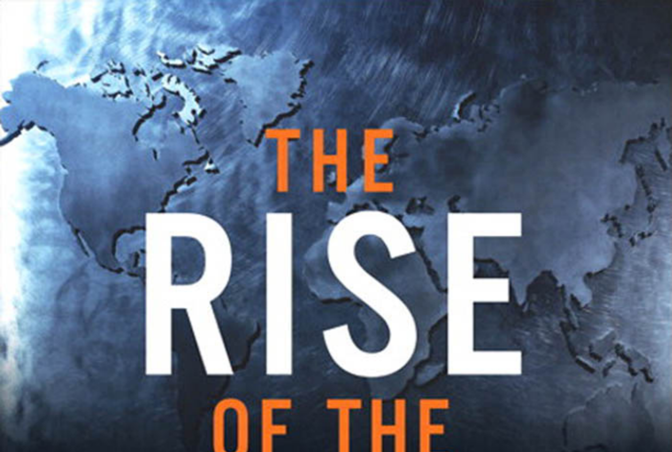

THE RISE OF THE STATE

PROFITABLE INVESTING *and* GEOPOLITICS *in the* 21st CENTURY

YIANNIS G. MOSTROUS
ELLIOTT H. GUE | DAVID F. DITTMAN

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Profitable Investing and Geopolitics in the 21st Century

Yiannis G. Mostrous,
Elliott H. Gue,
David F. Dittman

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“Events can move from the impossible to the inevitable without ever stopping at the probable.”

Alexis de Tocqueville

To our parents.

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About the Authors

Yiannis G. Mostrous is Editor of the *Silk Road Investor* (www.SilkRoadInvestor.com), a financial advisory dedicated to emerging markets, a field that he has been covering since 2001. He is also an Associate Editor of *Personal Finance*, a widely circulated financial newsletter. He has been a guest on radio shows around the country and Canada. He is a coauthor of *The Silk Road to Riches: How You Can Profit by Investing in Asia's Newfound Prosperity*. He holds an MBA degree from Marymount University.

Elliott H. Gue is Editor of *The Energy Strategist*, the premier financial advisory dedicated to energy markets, a field he has been covering since 2002. He is also editor of *Personal Finance* (www.pfnewsletter.com). He is a regular guest on "Clean Skies TV" (www.CleanSkies.com) and on radio shows in North America. He is a coauthor of *The Silk Road to Riches: How You Can Profit by Investing in Asia's Newfound Prosperity*. He holds a Masters of Finance degree from the University of London.

David F. Dittman is Editor of the *Maple Leaf Memo*, a weekly newsletter dedicated to the analysis of the Canadian economy and financial markets. He is also an Associate Editor of *Canadian Edge* (www.CanadianEdge.com), a financial advisory that identifies investment opportunities in Canada. He holds a *juris doctor* from the Villanova University School of Law.

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Past and Prologue

At a party during a trip to China in the 1930s Nikos Kazantzakis, one of the foremost writers and thinkers to emerge from Greece in the 20th century, became involved in a deep conversation with a mandarin. Kazantzakis noted that both the communists and the Japanese were advancing toward Beijing from different directions. Was the man scared? Kazantzakis asked. The mandarin, at one time China's ambassador to France, smiled. "Communism is ephemeral, Japan is ephemeral, but China is eternal," he said.

China is not new to the power game. For 500 years Imperial China was the world's preeminent force. At the height of its influence, between 1440 and 1433 AD, China's navy was the most formidable in the world in terms of sheer size as well as reach. Chinese Admiral Cheng Ho commanded ships that weighed 1,500 tons, with firepower and cargo capacity incomprehensible to his European counterparts.

Control of the seas and the extensive trade relationships it facilitated were the foundation of China's economic and political superiority. Because of a strategic decision to shift resources to strengthening its defenses against potential land invaders, by 1436 the mighty Chinese navy had been disassembled. The end of its power was not far off.

More than 500 years on and China is leading emerging economies in a rebalancing of the world's economic and geopolitical order. The increase in global trade, coupled with pragmatic leadership, set the stage for the awakening of what was a slumbering dragon. Furthermore, other countries that have also benefited from free trade and that also enjoy continentlike characteristics complement the rise of

China's star, Brazil, India, and Russia—the remaining three elements of the BRIC mosaic—are each in its own right important elements in the world's transformation.

Only in the aftermath of the crisis that nearly ruined the financial system in 2008-09 did the majority of people start understanding the growing importance of these emerging nations to global economic well-being. For the first time in financial history, major emerging economies were able not only to avoid total destruction when the developed economies were in dire straits, but also the leaders among them have actually delivered solid growth amid what was otherwise the worst economic downturn in seven decades. The relative resilience of these economies, primarily China and India, has helped the global economy absorb what would otherwise have been fatal blows.

The multiyear process that resulted in these economies playing a prominent role in stabilizing the global system, unfolded while the West was engorging itself on cheap credit and unsustainable consumption. During these fat years of self-congratulation, relatively little attention was paid by the West to the serious structural reform that Asian countries, in particular, in the wake of the regional crisis of 1997-98, had undertaken. The reality is that strong economic growth in the emerging world allowed the majority of the Anglo-Saxon economies to follow spendthrift fiscal and easy monetary policies, prolong the economic cycle on the upside, shorten it on the downside, and only delay an inevitable reckoning.

Responding to what now looms as the first in a series of upsets that will result in its eventual decline as the global hegemonic power, U.S. leaders—financial and political—managed, sadly, to discredit John Maynard Keynes in the eyes of the majority of Westerners. This result, however, springs from the vanity and hunger for power that led those who would relegate Keynesianism to history's dust heap to disregard Lord Keynes' advice in 1946 that the "classical medicine"—letting a recession run its natural course—must also be allowed to work and that government intervention would be ineffective in the long term otherwise. Our sophisticated society ignored substance in favor of superficiality and so the financial system continues to wither. Western countries, typified by the largest, the United States, lived beyond their means for too long, all the while developing a sense of invulnerability to the economic cycle and contempt for other growth models. It was not just the greed of "evil bankers" that brought the Western financial system to its knees. The greed of the public, the most dangerous of all avarice, also played a great role.

The failure of the state to effectively monitor markets beforehand led directly to inevitable, extraordinary intervention after the fact of the near-collapse of the financial system—the de jure and de facto control of the economy by the state. What we have, too, is the looming danger of moral hazard, a culture in other words of nonpayment, where everyone has recourse to a central authority. Because neither side of the great American political divide properly understands even what are considered well-known theories on the role of government in the economy, and the people who elect them aren't seriously concerned because they've effectively voted themselves rich, the door is now open, at least partially, to the destruction of the free market-based model of growth. This is the breach the West has opened.

But the crisis of 2008 also revealed that there are different ways to foster economic development, and that these varying structures can also lead to positive outcomes. Beginning in the mid-2000s serious economic researchers warned that "the cross-country evidence on the growth benefits of capital-account openness is inconclusive and lacks robustness." As the global recession that closed the decade revealed, relying less, not more, on foreign capital for growth has been a better recipe for success than the majority of economic experts and other Western commentators would have had us believe. The financial crisis demonstrated that countries that followed gradual approaches toward more open capital accounts had one less thing to worry about once the situation deteriorated rapidly in late 2008. Others, those in a hurry to follow the Holy Grail of Western financial success had significantly more exposure to cover.

Until recently a substantial part of Western elites propped up the idea that emerging economies would support the spending habits of their Western customers in perpetuity by financing their consumption via the endless purchase of bonds. These export-based economies in need of destination markets for their products had no alternative. This assumption is as false today as it was in the waning days of the 20th century when it was first advanced. What most expert commentators failed to notice was that while these economies did lend money to their Western customers, they were at the same time strengthening their own financial infrastructure.

The primary manifestation of this maturation is the rapid expansion of existing and proliferation of new sovereign wealth funds (SWF). The strong growth of these investment vehicles has set in motion a process through which emerging economies will evolve from creditors into owners. The rise of SWFs is a direct consequence of globalization. Oil-related SWFs have been around since the early 1950s; the expansion of global trade and the gradual opening of international markets have endowed nonresource-rich, export-based economies to support the creation of similar state-owned asset managers. Without free trade, SWFs would have remained what they have always been, namely a loose pool of money trying to find ways to diversify away from oil.

Asian nations have been at the forefront of this SWF process. The structural economic boom in the emerging economies has allowed new players such as China to enter the investment arena with money that's basically controlled by the state but is allocated primarily with investment returns in mind. Nevertheless, only the most naïve observer would suggest that investment decisions made by SWFs are entirely devoid of geopolitical considerations; the long-term economic development of one particular nation-state is inevitably a matter of strategic importance to its neighbors, and vice versa. Sovereign influence is a fact of international capital flows and always has been. That SWFs overtly owned by the states that sponsor them has nevertheless aroused a great deal of suspicion among the US- and EU-based commentariat.

Despite the short-term distractions caused by ambitious politicians, SWFs are here to stay. And the most significant investment development for the next decade will be SWFs soliciting funds from individual investors in their respective countries on a widespread basis. Singapore's Temasek Holdings, in the summer of 2009, was the first SWF to raise funds from institutional investors, making the next leap all the more possible to imagine. That SWFs will eventually tap their own citizens is not so far-fetched; in fact, the domestic base is theoretically preferable to foreign institutions because the latter are prone to withdraw funds for reasons other than investment performance.

Right now we can only contemplate the impact allowing, for example, Chinese to invest in China Investment Corporation (CIC), the country's primary SWF, would have on the global financial system. Apart from the pure amount of funds that would be at its disposal, this would represent yet another step toward a global system in which government plays not simply a supportive, nurturing role but a robust, active role in economic and financial decisions. Governments in the major emerging economies are already deeply entrenched in the financial game. Governments in the Western economies are, alarmingly, increasing their presence in it. Greater interconnectedness between the public and private sector is the inevitable outcome.

The rise of the state, the way it is viewed here, is about two things. First, geopolitical developments will have increasingly greater influence on the way investment funds are allocated as the coming decade unfolds. Second, government will have greater involvement in people's financial affairs—this is the great legacy the financial crisis of 2008 will leave with us.

The recent course of action undertaken by the US government provides a good example of what you should expect from duly constituted authorities around the world in the future. The US government now controls outright or has significant financial interests in some of the biggest, most important industries in the economy. It essentially owns nearly 50 percent of the domestic mortgage market. It owns an iconic automobile manufacturer. It controls large stakes in the major financial institutions that have only gotten bigger since they were deemed "too big to fail." Only hope informs the view that governmental involvement will be relatively short-lived or easily rolled back and that things will return to "normal" sooner rather than later. The financial problems the US federal and state governments face are of unprecedented proportion. The makeup of American society is also changing. The Baby Boomers—around 70 million people born between 1946 and 1960—are entering their 50s and 60s, and their financial needs are changing rapidly. Saving is now more important than spending. The idea of a safety net is a lot more personal, which makes people more amendable to the idea of greater government involvement in their financial affairs. American individual investors have stepped up their purchases of US government bonds, another indication of alignment of interests with the state and their search for income.

History clearly demonstrates that governments are reluctant to give up control of the economy. Successful challenges to authority in matters of commerce usually come from the people, during times of strong growth, as entrepreneurs struggle against burdens placed on them by the state. If, therefore, we've entered a period of structural stagnation and deregulation is viewed suspiciously by the majority of the people, it's impossible to imagine government ceding control soon.

We are in the early stages of an economic and social transformation the end of which could see governments in control over—though not owners of—the means of production. This is not a new idea. The Austrian economist Joseph A. Schumpeter discussed this outcome, in the context of a market-based economy, in his book *Capitalism, Socialism and Democracy* in the early 1940s. The liberal democracies of the West have now reached the point where implementation of a mild version of the ideas Schumpeter expressed can't be dismissed out of hand. Such a shift will be gradual and relatively seamless, through a democratic process, thus engendering relatively little opposition.

This is a book about ideas, the main one of which is that sustainable economic growth increases geopolitical power, which in turn allows for greater assertion in the pursuit of economic greatness. Consequently the investments made by the new powers, domestically and internationally, are more aggressive as well as different in nature than before.

As the book was written with the long-term investor in mind, we have identified the investment themes we believe will emerge as our forecast for the next decade. The majority of these themes share the characteristic that governmental involvement is present usually as a facilitator, but often as a partner to the private sector. Our energy theme is a good example, as governments are now more involved in every phase of the production chain, while also supporting new energy alternatives through elaborate subsidized schemes.

We also name many companies as potential investment candidates, but these recommendations are simply points of departure for more rigorous analysis the realities of time and space don't allow here.

At the same time, noninvestors will also benefit from understanding the themes we address. The political and economic rise of new powers will affect everyone. The ability to separate reality from fiction is, after all, the most useful characteristic of a citizen of a democracy.

We hope you find *The Rise of the State* a useful tool as you make your way through what is a fast-changing world, where the blurring of private and public will only increase.

Yiannis G. Mostrous
McLean, Virginia
March 2010

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Tectonic Shifts

Governments have always interfered in the investment process. Our contention is that the state's role in finance and the economy will only increase in scope and scale in the decade ahead, for two reasons.

Developed-world economies are in a precarious condition in the aftermath of the great economic collapse of 2008–09. This instability and the extreme measures required to counteract it have exacerbated stresses long-term commitments to citizens have placed on government balance sheets. A paradigm of entitlement has gripped these societies and will prove a difficult burden to shed. At the same time, rising powers feature governments that have traditionally been much more involved in financial and economic matters—practitioners of what many observers have defined as state capitalism.

Here we describe, in broad strokes, the world as it was under US dominance and how it will evolve going forward. Understanding this evolution is most important for the long-term investor. One must look no further than Central Asia to see how economic and political games today's great powers are playing in the region affect the rest of the world. Polycentricism is fast becoming the new norm among states.

Our assessment of how the world will be divided going forward is an effort to prepare the reader for the deep transformation that's already underway. We make no claim that the new financial and geopolitical order we envisage will be a better one. For Westerners, however, the new normal may not be as agreeable as the state of affairs. The example of political and economic order represented by China is a direct challenge to two centuries of accepted wisdom.

Economic and geopolitical scales are tilting eastward. Investors—and citizens—who understand and adapt will find this new world a profitable and exciting one.

In the 1980s, UK Prime Minister Margaret Thatcher was instrumental in blocking the Kuwait Investment Authority (KIA) from controlling more than 25 percent of British Petroleum. The Iron Lady objected on the grounds that she didn't want to see a national treasure owned by a foreign government. The KIA, which was owned by the Kuwaiti government, had to reduce its share of the company to less than 15 percent.

Apart from leading a revival of England's collapsed economy and injecting a dynamism that it until recently possessed, Lady Thatcher was a big proponent of capitalism. She acknowledged, however, that governments had occasionally to interfere, for a variety of potential reasons, in otherwise free markets.

History is full of examples of states intervening in the financial arena for political and economic reasons. The most characteristic examples involve the use of investments or other financial engagements as a geopolitical negotiating technique,[1] as was the case with the English East India Company and the Dutch East India Company. Both companies were founded in the early 1600s to exploit business opportunities in Asia, with initial focus on India and the Indian Ocean, respectively. Both were also involved in politics and acted as agents of the imperialistic aspirations of their countries.

Even the US, which has long projected the image of a free-enterprise haven, maintained high-tariff policies until World War II. "Freedom to trade" rather than "free trade" remains the maxim of its leaders. As recently as 2008, Germany adopted a bill that blocks non-European investors from owning more than 25 percent of a German company.

Peace and Prosperity

As World War II came to an end, the US had clearly evolved into a power financially and militarily able to lead a new era. Its isolationist pretentions were quickly put aside as the new global power was getting ready to take central stage.

President Truman, in an April 1946 speech to a joint session of Congress, observed, "The free people of the world look to us for support in maintaining their freedoms. If we falter in our leadership, we may endanger the peace of the world—and we shall surely endanger the welfare of our own nation." America's "sphere of interest" was now global.[2]

Although the US has been quick to use force in furtherance of its strategic goals, it's also responsible for important institutions with global reach. The most significant in the geopolitical arena are the North Atlantic Treaty Organization (NATO) and the United Nations (UN).

NATO may initially have been designed as its first secretary-general, Lord Ismay, allegedly said, "to keep the Russians out, the Americans in and the Germans down." In practice, it did shelter Western Europe from communism, and the threat of US power guaranteed stability—a prerequisite for economic growth.

The UN's role has been the subject of much criticism. But the UN, overall, has been a positive force in the world—even for the small countries that constantly note their underrepresentation in key decision-making circles. At the end of the day, as Paul Kennedy has observed, "We have a central, self-selected world security body that can be summoned day and night in the event of a new emergency and threat to international order. It is as strong or weak as its permanent members wish it to be. At least, the Great Powers remain inside the tent. At best, they can do great things."[3]

Mainly because of the leadership and restraint it exercised in its post-World War role as one side of a bipolar global power structure, the US has been able to exercise its military and economic power on a global scale essentially unopposed for more than 60 years. The phenomenon of economic globalization, as Baldev Raj Nayar has noted

> ...is not something that has occurred as simply the outcome of some autonomous economic process, but is fundamentally rooted in the geopolitical fact of the global reach of American military power. It is precisely the globe girdling American military presence that has provided the political framework—because of the accompanying security and stability that it assures—within which the Western regime of "embedded

liberalism" has functioned and the massive flows of post-war foreign direct investment have taken place.[4]

America's dominance was also helped by the failure of its two most important adversaries to keep up with a changing world. The Soviet Union eventually collapsed under the weight of its own misguided policies and disastrous economic planning. China suffered more than 30 years of "warlord-ism," genocide at the hands of the Japanese, financially disastrous policies, and oppression under Chiang Kai Shek. It didn't fare better under Mao Zedong, whose "Great Leap Forward" led to the starvation deaths of about 40 million Chinese. The Middle Kingdom's economy, by 1962, was decimated.

State Capitalism

As time passed US economic success, the consequences of which were greater power-projection capabilities and domination of the world's geopolitical scene, made a great impression on the rest of the world. Russia and China set out to emulate this Western model—once given the chance. China, under the guidance of Deng Xiaoping in the late 1970s, was finally able to reverse Mao's disastrous policies and establish a trajectory of economic growth the spectacular likes of which very few people around the world would dare even contemplate at the time. To its credit American leadership at the time, from 1977 and up to the presidency of George H. W. Bush, understood the implications of Deng's market-oriented reforms and, by building upon former President Richard M. Nixon's initiatives, laid a foundation that would allow American companies and investors to capitalize on opportunities in China for years to come.

Ironically, it was Mao's political instinct—a great asset during the early days of his leadership—that led him to bring Deng to Beijing in 1952. Deng was promoted rapidly to secretary general of the party. In terms of importance, he ranked behind Liu Shaoqi, then Chairman of the Standing Committee of the National People's Congress, and Zhou Enlai, the first Premier of the People's Republic of China. According to Mao's contemporaneous view, "Deng is a rare and talented man; he finds solutions. He deals with difficult problems responsibly."[5] These qualities the future leader of China would put to good use for years to come.

In the late 1980s, when the communist states in Eastern Europe were falling apart and the Chinese leadership was wracked with anxiety, Deng famously observed, "Don't be impatient; it is no good to be impatient. We should be calm, calm, again calm, and quietly immerse ourselves in practical work to accomplish something—something for China."[6] Deng's resolve to "do something for China" was a stark contrast at the time with the chaos surrounding the recently dissolved Soviet Union. The disastrous years of the Yeltsin administration, the main achievement of which was the humiliation of Russia on a global scale, pushed economic and institutional reform back by a decade. With the ascent of Vladimir Putin in 1999, Russia regrouped and began to make good use of its strategic natural resources. Proceeds from these strategic assets—contrary to past practice—have been used to secure Russia's future and to modernize its economy. The economic and geopolitical rise of the so-called BRIC countries (Brazil, Russia, India, China) demonstrates that economic growth comes wrapped in many political covers—liberal democracy is not a prerequisite for successful economic expansion. The one-size-fits-all policies advocated by Western operatives and financial zealots in the 1990s proved to be nothing more than nonsense, and actually almost destroyed countries as old and large as Russia.

The financial crisis of 2007-09 demonstrates the failure of the governments in the Anglo-Saxon sphere of economic influence to properly police the system. This failure may not destroy the capitalist model, but has altered it decisively. The failure of state agencies to perform their duties—provide a level playing field, intervene where there's foul play—was deconstructed, vividly, during Congressional hearings about the Bernard Madoff scandal.[7] When the state did intervene in the financial markets, during the years leading up to the crisis's peak in 2008, it did so in a way that invited high levels of moral hazard. The Federal Reserve's moves during the mini-crash of 1987 and the rescue of Long-Term Capital Management (LTCM) set a tone that permitted the 2007-09 bailouts that define the current era of American finance. The 1987 incident, had it been allowed to run its natural course, would not have undermined the US economy overall or the average American's economic security. But, stepping in as it did, the Fed demonstrated a reluctance to allow market forces to correct excesses. Traditionally, such excesses end with the punishment of unscrupulous, arrogant participants. As one observer noted at the time, high finance rewards success, but in the twilight years of the 20th century, it strangely protected failure as well.[8]

It was worrisome then and it's worrisome now that authorities in capitalist economies would step in to ensure endlessly rising markets. Implicit in their actions is the message that nothing can go wrong. This implied guarantee eventually almost caused the Western financial system's demise in 2008–09. This crisis revealed that for the first time in 65 years America doesn't hold all the cards in the global economic and political game.

The Great Game

For centuries Central Asia has been a key piece on the geopolitical chessboard. Its relevance peaked in the 19th century, when Great Britain and Russia vied for control of the region. Russia's desire for expansion and England's fear that the Russians were after India and access to the Indian Ocean created an explosive situation that brought the two great imperial powers to the brink of war numerous times. This competition came to be called "The Great Game."

The US, China, and Russia are the main actors in a 21st century version of The Great Game. Complicating the updated version are the natural resources that Central Asian countries have in abundance.

In 1997 Deputy Secretary of State Strobe Talbot, describing America's long-term view of the region, noted

> If economic and political reform in the countries of the Caucasus and Central Asia does not succeed—if internal and cross-border conflicts simmer and flare—the region could become a breeding ground of terrorism, a hotbed of religious and political extremism, and a battleground for outright war.
>
> It would matter profoundly to the United States if that were to happen in an area that sits on as much as 200 billion barrels of oil. That is yet another reason why conflict-resolution must be Job One for US policy in the region: It is both the prerequisite for and an accompaniment to energy development.[9]

Central Asia is home to the second-most important regional alliance in the world. The Shanghai Cooperation Organization's

(SCO) global influence is exceeded only by NATO's. The SCO, which was established June 15, 2001, includes China, Russia, Uzbekistan, Kazakhstan, Kyrgyzstan, and Tajikistan. Its secretariat is located in northeast Beijing. The SCO was formed to resolve issues between China and the states of Central Asia. It gradually expanded its reach into counterterrorism, defense, energy, and economic cooperation. The US tried to get observer status at the SCO in 2005 but was turned down. India, Iran, Mongolia, and Pakistan currently enjoy observer status.

The West has routinely dismissed the SCO as nothing more than a talk shop. But geopolitical events, particularly the US-led war in Afghanistan, have proved this assessment wrong. If countries that now hold observer status eventually attain full membership the alliance will represent more or less half of the world's population and four nuclear powers. Critically, the SCO has brought China and Russia closer together, aligning their interests, to a point, with regard to issues arising in Central Asia and beyond. The two countries have jointly voiced their opinions about global and regional issues, using the SCO as a platform. The SCO's advocates' major geopolitical argument is made in favor of "multilateral diplomacy." The organization's communiqués regularly include language that gently cautions the US about its global plans.

In late summer 2008, the heads of the SCO's member states gathered in Dushanbe, Tajikistan's capital, to discuss issues of international and regional importance.

The introduction to the official statement released following the meeting characterizes the thinking among policymakers around the world:

> In the 21st century interdependence of states has grown sharply, security and development are becoming inseparable. None of the modern international problems can be settled by force; the role of force factor in global and regional politics is diminishing objectively.
>
> Reliance on a solution based solely on the use of force faces no prospects, it hinders comprehensive settlement of local conflicts; effective resolution of existing problems can be possible only with due regard for the interests of all parties, through their involvement in a process of negotiations, not

> through isolation. Attempts to strengthen one's own security to the prejudice of security of others do not assist the maintenance of global security and stability.
>
> Search for effective response to common challenges and threats that are global in nature must be conducted in strict accordance with the UN Charter and generally accepted norms of the international law, by uniting the efforts of all states, overcoming the bloc mentality, bloc politics and unipolarity, using the means of multilateral diplomacy.
>
> The member states of the SCO believe that in modern circumstances the international security must be built on the principles of mutual trust, mutual benefit, equality and cooperation. The creation of a global antimissile defense system does not assist the maintenance of strategic balance, international efforts on weapons control and nuclear non-proliferation, strengthening of trust among states and regional stability.[10]

Central Asia is now vital to the maintenance of geopolitical stability. The rise of radical Islam and its military manifestation, jihadism, in the area is a critical danger. The US, China, Russia, and India share a common interest in drastically containing this phenomenon, the only geopolitical interest these four states share in common. US Special Representative for Afghanistan and Pakistan Richard Holbrooke said during a trip to Central Asia in February 2010:

> I think the real threat in this region is less from the Taliban but from al Qaeda, which trains international terrorists...this is an issue of common concern to the United States and to all the countries of this region. And by all the countries I definitely include Pakistan and China and India.

The war in Afghanistan makes many countries in the region important in terms of establishing supply routes for Western armies. Part of Russia's air space has been opened to Western military traffic as well, an indication that the Russian government continues to support US efforts. Russia has a keen interest in seeing militant Islam defeated or drastically contained. For this reason Russia has provided an air corridor for American and European supply lifts to Afghanistan, which remain open and was actually expanded more during the conflict with Georgia in August 2008, when Russia was being heavily criticized by America's mass media establishment. Although Russia and the US compete in the area, both their efforts to gain influence in Central Asia and the Caspian and a slice of the region's hydrocarbons have as a prerequisite minimizing the influence and actions of the jihadists.

Most important, a global consensus views instability in the region as extremely dangerous to the global situation. Afghanistan's neighbor Pakistan could also suffer greater destruction at the hands of radical Islamists, who could potentially gain access to the country's nuclear arsenal.[11] According to Seymour M. Hersh of *The New Yorker*, this scenario is at the top of Washington, DC, policymakers' discussions, as Pakistan's military and secret services are believed to have relationships with Islamic fundamentalists.[12]

Russia's problem with violent Islam is centered on what's called the *Caucasus Emirate*, which was founded in 2007. This is the latest manifestation of a jihadist movement that's plagued the northern Caucasus since the mid-1990s. Russia has long-term relationships with these newly independent countries. Their proximity to its borders means Russia can't afford to be a bystander to the changing military and strategic balance of power in its backyard, particularly as Russia has traditionally considered the region a strategic buffer against outside threats.

China is also tied to Central Asia. It shares common borders totaling more than 3,000 kilometers (1,864 miles) with Kazakhstan, Kyrgyzstan, and Tajikistan. Its long-term strategic plan for the region includes three priorities: Keep Central Asia stable; use the region as another way to diversify its energy resources; and contain separatist movements in its oil-rich Xinjiang province. China also views the region as a potential destination for its exports; already many Chinese products are found in Central Asian countries, and they're gradually displacing Russian-made goods.

The first strategic interest is rooted in China's history and the centuries-old internal debate over Chinese strategic security between proponents of maritime power and land power. Land-power advocates often prevail in these debates, a fact reflected by Central Asia's significant presence in China's strategic thinking.

The second interest concerns efforts by China to reduce its dependence on oil imports from the Middle East. Roughly 80 percent of Chinese oil imports pass through the 600-mile Strait of Malacca, which divides Singapore from the Indonesian island of Sumatra; Chinese officials see this as a weakness because the route can be easily closed down during conflicts, particularly where the conflict would involve China and the US. Pipelines from Central Asia are considered more reliable and are therefore highly desirable.

In 2005 the 1,000 kilometer oil pipeline connecting Atasu in Kazakhstan to Alashankou in western China started pumping oil. The pipeline, which boasts capacity of 20 million tons, was an important milestone in China's investment in the region, not only because it allowed China to further diversify its energy deliveries. China also financed most of the USD800 million construction cost for the project completed in ten months, record time for such an undertaking. In December 2009 China signed a deal with Turkmenistan to build a 1,800 kilometer pipeline to deliver gas from Turkmenistan to China. The pipeline, which will also pass through Uzbekistan and Kazakhstan, will deliver up to 40 billion cubic meters of natural gas a year to China by the time it reaches full capacity in 2013 and should serve the Middle Kingdom for the next 30 years.

The third long-term strategic interest—keeping the region stable—has to do with what the Chinese view as an unstable situation in the Xinjiang Uighur Autonomous Region (XUAR). The more than seven million ethnic Turkic Uighurs living in the region, who are largely Muslim, identify more closely with their Central Asian neighbors than with ethnic Chinese. Because many Uighurs desire greater autonomy—and it's believed that foreign-based, radical Islamic organizations are instigating a separatist movement—Chinese leaders view them as a potentially destabilizing force.

China's fast and decisive moves to secure natural gas and oil from Central Asian countries coupled with Russia's equally swift moves to guarantee Central Asian gas will keep flowing through Russian pipelines have made similar efforts supported by the US and other Western interests seem less viable. The best example is the highly advertised Nabucco gas pipeline, a 3,300 kilometer pipeline that's supposed to bring natural gas from the Caspian Sea to Eastern and

Central Europe, bypassing Russian territory. Initial talks about the project took place in February 2002; the timetable calls for transporting gas by 2014. According to market studies the pipeline has been designed to transport a maximum of 31 billion cubic meters per year. Estimated investment costs, including financing costs, for a complete new pipeline system amount to approximately EUR7.9 billion (USD11 billion). Set aside the high cost and the engineering challenges the Nabucco project entails, because of the projects detailed above involving Central Asian countries and China and Russia, there's simply not enough natural gas to fill this pipeline and make it even remotely economical. Azerbaijan, which would supposedly supply most of the volume, doesn't have enough gas.

Further complicating matters, Russia has already signed a deal with Italian, Bulgarian, Greek, and Serbian energy companies to push its South Stream pipeline forward and double its capacity. The South Stream will take gas from Russia to South and Central Europe from an entry point on the Bulgarian coast. This is one of two additional pipelines planned by Russia to deliver gas to Europe, both of which avoid Ukraine's pipeline network and the problems associated with it. Another very important project is the Nord Stream pipeline, which would deliver gas from Russia directly to Germany through the Baltic Sea.

If the Nabucco project fails to live up to expectations, the US will eventually abandon its heavy involvement in Central Asia, although it will continue to cooperate on issues that are vital to its operations in Afghanistan and the Middle East.

Polycentricism

Sustainable economic growth increases individuals' and governments' confidence. Ideas once expressed only amid casual conversation are now incorporated in official statements.

Over the past five years government officials around the world have repeatedly expressed a particular way of thinking about energy security. The world tends to view energy security issues through the lenses of developed economies. These economies were able, through government actions, to establish an energy status quo that, though it's been stable, was based on the premise that developed-economy leaders could dictate the politics of the international energy trade. At the same time, smaller nations, because they lacked the financial and economic muscle, weren't invited to participate in the decision-making process. They had to go with the flow.

Today China and India are at the forefront of a global effort to change this arrangement. Chinese and Indian political elites now exercise their right to strike energy deals according to their own interests and needs rather than the geopolitical considerations of others. Although this doesn't mean the sensitivities of their partners are discarded, the fact remains that it's incomprehensible to Indians, for instance, why their relationship with Iran is used by the US as a pressure point, particularly as more than 12 percent of India's oil imports come from Iran. To Indians the issue for the US is purely geopolitical—namely, the nuclear threat that Iran may in the future pose to Western interests. India has co-existed with an extremely unstable and economically deficient neighbor with a nuclear arsenal for a long time. This country, Pakistan, has offered its expertise on nuclear weapons, under the guidance of the notorious A. Q. Khan, to an assortment of rogue states, while all the time being an ally of the US in its "global war on terror."[13] Indian officials, as well as many Indian businesses, have often yielded to US pressures on these issues, against their will, because the US is a necessary ally and economic partner. But US actions are increasingly viewed in India the same way Western commentators view "resource nationalism." In other words, states that control natural resources are applying pressure to consumers via threats to cut supplies.

The US usually uses access to its markets as well as access to nuclear and other technologies as negotiating levers, what government officials and elites describe as "strategic interests." India will soon have enough standing to defy similar US requests that it considers contrary to Indian interests, particularly if Indians don't perceive their actions as threatening regional and global security and stability.

China and Russia are the main proponents of the concept of polycentricism. Their call is to return to the more stable situation that prevailed in the immediate aftermath of World War II, during which the US wasn't venturing around the world à la Gulliver, trying to "take care of business." The emerging Asian powers envisage a more subtle, diplomatic approach as the best road forward. Political scientist G. John Ikenberry expressed a similar idea in 2001. He noted that

> The institutional model of order building is based on a potential bargain between unequal states after a war...what makes the institutional deal attractive is that the leading state agrees to restrain its own potential for domination and abandonment in exchange for greater compliance by subordinate states. Both sides are better off with a constitutional order than in an order based on the constant threat of the indiscriminate and arbitrary exercise of power.[14]

The Chinese, for obvious reasons, have been very vocal in assuring the world that its rise will be peaceful. Its official policy position, expressed in a white paper on defense, indicates that China

> [W]ill encourage the advancement of security dialogues and cooperation with other countries, oppose the enlargement of military alliances, and acts of aggression and expansion. China will never seek hegemony or engage in military expansion now or in the future, no matter how developed it becomes.[15]

The US has been heavily involved in Asia since the mid 1800s, when marines landed in Guangzhou to protect American citizens from Chinese mobs. It became the dominate force in the region after its conquest of The Philippines in 1899. Forty-five years later the US ended World War II in Asia by guaranteeing that Japan had no choice but to surrender and making it essentially a vassal state. The US turned the island into a stationary carrier from which the rest of Asia could easily be accessed. As Professor Yoshihide Soeya of Keio University has said, there are three traumas from which the Japanese people are still reeling: defeat in the war, occupation by Americans, and the solidification of their country's subordination to the US.[16]

Nevertheless, the US, acting as the guarantor of regional stability, served Asia well. Its presence worked for the region overall, as long as communism was seen as a threat and the Japanese atrocities of old, mainly in China and Korea, were still fresh in people's minds. Neither of these conditions is present now. China's economic ascent is seen as a positive for the region, and the majority of Asian governments are more than willing to cooperate with China; a developing Chinese economy is good for their own economies. China is, after all, a neighbor state that will be there forever. Good relations are the right way to go.

The US has responded negatively to geopolitical change and the idea of polycentricism. America's ideas about its own exceptional status and the universality of its values are expressed prominently in dealings with other states. Although these ideas and the policies crafted to further them aren't new, the way they've been carried out over the past 10 to 15 years, combined with the economic rise of China, has created notable discomfort for governments around the world. Many countries are starting to identify with John Adams' words about the British and their handling of peace negotiations: "The pride and vanity of that nation is a disease; it is a delirium; it has been flattered and inflamed so long by themselves and others that it perverts everything."[17]

George H. W. Bush, whose gentlemanly approach to diplomacy advanced US interests around the world without eliciting serious opposition, noted in 1975 while in China as the head of the United States Liaison Office (USLO), that

> The American people do not have any concept of how others around the world view America, we think we are good, honorable, decent, freedom-loving. Others are firmly convinced that...we are embarking on policies that are anathema to them.[18]

Although this is the nature of international politics—not everyone looks at an issue the same way or has the same interests—it is still the case in America that people are genuinely puzzled when they find out that others don't necessarily see eye to eye with the US on a lot of issues. But geopolitical and economic developments are gradually laying this mind-set to rest. Probably—eventually—the US will once again adhere to the principles of its founders, who erected their constitutional regime on the sound proposition that power must be checked and balanced.[19]

Dividing the World

In March 1991, Richard Nixon went to Georgia, a trip that, because of his status as a former president, indicated US support for the former satellite's independence from the Soviet Union.

According to Dmitri K. Simes, an aide to Nixon who attended the meeting, the 37th president was alarmed when Zviad Gamsakhurdia, then president of Georgia, told him that not only was the Soviet Union dissolving, but also Russia itself was weak. The time might be right, he advised, to deliver a final blow. "Mr. President," Nixon replied, "there are two kinds of people in Washington you are going to encounter—those who will tell you what you want to hear and those who will tell you what you need to hear. And what you need to hear is that no matter what your friends and admirers in the United States may tell you, America is not going to go to war with Russia because of Georgia."[20] Nixon's words were prophetic. During the Russia-Georgia conflict 17 years later, Russia stopped short of taking over Tbilisi of its own accord, not because of the presence of the US army, which was not there. Russian President Dmitry Medvedev said in an interview a month later, "The last time I talked with President Bush on the phone it was during the active phase of military operations, and I told him that 'in this situation you would have done the same thing, only perhaps more severely.' He did not argue with me."[21]

The biggest contributions powerful states have made to global social progress have come during periods of cooperation that followed profound disruptions to established order. The need to restore stability has driven successful settlements such as those that followed the Napoleonic Wars in 1815 and World War II in 1945. Other arrangements, however, were doomed from the outset. The settlement of World War I, for example, led directly to a sequel only 20 years later. Although no shots were fired during the most recent disruption to established order, recent events have shaken public confidence in the prevailing global economic and financial architecture. What transpired during 2007 to 2009 will have long-term consequences similar to those that sprang from wars in the 19th and 20th centuries. Among them, the world will once again be informally divided into spheres of influence, determined primarily by geography.

The US, weakened in absolute terms by the financial and economic crises, is also in economic decline relative to China, Russia, and India. This is not to suggest the US won't be an important actor in the world's stage; this is not a zero-sum game. But an overstretched America is silently trimming its financial and military commitments abroad. As economic conditions in China, Russia, and India improve, their people will grow more eager to see their countries taken more seriously on the global stage. The first step toward making these aspirations reality is to enhance military strength; all three will beef up their armed forces to keep neighbors at bay and minimize potential interference in economic development and the well-being of their respective populations. This page is taken directly from the script followed by the US and other powers before it. This plot line has endured the test of time, and its logic is easily understood.

China will become the undisputed power in Asia. The US will maintain a presence, but only as a symbolic suggestion of balance. The Middle East will remain under the influence of the US, though Iran won't be materially destabilized because China has significant investments there, and it's also of interest to Russia and India. Central Asia will be the domain of Russia and China. South America will remain under US domination. Africa will stay open to all—the logic of economic cooperation will eventually supersede short-term political differences among the biggest players. Jihadism, a potential security threat in North Africa, is something all parties will have to deal with. The US will continue to try and influence Eastern European states, but the EU seems strong enough to remain the main relevant economic and political force in the Continent.

Finding this new equilibrium requires all interested parties to make concessions. The US, for example, must cease NATO expansion, and China, Russia, and India have to support US policy in the Middle East. But these are relatively minor points in the big picture. The exercise of restraint is already emerging as the defining characteristic of responsible global actors in the 21st century.

Emotional responses to this nascent order threaten what would be a mutually beneficial division of global influence. Suspicion aroused for domestic political purposes, direct confrontation, and unilateralism will undermine—perhaps undo—the profound economic progress the world has experienced over the last three decades.

"For the future, like the past," historian William H. McNeill observed in the early 1980s, "depends upon humanity's demonstrated ability to make and remake natural and social environments within limits set mainly by our capacity to agree on goals of collective action."[22]

Endnotes

1 *Geopolitics* is the analysis of the geographic influences on power relationships in international relations. The word "geopolitics" was originally coined by the Swedish political scientist Rudolf Kjellén about the turn of the 20th century. Its use spread throughout Europe in the period between World Wars I and II (1918–39) and came into worldwide use during the latter. In contemporary discourse, geopolitics has been widely employed as a loose synonym for international politics—*Encyclopedia Britannica* online edition. It is the latter definition that is being used throughout the book.

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[18] Jeffrey A. Engel, ed., *The China Diary of George H. W. Bush: The Making of a Global President* (New Jersey: Princeton University Press, 2008), 463.

[19] Robert W. Tucker, and David C. Hendrickson, "The Sources of American Legitimacy," *Foreign Affairs*, 83:6 (November/December 2004), 28.

[20] Dmitri K. Simes, "Westerners Resist Perception of Georgian Aggression," *The Washington Times*, September 17, 2008.

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[22] William H. McNeill, *The Pursuit of Power: Technology, Armed Force, and Society since A. D. 1000* (Chicago: The University of Chicago Press, 1982), 387.

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