THE G4:
UNDIMINISHED EXPECTATIONS
GEOPOLITICAL RIVALRY OR RAPPORT?

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Executive Summary

Rivalry or rapport?
The geopolitical implications of G4 growth

For the past decade, China, America, India and Japan have boasted the world's four largest economies, measured at purchasing-power parity (PPP) [1]. For that reason, we call them the G4. Trade and investment are binding these economies closer together. But their increasing economic intimacy coexists with an uneasy geopolitical rivalry.

In a series of white papers, we have explored the G4's economic prospects over the rest of this decade. Those prospects have dimmed substantially, according to many commentators [2]. This conclusion is, however, too hasty, in our view. We are not complacent about the threats to growth, but we are also wary of premature pessimism.

We have therefore been asking ourselves an unfashionable question: what might go right? What would happen if these four countries lived up to their reformers' ambitions and began to fulfil their economic potential? To quantify these hopes, we have explored a scenario in which India's growth averages **8** percent a year until 2020, China's averages **7** percent, America's **3** percent and Japan's **2** percent. We believe these growth rates are ambitious, but not impossible; contrarian but not crazy.

[1] IMF World Economic Outlook database http://bit.ly/1KWJXGZ

[2] http://larrysummers.com/wp-content/uploads/2015/07/IMF_Rethinking-Macro_Down-in-the-Trenches-April-20151.pdf

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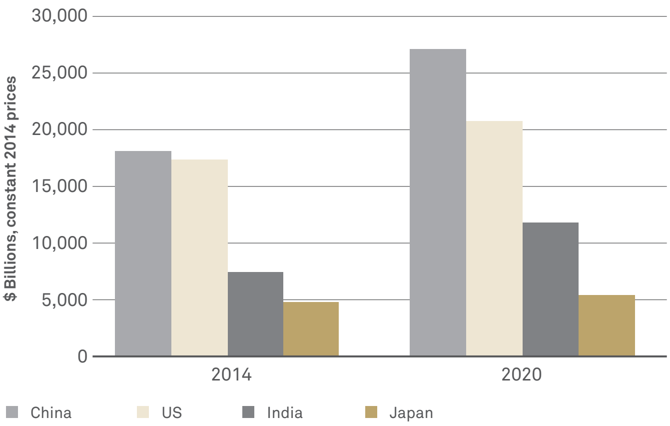
Previous papers have described the economic assumptions behind this optimistic scenario - and the possible market consequences[3]. This paper will explore the geopolitical implications. Asia, after all, is not accustomed to all four of its major powers (native and "resident"[4]) growing in confidence, power and prestige at the same time[5]. Is the region big enough for all four of them?

One might assume that economic success at home would inspire peaceful co-operation abroad. But uglier outcomes - rivalry and conflict - are also possible[6]. The "G4 geopolitics grid" below summarizes the positive and negative effects of G4 growth on the quartet's bilateral relationships.

Seven percent growth in China would bring it closer to realizing its dream of "national rejuvenation". By 2018 it would lift China's share of global GDP above its share of the global population for the first time since the 17th century[7].

GDP ($2014 PPP)

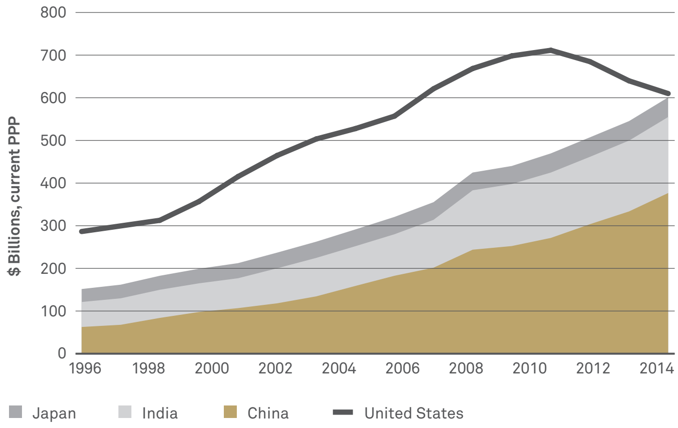


Source: BNY Mellon projections based on 2014 data from the IMF World Economic Outlook

These shifts in economic strength are driving matching shifts in military and political power. Measured at PPP[8], Asia's three big powers now spend almost as much each year on the military as the United States does.

G4 military spending

(Purchasing-power parity)



Source: BNY Mellon, based on World Bank World Development Indicators

Historians point out that when an upstart, rising power vies with a ruling power, trouble often ensues[9]. China does not have to do anything particularly unusual to disconcert its neighbors and peers. The simple fact of its size and growth will be enough to unsettle the status quo. In his book "The Rise of China versus the Logic of Strategy", Edward Luttwak likens China to a very fat man entering a crowded elevator. Even if he is affable and courteous, he cannot help but make everyone else uncomfortable. And China is not as courteous as it once was. For example, its "island-building" in the South China Sea has upset several of its neighbors, prompting a US warship in October to go out of its way not to stay out of the islands' surrounding waters.

The G4 geopolitics grid

	Sino-US		Indo-US		US-Japan	
	Positive effects	**Negative effects**	**Positive effects**	**Negative effects**	**Positive effects**	**Negative effects**
Fast US growth may:	Defuse US protectionist sentiment, including concern about currency manipulation	Allow US to commit resources to APAC; renew its self-confidence; renew the rest of the region's confidence in it	Defuse the H1B visa issue and offshoring fears	Renew Indian fears of US hegemony	Allow US to commit resources to APAC; renew its self-confidence; renew Japan's confidence in it	
Fast Chinese growth may:	Lessen the need for diversionary disputes with Japan that can entangle the US	Threaten US economic hegemony; bolster China's demands for "say and sway" [9]	Encourage India to weigh in on America's side of the balance of power	Increase China's appeal as an alternative source of investment; speed its emergence as a regional hegemon worth backing	Scare Japan into rejuvenating its alliance with America as a counterweight to a stronger China	Encourage Japan to side with China, the emerging economic hegemon
Fast Indian growth may:		Increase India's credibility as a counterweight to China, leading to Chinese fears of encirclement	Increase India's appeal as a market and investment destination; increase its credibility as a counterweight to China	Provoke a protectionist backlash if India makes conspicuous inroads into US markets		
Fast Japanese growth may:		Embolden Abe's nationalism, heightening tensions with China, which might entangle the US			Increase Japan's appeal as a market, especially after TPP; empower Abe, who is pro-US	Embolden Abe's nationalism, heightening tensions with China, which might entangle the US; Provoke a protectionist backlash against the cheap yen

3 At constant market exchange rates and prices. See https://www.bnymellon.com/apac/en/g4/download-whitepaper.jsp

4 http://www.iiss.org/en/events/shangri%20la%20dialogue/archive/shangri-la-dialogue-2008-2906/first-plenary-session-1921/dr-robert-m-gates-bce8

5 See "Rivals" by Bill Emmott, 2008

6 "Asia's Warring States era has just begun," writes Liu Mingfu, a former colonel in the People's Liberation Army, in his ominous book "The China Dream". "Today China, Japan, and India are acting out the Wars of the Three Kingdoms over the entire continent."

7 At PPP, based on 2014 data from IMF World Economic Outlook and historical data from Angus Maddison http://www.ggdc.net/maddison/Historical_Statistics/vertical-file_02-2010.xls

8 Should we use market exchange rates or purchasing-power parities to convert military budgets into dollars? Neither is ideal. Market exchange rates, which are determined by international purchases of goods and assets, provide a better guide to a country's ability to buy military equipment and supplies that can be traded across borders. On the other hand, purchasing-power parities better reflect a country's ability to keep a given number of men under arms. India, for example, can maintain a large army more easily than can the United States, where a given salary would not stretch as far.

9 Graham Allison of Harvard has examined 16 cases over the past five centuries. In 12 of them, the result was war. He calls this pattern the Thucydides trap, named after the ancient Athenian historian who chronicled the bloody war between a rising power (Athens) and a ruling power (Sparta) in the 5th century BC.

However, past battles between rising and ruling powers were mostly wars for natural resources, trading privileges and colonial possessions. In today's nuclear age, the option of all-out war - or anything that might lead to it - is no longer available. Nor is it necessary. The world economy is not a closed space. It can expand to fit the ambitions of its constituent nations, as they achieve them. Today, upstart powers are known as "emerging markets" ripe for investment not invasion. The competition for commodities has led to oversupply not a cornered market. And territorial disputes between Asia's great powers are mostly limited to thin-aired Himalayan plateaus, barely populated islands, and half-submerged islets.

Soft power

We anticipate that the rivalry between China and the other G3 members will take more subtle forms[10]. Seven percent Chinese growth will expand its "soft power", allowing it to gain geopolitical sway through its commercial appeal and largesse. China's "One Belt, One Road" initiative is an ambitious example. We also expect China to promote the Regional Comprehensive Economic Partnership (RCEP) negotiations (to which America is not a party) and to turn the Asian Infrastructure Investment Bank (of which the US is not a member) into a full-fledged multilateral lender.

As well as increasing soft-power rivalry with the US, China's fast growth may also deepen co-operation between the US, Japan and India. To extend Luttwak's metaphor: when a fat man enters an elevator, he pushes everyone else closer together. The US and Japan have rejuvenated their relationship and both are wooing India as a potential counterweight to the Middle Kingdom. Japan's government speaks of an "arc of freedom and prosperity" that spans the democratic powers.

Eight percent Indian growth would make it even more appealing, both as a potential counterweight and as a market. But India itself will be wary of allowing democratic values to dictate its foreign friendships. Its prime minister, Narendra Modi, is, after all, under democratic pressure to drum up growth and investment, some of which may come from China. Insofar as it moves closer to Japan and the US, India will likely be drawn more by the "prosperity" arc than the "freedom" arc.

Does rivalry hurt growth - or help it?

G4 growth will, then, heavily influence the four countries' geopolitical relationships. But the causal link between growth and rivalry also runs in the other direction. Rivalry can harm growth - and perhaps sometimes help it.

The harm is easy to imagine. Diplomatic hostility, mutual suspicion and saber-rattling can be damaging to trade and investment, even if this ill-will never ripens into outright armed conflict. For example, India's fear of being encircled by China-friendly ports (the so-called "string of pearls") may prevent it taking full advantage of the Chinese investment on offer as part of the "One Belt, One Road" project.

A modicum of geopolitical rivalry can also be conducive to growth, however. China's fear of being overshadowed and intimidated by foreign powers helped inspire its economic reforms[11]. China's quest for greatness is, in turn, a powerful motivation for economic reform in Japan, India and even the United States[12]. It is hard to imagine the US and Japan signing the recently negotiated Trans-Pacific Partnership (TPP) without it[13].

This paper therefore presents evidence that inter-power rivalry and economic growth follow a kind of "geopolitical Laffer curve"[14]. Too much geopolitical tension is obviously harmful for economic growth. So (less obviously) is too little. A dash of geopolitical rivalry may be good for growth, if it motivates reforms or gives reformers the leeway they need to overcome domestic opposition.

	Sino-Indian		Sino-Japanese		Indo-Japanese	
	Positive effects	Negative effects	Positive effects	Negative effects	Positive effects	Negative effects
Fast US growth may:	Revive fears of US hegemony, encouraging India to take a balancing step towards Beijing	Delay the day China supersedes the US as the regional hegemon worth backing		Delay the day China supersedes the US as the regional hegemon worth backing		
Fast Chinese growth may:	Allow China to invest more resources in India; increase China's demand for Indian exports	Embolden China; increase its demand for commodities and water, crowding out India's own demand	Increase China's appeal as a market and source of investment; hasten its emergence as the regional hegemon worth backing	Strengthen China's power and confidence, making Japan nervous	Scare Japan into siding with India in a concert of democracies	
Fast Indian growth may:	Increase its appeal as a market and investment destination	Embolden India and stiffen its spine in border disputes		Increase India's credibility as a counterweight to China, inflaming Chinese fears of encirclement by Japan,US and India	Increase India's appeal as a market and investment destination; increase India's credibility as a counterweight to China	
Fast Japanese growth may:				Embolden Abe, who may pursue nationalist aims that anger China	Allow Japan to invest more heavily in India	

10 "The wars one must fight are political wars, economic wars, science and technology wars, diplomatic wars," as Wu Chunqiu, of the Academy of Military Sciences, has put it. http://fas.org/nuke/guide/china/doctrine/pills2/part08.htm

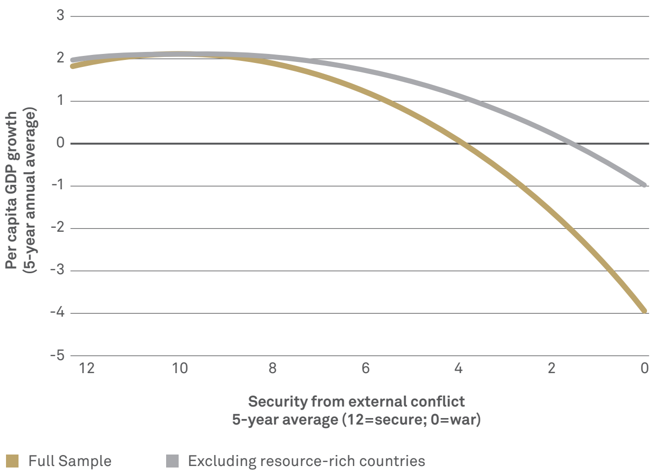
11 "If we do not develop then we will be bullied. Development is the only hard truth," said Deng Xiaoping, China's paramount leader, during his Southern Tour in 1992 "Beyond the Middle Kingdom: Comparative Perspectives on China's Capitalist Transformation", edited by Scott Kennedy. http://bit.ly/1GKy1NG

12 "It would have been impossible to find the impetus for economic reform without the inspiration of China's success…and the fear that both [China and Pakistan] could leave [India] behind," writes Shekhar Gupta in "India Redefines Its Role". Adelphi Paper 293, 1995.

13 'Obama's trade deal will not tame China' by Gideon Rachman, Financial Times, 18 May 2015

14 The original Laffer curve, drawn on the back of a napkin in 1974 by Arthur Laffer, sketched out a non-linear relationship between tax rates and tax revenues. Tax rates that are too low or too high yield little revenue, in Laffer's view. http://web.archive.org/web/20110503200219/http://www.polyconomics.com/gallery/Napkin003.jpg

The Geopolitical Laffer Curve



Source: BNY Mellon calculations, based on International Country Risk Guide; World Bank World Development Indicators

The paper arrives at three conclusions, one tentative, one firm, the third provocative.

The provocative conclusion is that geopolitical rivalry, up to a certain threshold, may not hurt growth - and may even spur reform. The firm prediction is that G4 growth will bring the US, Japan and India closer together. Our final conclusion is more tentative. We believe that the G4 scenario will intensify soft-power rivalry between the US and China, but not much more than that. The world economy is big enough for both of them. By 2020, if our optimistic growth scenario comes true, these four countries will have a combined GDP of $45 trillion[15]. That should afford them plenty of room in which to satisfy their aspirations for national prosperity, pride and prestige.

15 At 2014 prices and market exchange rates; BNY Mellon calculations, based on G4 growth assumptions and IMF World Economic Outlook 2014 figures.

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