Will Re-ARMAMENT
Wreck the 'Asian Miracle'?

The Asian miracle faces two external threats, both related to re-arming. One is that the region's arms race will trigger open hostilities. The other is that renewed conflict in the Persian Gulf will trigger an oil crisis, choking Asia's energy-hungry economies.

The immediate danger on both fronts is limited: In Asia, tangible 'peace dividends' from growth still far outweigh potential 'redistribution' losses from war, whereas in the Middle East the Arab-Israeli peace process remains on course. The long-term risks, however, are significantly greater. Asian growth will eventually decelerate, which implies a far thinner cushion to soften political disputes.

With the collapse of the Soviet Union and the end of the Cold War, disarmament and 'peace dividends' became fashionable topics. In his highly publicized book, The End of History and the Last Man, Francis Fukuyama announced that liberalism-capitalism-democracy was the winning ideological combination to which the entire world is now bound to converge. An alternative outlook was offered by Samuel Huntington, who argued that far from settling in peace, the world was heading toward a 'clash of civilizations,' with the eastern world and the Islamic countries pitted against the west.

It is too early to tell which view is right, but the answer is likely to depend on more than culture, ideology and politics. In matters of military spending and conflict, economics is no less important.

Indeed, as illustrated in Chart II-1, military spending began falling before the end of the Cold War — in the industrialized countries the downturn commenced in 1988, whereas in the developing countries it started even earlier, during the early 1980s.

The very decision to end the Cold War was rooted, at least partly, in hard economics. As illustrated in Charts II-2A and II-2B, during the 1980s, military spending by the Warsaw Pact was only 75% of NATO's, but this nevertheless absorbed up to 12% of its GDP compared with only 5% for NATO. These economic imbalances were crucial to the outcome of the Cold War. They also help explain why the countries of the former Warsaw Pact have curtailed their military spending by as much as 75% since the late 1980s, whereas NATO despite its growing military superiority, cut it by only 15%.

In the developing countries, most of the decline came from the Middle East, where military spending has dropped 56% since its 1983 peak. The main reason was falling oil revenues, suggesting that here too economics is no less important than politics.

Although the data indicate that global military spending is still heading down, there is reason to believe the downturn is now close to bottoming out. In the industrial countries, the negative implications of further demilitarization for growth and employment...
is already creating political pressure to stabilize military expenditures. And in the developing countries, where most actual conflicts are played out, some regions are already experiencing a revival of military spending. 3

The main developments to watch are in Asia and in the Middle East. The first region is now the principal

3. The industrial countries account for 60% of world military spending and are much as 95% of global military exports. According to the Stockholm International Peace Research Institute, however, of the 10 major armed conflicts waging around the world during 1995, none was in the industrial countries ( SIPRI, Yearbook, 1996, Ch. 1).

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kept permanently high, at least in comparison to the period prior the world wars.

The significance of this long-term pattern for our purpose is its close correlation with growth. If there is indeed a causal link running from military expenditure to growth, the implication is that further cuts in military spending would push economic growth to unacceptably low levels.

Political pressure to raise US military spending has grown in the last couple of years. Such pressure is bound to persist, but for the time being the risk of this being translated into a major military buildup remains limited. The principal reason is the ‘emerging-market boom’ led by Asia.

Rapid Asian growth should keep western re-arming pressures in check . . .

The growing significance of Asia is evident from Charts II-4A and II-4B. While economic growth in

the OECD countries has trended down since the 1960s, in Asia, it moved up, particularly since the mid 1980s. The divergence has become so pronounced, that although Asia accounts for only 5% of the world’s GDP, it currently generates over 1/3rd of its annual growth.

This shift has a profound impact on western business in general and on US business in particular. US-based transnational corporations now derive up to 20% of their net income from subsidiaries located in developing countries, primarily in Asia (Chart II-5). Moreover, the relative significance of US exports to developing countries in Asia has more than quadrupled — from less than 0.4% of GDP in the
early 1970s to over 1.6% presently (Chart II-6). This development is particularly fortuitous for large US corporations which were previously dependent on domestic military spending, since declining arms sales could now be ‘compensated’ by rising Asian exports. In 1996, these exports have for the first time surpassed weapon sales to the Pentagon.

Under these circumstances, where business prosperity in the US is increasingly dependent on domestic growth, the pressure to raise military spending will remain muted.

Thus, although western military spending is reaching a bottom, in the absence of a clear adversary and with Asia underwriting western profit growth, the industrial countries have no incentive for a new military buildup any time soon.

... just the Asian arms race is in full swing

The outlook for Asia is rather different. Just as it gets ready to enter the celebrated ‘Pacific Century,’ its economic ‘miracle’ looks increasingly entangled in security woes. The ghost of old conflicts is flaring-up again: a nuclear standoff between the two Koreas in 1994, a China-Philippines confrontation over the Spratlys Islands is the South China Sea during 1995, and dangerously real war games between China and Taiwan in 1995-96.
Such confrontations should not be too surprising, however. While elsewhere in the world military spending has been trending down, in Asia and the Pacific regions they are heading up (Chart II-7).

Part of this is a 'supply-side' phenomenon. East Asia’s military burden, approximated by its share of military spending in GDP, is a mere 1.8% — compared to the world's average of 3% and the slightly lower OECD average of 2.7%. This lighter load, combined with economic growth 3% times the world’s average, makes the purchase of military hardware far more 'affordable' in Asia than anywhere else. The 'demand-side,' however, is no less important.

Asia's unstable geopolitics

Many Asian countries feel they have good reasons to spend more on weapons. These reasons could be illustrated in reference to Chart II-8, which plots for every country its actual military spending, alongside the level of spending 'commensurate' to its GDP. The latter is computed by multiplying the country's GDP by the world's average ratio of military spending to GDP, currently estimated at 3%. The results provide some indication of the main 'military disequilibria' besieging Asia.

Until the collapse of the Soviet Union, the US Pacific Command assumed much of the responsibility for the security of Japan, South Korea, Taiwan and the ASEAN countries. But Russia as well as the US are now 'overburdened' by military spending (which still exceed 3% of their GDP by a wide margin), and with the risk of superpower confrontation gone, both are cutting their presence in Asia.

Against this backdrop, the main regional worry is the rise of China. The latter maintains Asia's largest army (2.9 mn), more than twice that of India, and is already the region's biggest military spender. However, China considers the US and Japan (rather than its immediate neighbors) to be its main adversaries, and relative to their military technological power, it still has a long way to go. This perceived threat, together with China's rapidly expanding GDP and relatively moderate military budget (4% of GDP), suggest that China's re-armament will continue.

The void created by declining US presence could in principle be filled by Japanese re-armament, though for the time being this is not in the cards. After the second world war, Japan's constitution put a spending cap on military spending equivalent to 1% of GDP. Although small even by regional standards, combined with Japan's rapid economic growth in the

Source: US Arms Control and Disarmament Agency

1960s and 1970s, this proportion nevertheless enabled a rapid military buildup (Chart II-7). In recent years, however, slower growth brought a sharp deceleration in military spending growth.

The only alternative, therefore, is to remove the constitutional cap. According to unoffcial sources, this has been done de facto by re-classifying some military-related spending, perhaps up to 6.5% of GDP, as civilian spending. Japan is also doing more intelligence gathering in Asia and has recently set up a spying agency with up to 2,000 new agents. And although nominally still at war, Japanese-Russian relations have been warming up recently, partly as an offset to the rise of China.

However, the troubled history of Japanese occupation in Asia during the second world war creates strong reluctance, both outside and inside
Japan, to any formal move toward re-armament. Japan’s military prowess will therefore grow, but only piecemeal and more slowly than the region as a whole.

And so, with no clear force countervailing China, the road for a regional arms race is now wide open.

Most of the smaller countries in South East Asia — primarily ASEAN, South Korea, and Taiwan — already have their military spending at or above the world average of 3% of GDP (Chart II-8), but few see an alternative to raising this burden even further.

And the South-East Asian arms race is spilling over into South Asia. There, the principal conflict has long been the India-Pakistan dispute over the contested province of Jammu and Kashmir; although this dispute is now softened by liberalization in the two countries, high military spending may well continue because of China. Partly due to the latter’s nuclear capabilities, India (which fought two border wars with China), refuses to sign the non-proliferation treaty, which in turn puts pressure on Pakistan to maintain its own (unofficial) nuclear capabilities.

Asia therefore continues to buy weapons, and the rest of the world, led by industrial countries, appears more than willing to supply them. Large segments of the Western defense sector have been bled white by the ‘peace dividend’ of the ending Cold War, and so although Asian conflict could seriously undermine western business interests there, the thirst for foreign military sales is so far proving far stronger. Political barriers on arms exports to the region are relatively minor, and Asian countries are now able to acquire most state-of-the-art military hardware.

Watch those growth figures . . .

The rapid military buildup, together with Asia’s numerous territorial disputes, suggest that the incidence of conflict could become more frequent. But there is a good reason to believe that, for the time being, such conflicts will not get out of hand.

The main reason is that conflict could spoil the benefits of growth which at this point are still too large to forego (Box II-2).

The Asian economies are growing more interdependent (Chart II-9). A decade ago, trade with the industrialized countries still accounted for over 60% of the total, but this has since dropped by almost 10%, in favor of greater intra-regional activity which now accounts for over 37%.

Notwithstanding this regional integration, external ties with the industrialized countries continue to intensify (Chart II-10). From the industrialized countries’ point of view, a rising share of their FDI is heading into Asia, while on the Asian side the domestic...
significance of this FDI is approaching 3% of GDP, up from less than 0.5% only ten years ago.

The internal and external integration of Asia means that the economic damage from local conflicts could spread far beyond its point of origin. The implication is that third countries, both inside and outside of Asia, have a strong incentive to mediate a peaceful resolution for such conflicts before they get out of hand.

Under these circumstances, the flare-up of local tension could create significant opportunities for alert investors: this has been the case in the wake of the 1994 nuclear standoff in Korea, and following the China-Taiwan war games in 1996.²

How long this environment of "militarization-without-war" can continue is of course difficult to tell. However, since the interest in reconciliation is intimately related to the perceived benefits from growth, investors can use simple rough-and-ready indicators to assess the risk of these expectations turning sour.

Chart II-11 provides two such indicators. One indicator is the ratio of FDI to profit remittances. By measuring how much foreign investors are pouring into the region relative to how much they are taking out of it, this ratio provides a barometer for long-term business expectations. Standing at 8.1, this ratio is currently way above the developing countries' average of 3.4:1, and is still rising.

However, because the FDI-to-remittances ratio is available only with a lag, it is useful to have a leading indicator for it. Such indicator is provided by the long-term moving average of Asia's growth differential Index vis-à-vis the world economy. Although investors are forward-looking, much of their future outlook is shaped by past experience. This means that long-term expectations tend to respond only

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5 EMA subscribers have been alerted to the "nuclear opportunity" in Korea in our April 1994 issue. The investment opportunity in Taiwan was picked up by our Phoenix model during its inception in October 1995 and elaborated in the Taiwan Quarterly a month later.
gradually to changing circumstances, and with a considerable lag.

The correlation, evident in Chart II-11, is between the long-term investment mood (proxied by the FDI/remittances ratio) and the growth differential underlying it, seems to confirm this logic. The contours of this correlation lead to two tentative conclusions:

1. Given that the leading growth-differential indicator is still edging up, for the next decade or so long-term expectations will likely remain high. Therefore, although militarization may well continue, the risk of this triggering open hostilities will remain limited.

2. Beyond this time range, however, all bets are off. Sooner or later, some Asian economies will begin to mature, and as this feeds into a smaller growth differential, the dividends from peace may prove too small to offset the winds of war. Of course, given that in many parts of Asia — most notably India — the urbanization process is still in its early stage, this maturation could still be far off.

However, Asia’s growth is vulnerable to an external shock which could come much earlier:

**The Middle-East energy link**

One possible trigger for such shock is another energy crisis. As illustrated in Chart II-12, over the past quarter century, Asia’s dependency on oil has risen sharply relative to the OECD, to 1970. Asian countries spent 17% more on energy for every dollar worth of GDP than did the OECD countries. But following the capital-intensive industrialization of the former and the gradual transition to labor-intensive services in the latter, the difference has risen to 19%. presently.

Now as Table II-1 indicates, Asia is highly dependent on imported oil. Thus, with the possible exception of Indonesia and Malaysia, most countries in the region will likely see their competitiveness eroded sharply in the event of an oil crisis.

This risk is illustrated in Chart II-13, which relates Asia’s trade deficit, expressed as a percent of its GDP.
overall trade (exports plus imports), with the annual change in the price of crude oil (lagged one year). The tight correlation between the two series exists because higher oil prices make Asian exports less competitive, while at the same time raising its import bill. In general, the overall effect of rising oil prices tends to be stagflationary. It chokes the economy by slowing the export sector, while concurrently putting upward pressure on prices by weakening the currency and by pushing up the cost of energy.

Because of Asia’s higher energy intensity, the stagflationary effect tends to be stronger than in the industrial countries. This makes the price of oil a good leading indicator for the relative performance of Asian emerging equity markets against those of the industrial countries (Chart II-14).

Thus, Asian equity prices suffered disproportionately following the brief oil price spike of the 1990/1 Gulf War, and were undermined again by the firming of oil prices since 1995. Clearly, if oil prices continue to move up, or if there is a new oil crisis, Asia is in for a rough ride.

How likely is such a crisis? Again, although this is difficult to answer, certain considerations are worth noting.

According to estimates published by the OECD’s International Energy Agency (IEA) and the US Energy Information Administration (EIA), rising demand for oil could require production levels in 2005 to be as much as 1/3rd higher than presently. This translates to an additional 17 mn bbl per day over today’s level of 68 mn bbl. Based on these estimates and on the geographical distribution of existing oil reserves, the US Congressional Research Service suggests that much of this new capacity will have to come from the Middle East. However, oil producers there plan to raise their daily capacity by only 6.5 mn bbl. Moreover, even that is uncertain given the estimated $120 bn price tag which the cash-hungry Persian Gulf countries may find difficult to raise. If this excess-demand scenario unfolds, the result may be a genuine oil shortage.

However, past experience suggests that proven oil reserves and production facilities are very responsive to higher prices, while demand growth could be significantly affected by greater energy efficiency and alternative energy sources. Indeed, the facts of the matter are that the

The world is yet to experience an energy crisis due to a real shortfall of oil. The more important risk is political-economic in nature. Note that all three energy crises of the post-war era where associated with military conflicts in the Middle East: the 1957 and 1973 Israeli-Arab wars, the 1979 Islamic Revolution in Iran and the 1980 onset of the Iraq-Iran War. In all three cases, the principal fear driving oil prices was not of a physical shortage of oil, but of a politically-imposed one.

With the end of the Cold War, the Middle East is no longer a theater of superpower confrontation, and regional tensions could ease further. As the Israeli-Arab peace process proves sustainable, however, a decade of depressed oil prices has heightened internal strife in the Persian Gulf, particularly in Saudi Arabia. Although petroleum prices have recovered over the past year, re-establishing political stability may require prices to remain high for a much longer period. In the interim, the crisis could return and without much prior notice.

Also, oil prices could be adversely affected by political developments in Asia. Indonesia, a large oil producer, is undergoing a successor period whose outcome is highly uncertain. And many of Asia regional disputes — most notably those in the Spratlys Islands — are directly related to oil.

**Investment Conclusions**

- World military spending is close to a bottom. Further declines in the US will be detrimental to growth and are therefore unlikely. However, a new military buildup is also not in the cards as long as Asian economic growth continues fueling US profits.
- The gradual withdrawal of Russia and the US from Asia is creating a power vacuum. The major geopolitical disequilibrium arises because China's re-arming is rapid, while for political reasons, Japan can do so only very slowly. The smaller countries therefore have no choice but to build up their own arsenals.
- For the next decade or so, however, open conflict could well be avoided. Because the "peace dividends" from rapid Asian growth remain far larger than the "re-distribuitional gains" from war, third countries outside and inside the region have a significant interest in peaceful conflict resolution.
- An environment of "militarization-without-war" is therefore likely to persist for the next decade or so. Under these circumstances, bear markets triggered by local tensions could offer significant contrarian opportunities for investors.
- The longer-term outlook is more uncertain. Asia's military arsenals are growing, and as its economies begin to mature and growth starts to taper, conflict will intensify while the imperative to resolve it peaceably weakens.
- Finally, the Asian economies are energy-intensive and for the most part dependent on imported oil. This makes their trade balance, currency and equity markets highly vulnerable to an oil crisis. The main risk for such crisis is military conflict in the Middle East or political instability in other oil producing regions, although the magnitude and timing of such risks are difficult to determine.

8 For more on the Middle East outlook, see "Israeli and South Arabian Prospects for their Transition." In the February 1996 issue of the ECA Emerging Markets Analyst, and "The Middle East: Another Reversal of Expectations?" in the January 1997 issue.