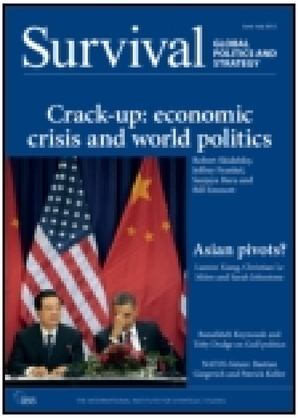

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Geo-economics and Strategy

Sanjaya Baru

Geo-economics may be defined in two different ways: as the relationship between economic policy and changes in national power and geopolitics (in other words, the geopolitical consequences of economic phenomena); or as the economic consequences of trends in geopolitics and national power. Both the notion that 'trade follows the flag' (that the projection of national power has economic consequences) and that 'the flag follows trade' (that there are geopolitical consequences of essentially economic phenomena) point to the subject matter of geo-economics.

Either way, the intellectual roots of geo-economics are embedded in seventeenth-century European, largely French, mercantilism. The military pursuit of markets, resources and bullion intended to allow a country to export more and import less, and to buy cheap and sell dear, preceded the advent of modern economics based on ideas of free trade and *laissez-faire.* While the nineteenth century was dominated by these classical economic ideas, mercantilism was never definitively buried, and has repeatedly raised its head, in inter-war Europe, for example, and most recently in China.[1] In the 1980s, the rise of Japan elicited mercantilist responses from Europe and the United States based on fears that Japan itself was rising on the back of mercantilism. Today, economic crises in Europe and North America are once again reviving latent mercantilism, with many accusing Germany and the United States of pursuing a mercantilist agenda.[2]

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In the Cold War era (1950–90), international economics and politics were marked by a conflict between the ideas of free trade and liberal democracy on the one hand, and those of statism and authoritarianism on the other, with a few countries experimenting with a mixture of the two. India, for example, mixed liberal democracy with state capitalism, while the 'Asian Tigers' (Hong Kong, Singapore, South Korea and Taiwan) and many Latin American countries combined free enterprise with military or one-party rule.

The dominant paradigm of the Cold War era, however, left politics in command, meaning that geopolitics was driven by ideological rather than purely economic factors. It is therefore no coincidence that the three most important ideas defining contemporary geo-economics were all articulated around the end of the Cold War, when a new era of international economic rivalry was being inaugurated.

The first important articulation of the new geo-economics came with Paul Kennedy's study *The Rise and Fall of the Great Powers*, published in 1987. Kennedy put forward the thesis of imperial overstretch, drawing attention to the fiscal and other economic limits on national power and its projection. As he put it,

> all of the major shifts in the world's *military–power* balances have followed alterations in the *productive* balances; and further … the rising and falling of the various empires and states in the international system has been confirmed by the outcomes of the major Great Power wars, where victory has always gone to the side with the greatest material resources.[3]

The fact that the book was written before the Cold War had definitively ended underscores its prescience.

The second important articulation of the idea of geo-economics came in Edward Luttwak's 1990 essay, 'From Geopolitics to Geo-economics: Logic of Conflict, Grammar of Commerce'. Observed Luttwak:

> Everyone, it appears, now agrees that the methods of commerce are displacing military methods – with disposable capital in lieu of firepower,

> civilian innovation in lieu of military–technical advancement, and market penetration in lieu of garrisons and bases. States, as spatial entities structured to jealously delimit their own territories, will not disappear but reorient themselves toward geo-economics in order to compensate for their decaying geopolitical roles … 'geo-economics' is the best term I can think of to describe the admixture of the logic of conflict with the methods of commerce.[4]

This argument drew attention to the nascent neo-mercantilism of the late-Cold War era, especially on the part of Japan and the architects of the European common market (ECM), a trend that was beginning to worry the United States.

A more forthright articulation of this view was to come in 1993, in Samuel Huntington's essay 'Why International Primacy Matters'. In it, Huntington extended Daniel Bell's assertion that 'economics is the continuation of war by other means',[5] setting out the bold hypothesis that

> in the coming years, the principal conflicts of interest involving the United States and the major powers are likely to be over economic issues. US economic primacy is now being challenged by Japan and is likely to be challenged in the future by Europe. Obviously the United States, Japan and Europe have common interests in promoting economic development and international trade. They also, however, have deeply conflicting interests over the distribution of the benefits and costs of economic growth and the distribution of the costs of economic stagnation or decline. The idea that economics is primarily a non-zero-sum game is a favourite conceit of tenured academics … Economists are blind to the fact that economic activity is a source of power, as well as well being. It is, indeed, probably the most important source of power and in a world in which military conflict between major states is unlikely economic power will be increasingly important in determining the primacy or subordination of states.[6]

It seemed clear that the end of the Cold War, coinciding with the rise of a new Japan, had ushered in a new era of geo-economics.[7]

Post-Cold War geo-economics

The implosion of the Soviet Union was in itself the most important geo-economic phenomenon of the post-war period. Long before the Soviet Union was actually dissolved, the economic basis for its dissolution was laid as the Russian economy began to falter. Few analysts actually predicted the dissolution of the Soviet Union, however: as late as 1987, Kennedy concluded his analysis of the paradox of Soviet economic decline combined with a military build-up by noting:

> This does *not* mean that the USSR is close to collapse, any more than it should be viewed as a country of almost supernatural strength … It is to be expected that the efforts and exhortations to improve the Russian economy will intensify. But since it is highly unlikely that even an energetic regime in Moscow would either abandon 'scientific socialism' in order to boost the economy or drastically cut the burdens of defense expenditures and thereby affect the military core of the Soviet state, the prospects of an escape from the contradictions which the USSR faces are not good.[8]

While few appreciated the inevitable geopolitical consequences of Russian economic decline, political fears related to Japan's economic rise around the same time now appear exaggerated. Many took a dim (and worried) view of what Huntington called the country's 'strategy of economic power maximisation', which, he wrote, consisted of five elements: producer dominance (opting for economic power over well-being); industry targeting (building manufacturing capability and capacity both for the domestic and export markets, with a focus on strategic, high-technology and high-value-added industries); prioritisation of market shares over profits (a deliberate strategy to invest in losses for the sake of ultimately dominating an industry); import restriction (placing curbs on imports and inward foreign direct investment); and sustained surpluses (building foreign-exchange reserves through sustained trade surpluses and by intervening in currency markets with the intention of maintaining a strong currency).[9] Many believed that Sony co-founder Akio Morita was correct in predicting that this 'neo-mercantilist' strategy was destined to produce 'a totally new configuration in the balance of power in the world. The time will never again come when America will regain its strength in industry.'[10] In Europe, fears that the continent would increasingly lose global market share to Japanese (and US firms) drove the creation of the Single Market.[11]

Interestingly, while Japan did emerge as a major economic power (for many years it was the world's second largest economy, and is still number three), it never became a geo-economic power, having failed to convert its new-found economic clout into military and political power. Thus, a Japanese initiative to stitch together a new regional grouping, the East Asian Economic Group, failed to take off. Similarly, in 1995, Japan's bid to install Bank of Japan governor Toyo Gyoten as head of the International Monetary Fund went nowhere. Tokyo's next idea, to create an Asian Monetary Fund, was also rebuffed. By the mid-1990s it was clear that, as Mark Thirlwell put it, 'Japan's challenge was fading fast'.[12] Japan's economic stagnation in the 1990s – the 'lost decade', as it has been called – is one important reason for this.[13] There were, to be sure, other reasons, well articulated in Shintaro Ishihara's angry essay, 'The Japan That Can Say No'.[14]

While Japan may have failed to translate its economic success into geopolitical power, elsewhere in Asia a key geo-economic event of the post-Cold War period, the 'Asian financial crisis', helped China to do just that. The crisis began with speculative attacks on the Thai baht in summer 1997. Within months, it had engulfed several more Southeast Asian and East Asian economies, including Indonesia and South Korea.[15] China, sensing an opportunity to leverage its geo-economic power, stepped in to extend a US$1 billion line of credit to Thailand to enable it to defend the baht. Soon afterwards, Beijing provided an additional US$3.5bn through the International Monetary Fund (IMF) to other Asian economies. Meanwhile, China ensured that the renminbi remained a rock-solid currency, maintaining a steady exchange rate even as almost all other Asian currencies devalued. According to the Chinese foreign ministry,

> the Chinese Government, with a high sense of responsibility, decided not to devaluate its Renminbi in the overall interest of maintaining stability and development in the region. It did so under huge pressure and at a

> big price. But it contributed considerably to the financial and economic stability and to the development in Asia in particular and the world at large.
>
> While sticking to its non-devaluation policy, the Chinese Government adopted the policy of boosting domestic demand and stimulating economic growth. This policy played an important role in ensuring a healthy and stable economic growth at home, easing the pressure on the Asian economy and leading it into recovery. China actively participated in and encouraged regional and international financial cooperation together with the relevant parties.[16]

As the original Asian tigers faltered and the region's laggard economies became increasingly dependent on the Chinese economy, China itself was consolidating its importance as both a major exporting power, particularly with North America and Europe, and as an importing power within Asia (of goods, resources, technology and capital).[17] By the time China entered the World Trade Organisation, with US support, in 2001, it was widely seen as a major trading nation and a geo-economic power. The subsequent restructuring of the multilateral financial institutions, especially the IMF; the creation of a new regional architecture in Asia through the Chiang Mai Initiative Multilateralisation; and the creation of an Asian bond market only enhanced China's global economic power. Today, a resource-guzzling China has seen its power enhanced still further by the effects of the 2008 transatlantic financial crisis and the ongoing European debt crisis.

Another geopolitical beneficiary of the European debt crisis has been Germany, whose economic and financial power within Europe has allowed it to acquire political power of a kind that it has not enjoyed in a long time. As Hans Kundnani put it:

> The concept of geo-economics now seems particularly helpful as a way of describing the foreign policy of Germany, which has become more willing to impose its economic preferences on others within the European Union in the context of a discourse of zero-sum competition between the fiscally responsible and the fiscally irresponsible. For example, instead

> of accepting a moderate increase in inflation, which could harm the global competitiveness of its exports, Germany has insisted on austerity throughout the eurozone, even though this undermines the ability of states on the periphery to grow and threatens the overall cohesion of the European Union. In Luttwak's terms, Germany is applying the methods of commerce within a logic of conflict.[18]

In other words, Germany, like China, has used exchange-rate policy as a means of enhancing its geo-economic power. German policy on the euro is not much different than China's consistent under-valuation of the renminbi, which, given its impact on the competitiveness of China's trade partners in Asia, has been widely viewed as a mercantilist intervention. Implicit in both China's and Germany's exchange-rate policies is a 'beggar-thy-neighbour' strategy that has helped both countries generate high current-account surpluses, while shifting the burden of adjustment to neighbouring economies. By making good use of financial crises to shift the regional (and perhaps even global) balance of power in their favour, both have emerged as the geo-economic leaders of our time. That said, the ultimate fate of the eurozone will depend to a great extent on whether it is prepared to take the next steps towards a federal fiscal system. If Germany fails to help rescue Spain and Italy in the interest of stabilising the eurozone as a whole, this could undermine the efficacy of Berlin's economic strategy from a geopolitical perspective.

Structural shifts and economic shocks

The rise of China and indeed of other emerging economies both in Asia and elsewhere denotes a structural shift in the locus of growth in the world economy, one that has already had, and will continue to generate, geopolitical consequences, along with political risks and opportunities. This long-term structural shift must, however, be distinguished from economic shocks, such as financial crises, which can have their own geo-economic consequences, sometimes accelerating the underlying structural shifts, sometimes slowing them down.[19] Moreover, the impact of economic shocks on structural shifts may be benign for some countries while malign for others. An oil shock would hurt China and India in the short-term, for example, while benefitting Russia and Iran. In the long-term, however, the structural or institutional factors that have contributed to what are now very clearly long-term shifts in the global economy in favour of China and India are likely to prove more enduring than the effects of any random economic shock.

What are the long-term factors that contribute to a country's geo-economic power? The first could be called 'knowledge power', which is linked to a country's demographic profile. Knowledge, or human capability, is the single most important attribute of power in the modern world. As Winston Churchill observed in 1946, the empires of the future will be empires of the mind.[20] Long-term demographic shifts can alter the dynamics of knowledge power, with implications for both the geo-economic and geo-political order. The decline of Japanese power vis-à-vis China, for example, is writ into the former's demographic structure. (The same could be said of India's rise.) Actual investment in human capabilities is also important, and in some cases can offset unfavourable demographic trends. So too can policies that promote in-migration. In that sense, less pluralistic and open societies may be at a disadvantage.

Another factor that has contributed to the rise of China and India, and indeed to the success of other newly industrialising economies, has been a transformation in those countries' ability to generate food and other resources required to sustain long-term economic growth. Agrarian change and increases in the productivity of land and other natural resources accelerates the pace of economic growth, facilitates industrial development and helps ensure food security. Countries with assured access to natural resources have an advantage over those dependent on imports for vital resources, especially food and energy. India's policy options widened when it graduated from what was dubbed its 'ship-to-mouth' existence (a reference to its dependence on imports for food) to greater domestic self-sufficiency following the Green Revolution. A great weakness of the erstwhile Soviet Union, on the other hand, was its inability to remain self-sufficient in food.

A direct social consequence of agrarian transformation is urbanisation and the rise of both an urban middle class and an entrepreneurial class. These trends are necessary for sustained and sustainable long-term economic growth and development. Highly unequal societies are internally fragile, which limits their external power. A vibrant middle class and an entrepreneurial class extend the range of developmental possibilities and also enable nations to build more sophisticated institutions for the management of complex challenges and trends. No nation can create and sustain a middle or entrepreneurial class overnight. But once such social development takes place, it cannot be easily reversed. In other words, these processes may be slow, but they are enduring.

Finally, even the most modern and dynamic economy requires an effective government that has the necessary financial and human resources at its command to enable it to project power. As the ancient Indian strategist Kautilya wrote, 'from the strength of the treasury the army is born'.[21] Improvements in the fiscal capacity of the state, driven by high growth and improved governance, create the resources required both for welfare and infrastructure spending and for building technological and military capability. This too is a long-term phenomenon.

Unequal societies are internally fragile

Predatory and rent-extracting states may be able to amass the resources required for a war effort or for power projection in the short term, but this is not a sustainable strategy. On the other hand, as a country's national income grows and its economic capabilities improve on a long-term and sustainable basis, its ability to garner the resources required to acquire and project power also grows. Thus, China's sustained economic growth has generated the resources required to fund an ever larger defence budget. On the other hand, economic incapacity contributed to the implosion of the Soviet Union, whose low-productivity economy was weighed down by the burden of high defence spending.

* * *

While each of these four factors – knowledge power, agrarian transformation, an active middle class and fiscal capacity – is an important determinant of a country's geo-economic and geopolitical power in the long term, in the short term countries will still be faced with unpredictable economic shocks and other risks that may have at least a temporary effect on their geopolitical trajectories. The Asian and transatlantic financial crises, as well as the European debt crisis, all had the effect of either accelerating or decelerating long-term structural shifts. Were the world to experience an energy shock today, perhaps because of a war in the Gulf, it would have a similar impact on national capabilities.

Of course, some forms of risk are more amenable to planned policy intervention than others. In its analysis of 'Global Risks 2012', the World Economic Forum identified 'severe income disparity', 'chronic fiscal imbalances', 'rising greenhouse gas emissions', 'cyber attacks' and 'water supply crises' as the top five global risks in terms of likelihood.[22] It is easy to see that the kind of policy responses that will be needed to address these risks differ both in terms of their content and in the time they will take to implement. Further, the ability of governments to deal with any one risk is contingent upon its ability to deal with another. Thus, 'chronic fiscal imbalances' can be more easily addressed if governments have the political mandate and will to redress 'severe income disparities'.

In the end, there may be a mismatch between a state's capacities and the demands placed on it by shifts in the international system. Such a mismatch may not, however, be immediately evident; that is, a country may for a time be able to exercise or project more political or military power than is warranted by its true economic capability. The Soviet Union of the 1970s is a good example. Similarly, a prosperous country may be able to exercise influence in excess of its military and geopolitical power, as Japan did in the 1980s. If a country lacks one of the four elements of geo-economic power, however, such an imbalance will not be sustainable. Eventually, the state's inability to deal with the shocks and risks that inevitably arise will expose its true geo-economic status.

Notes

1 For a discussion on mercantilism and geopolitics, see Ronald Findlay and Kevin H. O'Rourke, *Power and Plenty: Trade, War and the World Economy in the Second Millennium* (Princeton, NJ: Princeton University Press, 2007).

2 See Alen Mattich, 'German Mercantilism to Rescue the Euro', *Wall Street Journal*, 28 June 2011, http://blogs.wsj.com/source/2011/06/28/german-mercantilism-to-rescue-the-euro/; Sergio Cesaratto, 'Europe, German Mercantilism and the Current Crisis', Working Paper no. 595, Dipartimento di Economia Politica, University of Siena, http://www.econ-pol.unisi.it/dipartimento/it/node/1173; and Clyde Prestowitz, 'Mercantilism is a State of Mind', *Foreign Policy*, 16 April 2012, http://prestowitz.foreignpolicy.com/posts/2012/04/16/mercantilism_is_a_state_of_mind.

3 Paul Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict From 1500 to 2000* (New York: Random House, 1987), p. 439. Emphasis in original.

4 Edward Luttwak, 'From Geopolitics to Geo-economics: Logic of Conflict, Grammar of Commerce', *National Interest*, no. 20, 1990, p. 18.

5 Daniel Bell, 'Germany: The Enduring Fear', *Dissent*, vol. 37, no. 4, Fall 1990, p. 466.

6 Samuel Huntington, 'Why International Primacy Matters', *International Security*, vol. 18, no. 4, Spring 1993, pp. 71–2.

7 See, for example, Mark P. Thirlwell, 'The Return of Geo-economics: Globalisation and National Security', Lowy Institute for International Policy, September 2010, http://www.lowyinstitute.org/Publication.asp?pid=1388; Klaus Solberg Soilen, 'The Shift from Geopolitics to Geoeconomics and the Failure of our Modern Social Sciences', paper presented at the TELOS conference, New York, 2010, available from the Electronic Research Archive of Blekinge Institute of Technology, http://www.bth.se/fou/; Michael D. Ward and Peter D. Hoff, 'Analysing Dependencies in Geo-economics and Geo-politics', June 2007, available at http://www.duke.edu/web/methods/pdfs/mannheim.pdf.

8 Kennedy, *The Rise and Fall of Great Powers*, p. 513. Emphasis in original.

9 Samuel Huntington, 'Why International Primacy Matters', *International Security*, vol. 18, no. 4, Spring 1993, pp .73–5.

10 Quoted by Huntington in *ibid.*, p. 75.

11 See Paolo Cecchini, *The European Challenge, 1992: The Benefits of the Single Market* (London: Wildwood House, 1988). German re-unification following the end of the Cold War also contributed to the expansion of the EU and a surge towards greater economic and monetary integration within it.

12 Thirlwell. 'The Return of Geo-economics', p. 10.

13 See Tim Callen and Johnathan D. Ostry (eds), *Japan's Lost Decade: Policies for Economic Revival* (Washington DC: International Monetary Fund, 2003).

14 Shintaro Ishihara, 'The Japan That Can Say No' (New York: Simon & Schuster, 1991).

15 For a detailed discussion of the geo-economics and geopolitics of the Asian financial crisis see chapter 30, 'The Asian Economic Crisis and India's External Economic Relations', in Sanjaya Baru, *Strategic Consequences of India's Economic Performance* (Abingdon: Routledge, 2007), pp. 258–69.

16 Ministry of Foreign Affairs of the People's Republic of China, 'Pro-Active Policies by China in Response to Asian Financial Crisis', 17 November 2000, http://www.fmprc.gov.cn/eng/ziliao/3602/3604/t18037.htm.

17 For a discussion of China's rising profile as a trading power in its neighbourhood, see chapter 38, 'India, China and the Asian Neighbourhood: Issues in External Trade and Foreign Policy', in Baru, *Strategic Consequences of India's Economic Performance*, pp. 330–45.

18 Hans Kundnani, 'Germany as a Geo-economic Power', *Washington Quarterly*, Summer 2011, p. 41, available at http://www.twq.com.

19 On a more detailed consideration of such long-term shifts, see Angus Maddison, *The World Economy: A Millennial Perspective* (Paris: OECD, 2001).

20 Winston Churchill, Speech at Harvard University, 6 September 1943, quoted by Adrian Wooldridge in 'The Battle for Brainpower', *Economist*, 5 October 2006, http://www.economist.com/node/7961894.

21 Kautilya, *Arthasastra*, originally published circa 400 BC; this edition edited by Jawahar Mulraj (Pune: Hinduja Foundation & Ameya Prakashan, 2005), p. 178. This is an idea that informs Paul Kennedy's theory of 'imperial overstretch' and Niall Ferguson's hypothesis about the 'square of power' as discussed in his *The Cash Nexus: Money and Power in the Modern World, 1700–2000* (London: Allen Lane, 2001).

22 World Economic Forum, *Global Risks 2012* (Geneva: World Economic Forum, 2012), p. 11, http://www3.weforum.org/docs/WEF_GlobalRisks_Report_2012.pdf.