

China: America's Greatest Challenge

Courcy's Intelligence Service - Established in 1934

January 2012

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Introduction

During 2010, China overtook Japan to become the world's second biggest economy, and, perhaps just as significantly, it became the world's biggest manufacturer, a position that the US had held for more than a century. As a consequence, China is beginning to mount a serious challenge to the US in a number of spheres. China's mercantilist economic policies are simultaneously undermining American competitiveness (and threatening jobs) while making the US dependent on Chinese purchases of government debt; its booming economy enables it to buy diplomatic allies in forums such as the United Nations, to limit the opposition of even major countries such as France, and to extend its influence into traditional American spheres of influence such as Latin America; and its growing military capabilities, although limited by American standards, are becoming an impediment to US freedom of action in East Asia.

All of this is well known and widely debated within the United States. The purpose of this paper is not to rehash well-understood facts but to argue that the main area for concern is less China's inexorable rise and challenge to the US as a superpower, but the fall-out that will follow from the coming end to a Chinese economic miracle that has been based on unsustainable policies. The tragedy is that these unsustainable policies will, in the meantime, have done significant damage to the United States and reduced its ability to cope with the fall-out from the implosion to come.

The changing balance

In 2010, the US trade deficit with China was \$252bn, based on US exports of \$82bn and imports of \$334bn. This is up from a deficit of \$89bn in 2001, the year that China joined the World Trade Organization (WTO), a move that was intended by its supporters to open up the Chinese economy. This colossal imbalance is maintained by China lending back US dollars to the United States by way its purchases of US bonds. As of Q2 2011, China held \$1.152trn of US Treasury securities.

A key difference between the US and Chinese economies is that final consumption accounts for around 40% of China's GDP but for around 70% of the US's. China has built its astonishing economic growth in recent years on exports, an undervalued currency, and protectionism. On the latter point, the American Chamber of Commerce in China reported in its 2010 annual survey

China has directed state-owned airline companies to buy only domestically produced aircraft.

that 31% of over 300 member companies said their ability to participate and compete in China's market was impeded by discriminatory government policies and inconsistent legal treatment – and this was before the full implementation of China's 2010 indigenous innovation policy.

A prime example of Chinese protectionism is the aviation manufacturing industry. China has been insisting on technology transfers from foreign aviation manufacturers in return for current market access while at the same time providing financial and other support to its state-owned aviation manufacturers. It has also directed state-owned airline companies to buy only domestically produced aircraft.

In a 2010 report, the consultancy firm APCO Worldwide described China's strategy as "a massive and complicated plan" to turn China into a technology powerhouse by 2020 and a global leader by 2050 on the basis of its "blueprint for technology theft" on a grand scale. The government's policy of "indigenous innovation" focuses on seven strategic industries including alternative energy, green vehicles, and information technology. The scheme, according to APCO Worldwide, involves creating new Chinese technologies on the back of foreign expertise attracted by massive current government spending.

The US's trade deficit with China in advanced technology products (ATP) had soared from just \$6.1bn in 2001 to \$72.5bn in 2009.

This has a real cost to the United States in terms of jobs. C Fred Bergsten, director of the Peterson Institute for International Economics, has estimated that if China were to eliminate the undervaluation of the RMB, the consequence would be to reduce the US global current account deficit by \$100bn-\$150bn. Furthermore, he argues: "Every \$1bn of exports supports about 6,000 to 8,000 (mainly high paying manufacturing) jobs in the United States. Hence, such a trade correction would generate an additional 600,000 to 1.2m jobs."

Nobel prize winning economist Paul Krugman goes even further. He says that for the next couple of years, "Chinese mercantilism may end up reducing US employment by around 1.4m jobs".

In addition to taking American jobs, the flipside to Chinese mercantilism has been to build up an enormous holding of nearly \$1.2trn of US Treasury securities. The optimists say that this gives China less power over the United States than is generally supposed as there is little alternative to holding US dollars. As the United States China Economic and Security Review Commission (USCC) put it in its 2010 annual report: "If China were to decide to sell its Treasury securities, China would lose billions of dollars and also have to abandon the very system that supports its export-led economy."

There is some truth in this, but only to the extent that it supports our thesis that the current position is both unsustainable and mutually self-destructive. Unwinding the imbalances will be painful for both sides.

However, for the time being, there is little doubt that the US's reliance on Chinese purchases of US Treasuries weakens US diplomacy vis-a-vis China.

“The lesson of Suez for the US is clear: political might is often linked to financial might...”

The hold-up in Taiwan's attempts to buy advanced F16C/D jet fighters is a case in point, as is lack of Chinese cooperation on Iran and North Korea. As the USCC itself pointed out, history shows that lending nations have usually sought to use their financial leverage to secure foreign policy benefits. A salient example is the way in which the US forced Britain and France to abandon their attempt to take the Suez Canal in 1956. The Eisenhower administration had threatened to withhold further purchases of British debt, and faced with a possible collapse of the pound the British capitulated.

Brad Setser of the Council on Foreign Relations has written: “The lesson of Suez for the United States today is clear: political might is often linked to financial might, and a debtor's capacity to project military power hinges on the support of its creditors.” The fact is that the US's military operations in Iraq, Afghanistan, and elsewhere (including the Western Pacific) are dependent on Chinese purchases of US Treasuries.

Those who argue that China has no option but to continue to buy US Treasuries may be correct in the medium-term (because it is upon that that its export-driven economic model depends), but that would not prevent China turning off the tap in the short-term for specific foreign policy gains – and as with Britain in 1956, the US would find it next to impossible to resist.

The rare earth case study

That China is not shy of using economic means for foreign-policy ends was clearly demonstrated by its banning of rare-earth exports to Japan in September 2010 over a territorial dispute in the South China Sea. China has also managed to develop what can only be described as a stranglehold on the supply of rare earths critical to the US defence industry.

Rare earth elements (REE) play a vital role in a wide range of electronics and environmental technologies. They are also critical for military applications. The US military uses REE in precision-guided munitions, lasers, communication systems, radar systems, avionics, night vision equipment and satellites. Other off-the-shelf products used in defence systems also require REE, such as computer hard drives. They are not something the military can do without.

China has 37% of the world's proven recoverable rare-earth deposits, but now produces approximately 96% of the supply, including 100% of the HREE (exact supply percentages are difficult to determine due to the prevalence of smuggling). Recently there has been growing awareness that precisely because there are only a small number of mines outside China there is a threat to the supply. This threat has become realised as China has begun severely restricting the production and export of REO, and has increased export taxes on all REE to within a range of 15%–25%. Chinese export quotas have been dropping for several years, but the quota slash in 2010, from 50,100 tonnes down to 30,300 tonnes, caused consternation for investors and manufacturers around the world.

The strategy appears to be threefold. The first stage is to limit exports. This year's export quota is likely to be the smallest yet, and there is no indication

Experts estimate it will take about 15 years to rebuild a complete US-based rare-earth supply chain...

they are going to increase in the future. The second phase is to force manufacturers that use rare earths to move to China. Beijing is no longer content to dominate the market as an exporter of raw materials. China already accounts for about 60% of the REE consumed each year, and the plan is to increase that percentage. China wants to retain as much of the REE as possible, and force the world to buy Chinese manufactured components, thus boosting the economy not only in terms of GDP, but also by increasing education and training to support a manufacturing industry that requires more skilled labour.

Thirdly, China seems determined to control the markets by gaining influence over deposits in other countries. Two Australian companies, Lynas Corp and Arafura Resources, planned to open mines that would have a combined production equal to a quarter of the annual global output of REE. When the credit markets collapsed in 2008 both companies lost their financing. China seized the opportunity and stepped in with the funds and resources required to finish the construction of the mines and ore-processing factories, provided by Chinese state-owned companies. In return the Chinese companies received 51.7% of Lynas and 25% of Arafura.

Rare earth materials have to go through five distinct processing stages. These are mining, separating, refining, forming and manufacturing. The US used to perform all stages in the REE supply chain, but now most REE processing occurs in China. Industry experts estimate that it will take about 15 years to rebuild a complete US based REE supply chain from mining through to manufacturing. This would require securing capital investment in infrastructure, developing new technologies, and acquiring patents currently held by non-US companies. The US's Department of Defence (DOD) is in the process of assessing the current reliance on REE, and will soon be ready to start taking steps to reduce future dependency, but the need for REE cannot be diminished quickly. Even though a 2010 United States Geological Survey (USGS) study found that the United States had 13m metric tons of REE, the US still lacks deposits of vital HREE. Also environmental concerns have prevented these reserves been tapped, as much lies beneath various National Parks.

The only way to escape China's stranglehold on the REE market is to dramatically reduce demand. This will be difficult, as China is likely to do everything in its power to support and develop an industry that provides it with such levers over other countries and other economies.

China's military advances

China's extraordinary economic advances have been matched in part by military advances. It is not close to challenging the United States as a global power, but it is developing capabilities that could restrict America's room for manoeuvre in the Western Pacific, particularly in support of Taiwan.

Admiral Robert F Willard, commander of US Pacific Command, warned in March 2010: "Of particular concern is that elements of China's military modernization appear designed to challenge our freedom of action in the region."

The main threat to US interests comes from China's rapidly developing air

China has the capacity to attack with its conventional missile capabilities five or the six main US air bases in East Asia.

force, which with 1,600 combat aircraft is now the third largest in the world behind Russia and the US. The 2008 defence white paper made no bones about China's ambitions for its air force, saying that it is working "to accelerate its transformation from territorial air defence to both offensive and defensive operations, and increase its capabilities for carrying out reconnaissance and early warning, air strikes, air and missile defence, and strategic protection, in an effort to build itself into a modernized strategic air force."

As an indicator of the advances China is making, in 2000 only 2% of China's combat fighters were considered to be modern (that is 4th and improved 3rd generation fighters). Today that proportion is 25%. China is also developing its 5th generation J-XX fighter and is expected to deploy it by 2018. China also has, according to the US Department of Defence, "the most active land-based ballistic and cruise missile programme in the world".

The main consequence of these developments is that China has dramatically increased its ability to hinder or prevent the deployment/operation of US forces in the Western Pacific region. According to the US Department of Defence: "Since 2000, China has expanded its arsenal of anti-access and area-denial weapons, presenting and projecting increasingly credible, layered offensive combat power across its borders and into the Western Pacific."

China already has the capability to attack with its conventional missile capabilities five of the six main US air bases in East Asia. In due course, improvements to China's bomber capability will bring Guam within range as well.

China' vulnerability

But for all the advances that China has made, many at the direct expense of the United States, its future is by no means certain, and the greatest threat to US-China relations could come from China's failure rather than from its success.

The historian Niall Ferguson in his book *Colossus* drew a worrying parallel between China today and late 19th Russia. Under Alexander II and his two successors, the Russian empire embarked on a comparable programme of industrialization, "opening its economy to foreign trade and capital and achieving exceptionally rapid growth by the standards of the time". However, the Russian autocratic political model was unable to cope with the social strains caused by the economic boom, and when it tried to harness the country's new wealth for war it was destroyed by revolution. The difficulties that revolutionary Russia were to cause the Western powers over 75 years hardly need rehearsing.

China's leaders are worried people, and probably with good reason. In 2011, for the first time, the budget for domestic security was higher than that for defence. This does not suggest a country at ease with itself. Early 2011 witnessed a wholesale crackdown on domestic dissent encompassing lawyers, internet activists, NGOs, and many others. The worries have been compounded by the events in the Middle East, but China's leaders also know that there are economic challenges ahead. Average 10% growth is not sustainable, particularly as China's demographic advantage is peaking.

Over time, there will be "immense overcapacity and a staggering non-performing loan problem".

By 2020, people of 60 years in the population will have increased to 20% from 12.5% in 2010. By 2030, there could be more than 350m over sixties in China.

And as China loses its advantages in labour-intensive industries, so its political and social system will hold it back from new sources of growth that require entrepreneurial innovation and greater domestic consumption. There is also a huge problem of bad lending by state-owned banks that has yet to be addressed.

The government is acutely aware of what could go wrong once the export-led economic miracle falters, which is why it won't contemplate a serious currency revaluation. As China's Premier Wen Jiabao told EU officials in Brussels recently: "If we increase the renminbi (RMB) by 20% or 40%...many of our factories will shut down and society will be in turmoil." In an earlier speech, he warned: "We cannot imagine how many Chinese factories will go bankrupt, how many Chinese workers will lose their jobs, and how many migrant workers will return to the countryside" should China acquiesce to Western demands for a revaluation.

Wen put it even more starkly back in 2007 when he described the Chinese economy as "unstable, unbalanced, uncoordinated, and unsustainable". His five-year plan that took effect in 2006 was intended to reduce growth and to wean the economy off its overdependence on exports and investment. But the policy was a failure. Far from decelerating to 7.5%, growth increased to 11% and consumption fell sharply. The new five-year plan adopted in March this year will try again, once again looking to a rise in domestic consumption. But the problem is that China's political system is ill-adjusted to promoting and managing a consumer economy. There is also the prospect of having to cope with a looming debt burden as a result of years of misdirected government lending.

And for all the good intentions, China avoided a recession following the global financial crisis by increasing investment in fixed assets to 50% of GDP, which must in time lead to enormous overcapacity and a non-performing loan problem of extraordinary proportions.

Signs of trouble

The year 2011 provided plenty of evidence of the possible trouble ahead. At the Shangri-La security summit in Singapore in May, there had been a strong sense of China's neighbours no longer trusting Beijing's protestations of "peaceful rise". This feeling of mistrust has been reinforced since.

In a front-page article on 8 June in *China Ocean News* to mark the UN's World Oceans Day, Liu Cigui, director of the State Oceanic Administration, said that China intended to step up regular maritime surveillance near the country's exclusive economic zone and continental shelf. He said: "It is an arduous task to safeguard our nation's maritime interests as the international fight for resource and strategic interests grows increasingly intense and complex." The tone of Li's article was particularly noteworthy given that the rest of the world sees World Oceans Day as an opportunity to focus on marine conservation.

“Vietnam has gravely violated China’s sovereignty and maritime rights...”

His article also coincided with the passage, on 8-9 June, of 11 Chinese naval ships into the Pacific by way of the sea lane between Japan’s Okinawa and Miyako Islands. The passage of the ships was not an infringement of international law, and China said that the deployment was for the purpose of “routine” drills at the end of the month in international waters in the western Pacific. But Japan still took the deployment as a threat, with Chief of Staff General Ryoichi Oriki saying: “We are greatly concerned about the fact that the Chinese navy has activated operations. We will implement warning and surveillance activities as necessary.”

A day later, Japan’s Defence Minister Toshimi Kitazawa added: “Our country’s policy is to keep monitoring Chinese naval vessels with serious concern and gather information on it.”

Also on 9 June, Vietnam complained that again Chinese ships had harassed a Vietnamese vessel conducting a seismic survey in the South China Sea (or East Sea as the Vietnamese call it). A similar incident had occurred on 26 May, but this time Vietnam responded by conducting a live-fire naval exercise off Quang Nam Province on 13 June.

China, in turn, responded by accusing Vietnam of misrepresenting the 9 June incident and “gravely violating” its sovereignty. Chinese Foreign Ministry spokesman Hong Lei complained: “It must be pointed out that by conducting unlawful oil and gas surveys in seas around the Wanan Bank of the Spratly archipelago and by driving out a Chinese fishing vessel, Vietnam has gravely violated China’s sovereignty and maritime rights.”

At the same time, the Philippines complained of six Chinese intrusions since January, and in response started referring to the “West Philippine Sea” instead of the South China Sea. Likewise, it has started calling Reed Bank “Recto Bank” after Filipino nationalist Claro M Recto.

China, in turn, has accused the Philippines of harming its sovereignty. On 9 June China’s foreign ministry said: “China asks the Philippine side to stop harming China’s sovereignty and maritime rights and interests...The Philippine side should stop publishing irresponsible statements that do not match the facts.” China also demanded that the Philippines should seek China’s permission before conducting oil exploration activities in areas that China claims.

Finally, China warned the US to keep out of the dispute, saying that using the need to maintain freedom of navigation as an excuse for becoming involved was not convincing “because the maritime route has always been peaceful, stable, and free”.

Losing control

What was particularly interesting – and worrying – about these developments is that they came at a time of increasing social unrest within China.

First, there was the trouble in Inner Mongolia which began when ethnic Mongolians were infuriated by the death of a farmer on 10 May. He had been trying to protect his land when he was run down and killed, apparently by a

“Subjects are turning into citizens. There is a path of hope.”

Han Chinese driver. Then five days later, another ethnic Mongolian was killed during a protest at a mine. The protests in Inner Mongolia revived memories of the riots in Xinjiang in July 2009, which left 200 Han Chinese dead and a further 1,700 injured, and the deadly riots in Tibet in March the year before.

Nerves in Beijing were then further rattled by the incident on 26 May in Fuzhou, Jiangxi province, in which a 52-year-old man angry about property redevelopment set off three explosions at government offices, killing himself and two others.

Parallel to these signs of discontent, there have been more peaceful, but for Beijing equally alarming, signs of political activism, in particular a wave of independent candidates announcing their intentions to run in local elections. In May, for instance, a popular author called Li Chengpeng announced to his nearly 3m followers on Sina Weibo (a Twitter-style micro-blogging site) that he intended to run as an independent candidate for the People's Congress of Wuhou District in Chengdu, the capital of Sichuan province. His announcement produced a wave of support and a number of high-profile followers declaring similar intentions.

Li Chengpeng was himself following the lead of a woman from Xinyu in Jiangxi Province, Liu Ping, who declared her intention to stand as an independent candidate in April. She was prevented from standing after the local party chief defined her attempt as “a major political incident manipulated by political forces at home and abroad in order to subvert Communist Party rule”. She was harassed from the time she declared her intention to stand in the poll, and finally she was detained for 5 days ahead of the election.

It was this bid that prompted Li Chengpeng to declare himself as an independent candidate, and a comment by Li illustrates well the cumulative effect that these individual demonstrations can have. He said: “Without her failed bid, I would not have stepped forward bravely. Without my stepping forward, the over 30 people who came after me might not have stepped forward as candidates representing the popular will. I think this is a small step for me but a big step for citizens.”

Public support for these activities is also difficult to prevent. The *Southern Metropolis Daily*, for instance, commented: “Subjects are turning into citizens. This is a path of hope. It can be responsibly said that the political apparatuses are caught in a race with bombs [a reference to the Fuzhou bombs]. Civil society is not a trap, and the authorities should let people see hope.”

The danger signals are coming from almost every quarter, from the lowest Mongolian peasant to the highest beneficiaries of China's booming economy. A recent study has suggested that the number of Chinese high net worth individuals is projected to rise to 585,000 in 2011, but that of these nearly 60% are either considering emigration through investment overseas or are already finalising the process. In 2009, 70% of the 4,218 EB-5 visas issued in the US (that is visas for applicants willing to invest \$1,000,000 in a new business or \$500,000 in a business in a targeted employment area) were applicants from China, double that of 2008.

Put alongside the continuing events in the Middle East and the pro-democracy demonstrations in Russia that began after the rigged 4 December 2011 elections, these and other developments would suggest the government has good reason for the paranoia that we are told has begun to grip its highest echelons. But there is also plenty of evidence that its intimidatory tactics are working - for now. Most of China's roughly 170,000 lawyers and several thousand law professors have kept conspicuously silent about the increasingly serious plight of rights lawyers. In 2009, over 500 lawyers signed a petition protesting at their colleague Liu Yao's unjust conviction, resulting in his reduced sentence, but there has been no similar outpouring of support during the current wave of disappearances and repression.

Conclusions

The key points are these:

1. China's exceptional economic rise has been based on a policy of mercantilism that has greatly damaged America's economy and jobs market.
2. In order to maintain its export-led growth and to keep the renminbi undervalued by up to 40%, China has acquired nearly \$1.2 trillion of US Treasuries. However much theoretical economists argue that China cannot withdraw its favours, because of the need maintain export-led growth, these holdings do give China huge leverage over Washington.
3. The current model is unsustainable, but China's one-party political system makes a transformation of China's economy into a more consumer-based one fraught with political danger for the Chinese Communist Party.
4. China's economic growth has enabled it to build up significant military power with the capability to restrict US activities in the Western Pacific.
5. Throughout 2011 there was evidence of China ratcheting up disputes with neighbours (notably Vietnam, Japan, and the Philippines) possibly in an attempt to divert attention from rising social unrest (which, in turn, could be a response to the Arab Spring).
6. There has been a strong improvement in recent years in cross-strait relations with Taiwan, but this would be unlikely to survive serious social unrest in China, particularly if it involved another Tiananmen Square incident or worse.
7. The combination of all the above is a combustible mix that has the potential to hugely destabilize US-China relations, with serious economic and possibly even military consequences.

Courcy's Intelligence Service, January 2012

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