TECTONIC SHIFT: THE REALIGNMENT OF NATIONS AND THE RISE OF REGIONAL SUPER STATES

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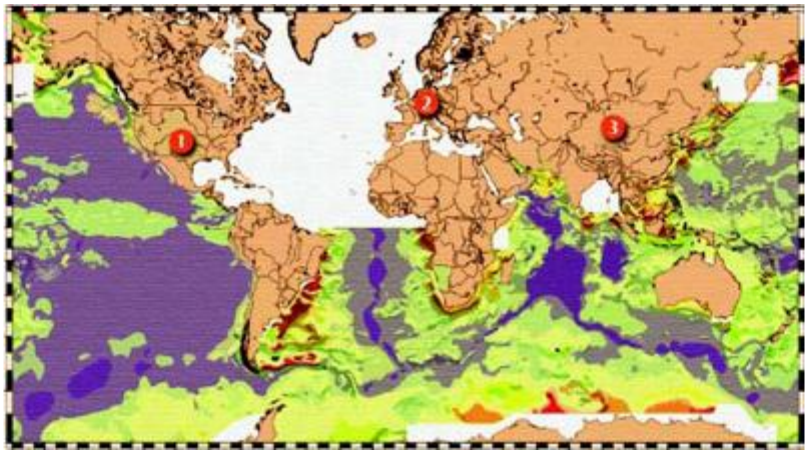

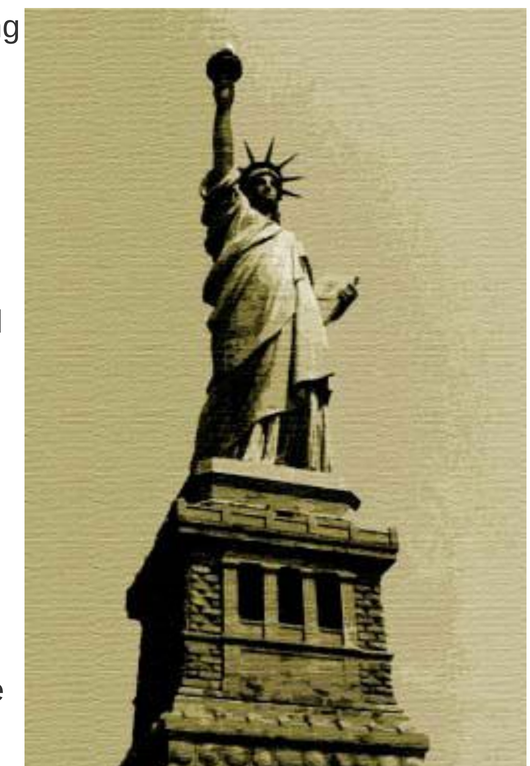

Contrary to popular belief, the world is not becoming globalized. Instead, it is evolving towards the formation of three huge regional blocs - a US-led bloc, a European-led bloc jointly led by Germany and France, and an Asian bloc jointly led by China and Japan. This evolution was triggered by and is still being driven by the European Union. Even as the US becomes Europeanized through regionalization and Europe becomes Americanized through economic and political integration, the two are rapidly drifting apart. Led by an extraordinarily united front of France and Germany, Europe today is determined to emerge from sixty years of domination by the US. On the other side of the world, China is equally determined to control its destiny and stake out its own regional sphere of influence.

Developed countries, almost without exception, are going through an economy-depressing process of aging and deyouthing; to create economic growth, they will need access to emerging markets. Reflecting this reality, the regions will go dramatically beyond the traditional East-West integration of similarly placed economies to include extensive North-South integration of developed and developing economies in a tight economic and eventually social and political embrace.

Each region will ultimately evolve to something akin to a superstate, with a common currency and even shared militaries. Our analysis indicates that the New Europe will expand eastward as well as south, eventually integrating Russia, the Middle East and much of the African continent. India (and likely all of South Asia) and the United Kingdom will join the American bloc (which will stretch from Alaska to the southern tip of South America), while Australia and New Zealand will be part of the Asian bloc. Putting aside ancient and recent enmities, China, Japan and a reunited Korea will take the lead in shaping the future of Asia, integrating North Asia and the ten countries of Southeast Asia.

We foresee dramatic disinvestments by US companies in Europe and Asia and vice versa, and escalating two-way trade and investments between the US and Central and South America, India and the UK.

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The move towards a tripolar structure will occur through a peaceful and gradual process that will result in a more stable world with far fewer economically distressed regions. Resources will be harvested from military spending and invested in economic development. The tripolar structure that we see emerging is a natural configuration that is inherently more stable than the current unipolar structure; any overly belligerent power can always be countered by a united front of the other two.

Why the World is Going Regional, Not Global

The dominance of the U.S. is already over. What is emerging is a world economy of blocs represented by NAFTA, the European Union, ASEAN. There’s no one center in this world economy.

Economist, professor and author Peter Drucker, Fortune magazine, 2004.

On major strategic and international questions today, Americans are from Mars and Europeans are from Venus: They agree on little, and understand one another less and less.

Robert Kagan, (2003), Of Paradise and Power, New York: Vintage Books.

The world has never truly globalized; it has always been regional. Though there is much talk of the global economy, there is in fact no such thing. The world economy is international but it is not global. As economist and professor Alan Rugman pointed out in, The Myth of Global Strategy, International Marketing Review (18,6, pg. 583., 2001), globalization does not, and has never, existed in terms of a single world market with free trade.

The primary driver for the world evolving towards regionalization rather than globalization is the rising economic and political rivalry between the United States and Europe. Let us examine the background of how and why this has happened.

The US was the dominant economic player on the world stage for much of the 20th century, especially after World War II. It had many unique advantages, on a scale the world had never before seen: a huge and prosperous domestic market, abundant natural resources, a common language, a strong and stable currency, well-developed infrastructures for the transportation of people, goods and information, an outstanding educational system, strong financial markets and so on. No country in the world even came close to matching these advantages.

The journey towards a world carved up into three major regions started soon after World War II. The US emerged from that war at the zenith of its power and influence, while Europe and Japan were down and nearly out. The Americans created the Marshall Plan to help rebuild Europe; they also occupied Japan until 1952 and oversaw the rebuilding of that economy into the formidable competitor that it soon became.

The Europeans, while grateful to the US for helping them get back on their feet, started to assert themselves soon after the end of the war. The US so dominated the world politically and economically after WWII that the Europeans felt severely disadvantaged; Europe was fragmented into many small and insular markets, each with its own currency and widely varying rules for conducting business. To counter the US advantage, the Europeans created the Common Market.

As European nationalism started to become more pronounced after WWII, the US began to look eastward more and more. It began to outsource basic manufacturing to Asia, initially to Japan, followed by Taiwan and then South Korea after the Korean War. Economic policy was heavily dictated by strategic military considerations, which were mostly driven by the Cold War between the West and the USSR-led communist bloc.

With the end of the Marshall Plan, the Europeans had to take charge of their own destiny. They were also worried about the Japanese coming to Europe. And politicians in country after country in Europe were quickly learning that ideology is not what people vote on; they vote largely on pocketbook issues such as economic growth, employment and inflation.

To strengthen its economy, Europe sought to match the US advantage of a large market with a single currency. The US saw Europe as countering its own strength in the world, as well as becoming a bigger and more integrated market and economy. It decided that it had to expand its home market, and did so by integrating Canada. This started with integration of the auto industry in 1965, followed by the signing of the comprehensive CUFTA (Canada-US Free Trade Agreement) in 1989, and ultimately the addition of Mexico through NAFTA in December 1992. Seeking to trump these moves, Europe created a common currency and made plans to expand east and south. In response, the US has renewed its efforts to create the FTAA, a free trade zone spanning the northern tip of Alaska to the southern tip of South America. So this has become an iterative process with elements of one-upmanship.

The integration of Mexico into the existing free trade agreement between the US and Canada was a watershed event; it marked the first time that developed and developing countries had entered into a free trade agreement. While some countries within the European rubric are less developed than others (e.g. Portugal), the differences are not nearly as stark as those that existed between the US and Mexico. Europe has now embraced this North- South thinking to expand the European Union to include less developed Eastern European countries.

The most passive player in all of this jostling for position was Asia, which has somewhat reluctantly joined the process by embracing what it calls open regionalism.

This involves creating and expanding free trade agreements within Asia while seeking to maintain favorable trade terms with countries outside the region as well.

In the past few decades, numerous regional trade pacts have been created, such as MERCOSUR, the Andean Pact, CARICOM, NAFTA, the Baltic Free Trade Area (BFTA), the Central European Free Trade Area (CEFTA), the Economic Community of West African States (ECOWAS), the South African Development Community (SADC), Asia Pacific Economic Cooperation (APEC), the Closer Economic Relations Agreement (CER) between Australia and New Zealand, the South Asian Regional Cooperation Council (SARCC) and many others.

This seeming fragmentation of the world into dozens of regional trade pacts is just a prelude to their eventual consolidation into three major regional economies: the FTAA (Free Trade Area of the Americas), AFTA (Asian Free Trade Area) and the as-yet unnamed Europe-centered trade region.

These three regional economies will become strong economic rivals, and they may well fight economic wars with one another. In the past, economic wars have often led to military wars. However, military wars between the emerging region-states are highly unlikely, because of the very fact that three groups are emerging. If it was just Europeans versus Americans, there could be huge economic conflicts leading to military face-offs: it would be like communism versus capitalism all over again. But fortunately, a counter-balancing third force is emerging in Asia

Is Regionalization Inevitable?

We strongly believe it is. The world currently is in an unnatural unipolar state, with one superpower the United States. In such a world, the rise of anti-American sentiments globally is inevitable. With rising European assertiveness and the undeniable power of what is happening in China and all across Asia, two centers of power to rival the United States are fast emerging. It is clear that a greatly enlarged Europe and a combination of North and Southeast Asia will not tolerate being subservient to the US for much longer. The forces for regionalization have already been set in motion.

Today, Europe and Japan believe that, while they needed and benefited from American largesse in the years following World War II, they ultimately lost out by depending on the US too much. The US has been determined to prevent the rise of any power in the world that might challenge its own. Already, it sees China as a clear future threat to its world dominance. The Chinese have learned the lessons of Japan and Europe, and will not make the same mistakes. Chinas growing economic assertiveness today stands in marked contrast to Japans conduct, even after it became a highly developed economy. The world economic/political/military system can move towards a peaceful balance of power; it is up to individual countries and regions to best manage this transition in a way that provides maximum benefits with the smallest amount of disruption.

How it Will Play Out

The broad outlines of the coming transition to regional economies are already quite clear:

- NAFTA will expand to include all of the Americas North, Central and South, as well as the Caribbean nations and even Cuba in the FTAA, which will be dominated by the US and Brazil (in that order).
- The European Union will expand to include Eastern Europe and Russia, in a free trade zone dominated by Germany and France (in that order).
- Almost all Asian countries will come together (with the exception of countries in South Asia), including Australia and New Zealand, in a free trade zone that will be dominated by China and Japan (in that order).

Who Gets Left Out?

Two categories of countries are in danger of being ignored or even shunned from entry into one of the three major economic alliances: ideology-driven nations and Fourth World countries.

Firstly, countries that are too ideologically driven will be shunned by others. After WWII and all through the Cold War, ideology was a highly effective sales mechanism to get countries to align themselves with one group or another. The ideology could be political (such as communism), religious (such as Christianity or Islam), isolationist (like North Korea or Burma, now Myanmar) or even social. Today, ideology has been replaced in much of the world by economic pragmatism. Countries such as Israel, the Arab world, and many Central African countries will have a difficult time overcoming this obstacle, as their ideological orientations have become barriers to economic growth.

Singapore under Lee Kuan Yew was the very model of pragmatism. Today (with Lee Kuan Yews help), China is essentially replicating the Singapore economic miracle on a much grander scale. While China still has single party rule, the Chinese Communist party has become far more economics-driven than ideology-driven. A similar ideological change has taken place in

India, which has moved away from Fabian socialism to embrace the free market with a vengeance. In the Middle East, a change is taking place right now. The Iranians cannot sustain their fundamentalist ideology anymore; Libya is waking up to a similar reality. Another example is Cuba, which we believe will eventually get totally integrated into the North American economy.

A second category of countries that have little to offer by way of either import or export potential are the so-called Fourth World countries. These countries are so poor and so small that they have little to offer the world on the supply or demand side. Some African countries such as Rwanda and Malawi fall into that unfortunate category. They are unlikely to be integrated into the emerging regional economies for quite some time.

Is This a Good Thing?

The forces propelling regionalization are much more potent than those propelling globalization. While we expect that the WTO will be successful in gradually lowering barriers around the world, its impact will continue to be dwarfed by the success of regional economies.

The ultimate yardstick by which this development needs to be assessed is a simple one: will it lead to a more rapid and broader upliftment of the economic fortunes of a larger number of people? On this score, the answer is likely to be a resounding yes. This evolution will definitely act as a spur to economic development. It allows regions and the countries within them to more aggressively harness the opportunities that exist to rationalize economic activity and release the magic of Ricardos simple yet bold prescriptions on the virtues of trade.

The key is to understand that the future evolution of regional economies will be heavily dominated by North-South integration. Until recently, trading blocs were each a rich countries club. They jealously guarded their exclusivity, and only let in new members after they met a stringent set of tests that essentially measured how similar they were to the countries that were already members. That insular mindset, fortunately, has been broken, most dramatically when the US and Canada took the bold step of integrating with Mexico under NAFTA. Going forward, most of the action will be in rapidly integrating a new and diverse set of members. This will pay rich dividends on all sides, since North- South integration offers far more potential to lift living standards than East-

West integration, which simply raises economic efficiency for companies and lower prices for consumers.

A second and equally important consequence of the creation of these three mega powers is that the world has the potential to be a much more stable and peaceful place than it has been at any time in the past. In a unipolar world (such as exists currently), the tendency towards unilateral action (however well-intentioned) invariably breeds resentment and foments rebellion and even terrorism. In a bipolar world, with two evenly matched rivals, there is real potential for destructive tit-for-tat cycles of various kinds economic or military. In a tripolar world, however, stability is built in. When any one of the three powers becomes overly belligerent, it can always be countered by a united front of the other two. With three significant rivals, the level of deterrence for military or economic adventurism will be far greater than ever existed before. Given that the regions will have little to gain and much to lose from aggression, it is highly probable that resources will be diverted away from military spending and towards economic development. It will be a better world, with less illiteracy and poverty. Past approaches based on shunning trade altogether, trading only with similarly developed trade partners, or relying purely on multilateral trade agreements to open markets have simply not succeeded in lifting many out of poverty; for the most part, they have been ineffectual or simply made the rich richer and the poor poorer.

2025 Vision

Here is how we see the world in the year 2025:

- Three massive regional economies, each with 2-3 billion people. The largest of these (in terms of population) will be the Americas bloc, followed by the Asian bloc and then the European bloc.
- Each region will be roughly on par with the others in terms of economic output and per capital income
- Cooperative rivalry will prevail between the regional economies. While the regional economies will be self-sufficient in many respects, there will be a number of industries that will feature competition across regions. These are likely to include industries such as automobiles, pharmaceuticals/biotechnology, electronics and commercial aviation.
- Each region will be akin to a super-state or super-country, adding one more layer of government. Just as the Europeans are creating a separate power structure in Brussels, each region is likely to see a similar structure emerge. These will be led by directly elected presidents with real, not just ceremonial, powers. Each region will have its own jointly controlled military, while each country within a region will have its own police force.
- Each region will have its own equivalents to the UN and the World Bank. These organizations will deal swiftly with any internal conflicts that may arise, as well as funnel resources to areas that need assistance.
- Each region will have its own common currency. The Europeans will have the euro and the FTAA will use the US dollar. The Asian bloc may use the Japanese yen (revalued by a factor of 100 to 1 to make it more comparable to the dollar

and euro) in the short run, but will probably use the Chinese currency (yuan) in the long run.

- Each region will have a dominant shared language, with a widely used second language. In the FTAA, the languages will be English and Spanish. English will serve as the shared language within each of the other two regional economies, as well as the language of most cross-region trade and interchange.
- Going forward, trade between the regional economies will decline and the trade within each region will rise. Trade will be concentrated 80-90 percent within regions, 10-20 percent across.
- Each region will develop its own technical and other standards in some industries, while sharing global standards in others.
- While most companies will operate only within a region, some large multi-region companies will operate in all regions.
- The European bloc will suffer in comparison to the other two because of two major weaknesses: it will not have a huge growth engine akin to India or China, and its population will continue to skew elderly, leading to social problems.

Implications for Outsourcing

As a result of this evolution, outsourcing will have to become more strategic rather than ad hoc, as it has been in the past. Companies in each regional economy will have strong incentives to do business within the regional economy. Outsourcing within each regional economy will also lead to the sourcing of other products and services within the regional economy. Trade imbalances will decline; we will no longer consider unbalanced trade such as exists between the US and China or between the US and Japan to be acceptable.

We foresee dramatic disinvestments by US companies in Europe (except for UK) and Asia (except for India) and vice versa. We foresee escalating investments by US companies in Central and South America, India and the UK, and vice versa.

As the US government starts favoring South Asia over East Asia, we expect to see US companies gradually shift manufacturing from China to India and Latin America.

None of this will happen overnight; it will be a gradual process over the next two decades

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This article is based on a forthcoming book of the same title, to be published in 2005.