States might be less hostile to the reform of global economic institutions, Drysdale, King and Triggs argue that the task of renovating the global order will fall to Asian collective leadership.

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