COMMERCE WITH COMPETITORS:

Economic interdependence, vulnerability and security policy

in contemporary East Asia

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A DISSERTATION

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Abstract

Under what conditions does economic interdependence render contemporary East Asian states vulnerable to China, and when can interdependence actually affect these states’ security policies? Existing measures do not accurately account for the microfoundations of interdependence, and miss the reality that modern production and trade have evolved from traditional bilateral movements of final goods to vertically fragmented transnational production networks and trade in intermediate inputs. Interdependence generates vulnerability through asymmetry, and I propose a novel theory of asymmetry and operationalize interdependence according to an economy’s specialized profile in the transnational production network. I hypothesize that certain types of production profiles face greater potential losses from disruption of the bilateral relationship because of the specificity of their economic linkages with China, thereby increasing their vulnerability. I also test the hypothesis that economic vulnerability causes accommodating security policy. Case studies of East Asian states’ bilateral relations with China between 2002-2013, loosely structured as two paired comparisons—Japan and the Philippines, Singapore and Australia—provide confirmatory evidence that specialized production profile is a superior measure of interdependence and vulnerability, but that the political salience of security issues limits the influence of economic interdependence on security policy.
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<td>ADIZ</td>
<td>Air Defense Identification Zone</td>
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<tr>
<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
</tr>
<tr>
<td>CMS</td>
<td>China Marine Surveillance</td>
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<tr>
<td>CPO</td>
<td>Causal Process Observation</td>
</tr>
<tr>
<td>DPJ</td>
<td>Democratic Party of Japan</td>
</tr>
<tr>
<td>DSO</td>
<td>Data-set Observation</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
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<tr>
<td>FLEC</td>
<td>Fisheries Law Enforcement Command (China)</td>
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<tr>
<td>EEZ</td>
<td>Exclusive Economic Zone</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>GIC</td>
<td>Government of Singapore Investment Corporation</td>
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<tr>
<td>GLC</td>
<td>Government-linked Company</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>JBIC</td>
<td>Japan Bank for International Cooperation</td>
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<tr>
<td>JCG</td>
<td>Japan Coast Guard</td>
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<tr>
<td>JETRO</td>
<td>Japan External Trade Organization</td>
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<tr>
<td>JMSU</td>
<td>Joint Marine Seismic Undertaking</td>
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<tr>
<td>LDP</td>
<td>Liberal-Democratic Party of Japan</td>
</tr>
<tr>
<td>MNE</td>
<td>Multinational Enterprise</td>
</tr>
<tr>
<td>MSDF</td>
<td>Japan Maritime Self-Defense Force</td>
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<tr>
<td>ODA</td>
<td>Official Development Assistance</td>
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<tr>
<td>SCS</td>
<td>South China Sea</td>
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<tr>
<td>SFA</td>
<td>Strategic Framework Agreement (U.S.-Singapore)</td>
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<td>SIP</td>
<td>China-Singapore Suzhou Industrial Park</td>
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<td>SME</td>
<td>Small and Medium Enterprise</td>
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<td>SOE</td>
<td>State-Owned Enterprise</td>
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<tr>
<td>TMG</td>
<td>Tokyo Metropolitan Government</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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1. INTRODUCTION

1.1 Motivating the project

Trade and investment increase economic growth and contribute to the wealth of nations, but also crystalize interdependent economic relationships which may be costly to break. International economic relations with states that constitute potential security threats can therefore be a fraught proposition. In some situations, a state may have to choose between continuing to enjoy the fruits of lucrative economic links and pursuing the policies needed to protect its core security interests. This research project speaks to this dilemma by focusing on two simple questions: under what conditions does economic interdependence render states vulnerable to influence and coercion, and when can interdependence actually affect security policy?

History shows how international economic links can put states in vulnerable positions. An early and prominent example of this phenomenon is Hirschman’s account of how, during the interwar period, Nazi Germany was able to leverage asymmetric economic relationships with central European states into significant political influence.¹ Less well-known is the experience of Norway during the First World War. Despite Norway’s neutrality, Great Britain was able to gain increasingly beneficial concessions from Norway at Germany’s expense by using its naval power to pressure the Norwegian shipping-based economy. Sweden’s economy was not as exposed to the Royal Navy, affording its government greater capacity to resist British pressure, allowing Sweden to maintain its neutrality. In contrast, as Orvik documents, Norway’s incremental concessions to Britain provoked German attacks on Norwegian vessels to such an extent that

¹ Hirschman 1945.
Norway lost almost 50 percent of its merchant marine during the war, the most of any country. While this was an instance of military coercion against economic assets, it illustrates how different types of economies can be exposed to different degrees of vulnerability.

Security policies are arguably the most important expression of state preferences because of their connection to the state’s survival, territorial integrity and autonomy. Yet economic interests are also significant, as growing economies are better able to provide employment and material prosperity to their people. The conditions under which economic interests create vulnerability which could affect security policy, and the mechanism through which this occurs, are thus questions of great theoretical interest. They are also of striking policy relevance in the context of contemporary debates on the rise of China. A rapidly growing economy has seen China develop ever-deeper economic relationships with its neighbors. In the years following its accession to the WTO in 2001, China became one the largest trading partners of every state in East Asia (often the largest) and an important recipient and supplier of foreign investment. The ‘miracle’ of Asian prosperity is based upon the networked integration of economies via cross-border movements of goods and capital; China stands at the heart of this network. And yet, as China also modernizes its large military, it becomes a potential security ‘competitor’, either directly from territorial disputes or indirectly through challenging the United States-led security order. If states are willing to sacrifice the gains from economic exchange to protect their security interests under all circumstances, then rising conflict may portend significant economic losses for the region. On the other hand, if states are beholden to economic relationships to the detriment of security imperatives, then China’s increasing economic weight will enhance its strategic influence. It is therefore important to understand the mechanism through which economic interdependence

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2 In the author’s words, “it is obvious that the neutrality Norway claimed to maintain was not a real one”: Orvik 1953, 59.
might create strategic vulnerabilities that could affect a state’s security policies, and to what degree any such vulnerability might shape these security choices.

1.2 Economic interdependence with a competitor state: Responding to rising China

Contemporary East Asia offers a wealth of opportunities to consider how interdependence might create vulnerability and whether this could affect states’ security policies. There is evidence that China is already using its newfound economic weight to pursue broader strategic objectives—one study found that countries suffered a temporary reduction in trade with China after their leaders met with the Dalai Lama. But how exactly is economic leverage deployed, and does it affect security policies? Consider the following empirical puzzles.

Both Japan the Philippines have experienced attempts by China to utilize the close bilateral economic relationship as leverage in political disputes over maritime territory. In September 2010 the arrest of a Chinese fishing boat captain following a collision with the Japanese Coast Guard off the Senkaku/Diaoyu Islands provoked a strident response from China which included the temporary suspension of rare earth element exports. In September 2012, a second crisis arising from the purchase of the same islands by the Japanese government saw vigorous anti-Japan protests in mainland China, violence against Japanese assets and boycotts of Japanese products by Chinese consumers. Factories were temporarily closed and sales of certain Japanese-branded goods—especially cars—fell sharply. In contrast, the territorial dispute with the Philippines, marked by a two-month maritime standoff around the Scarborough Shoal in April

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3 Fuchs and Klann 2013. See also Zhao 2010.
4 There is disagreement on whether China’s suspension of rare earth exports even occurred, and whether it constituted deliberate punishment for the captain’s arrest; Tiberghien 2010, Hagstrom 2012, Morrison and Tang 2012 and Johnston 2013.
2012, elicited a very different economic response from China. The primary victim was the banana industry, which suddenly found itself banned from exporting to China due to alleged quarantine concerns. Overall however, economic links between the Philippines and China were far less affected.

How did Japan and the Philippines respond to these tactics? When the Scarborough Shoal crisis first broke, Manila sent its only warship to the area, Filipino sailors boarded Chinese fishing vessels and, publicly, the government was quick, clear and assertive in its intention to defend its sovereign interests. Despite China’s superior maritime capabilities ultimately taking control of the situation at sea, Manila continued to push its interests by initiating litigation through an international tribunal to force China to clarify its ambiguous maritime claims over the South China Sea. Japan’s response, in contrast, was more variable. The 2010 arrest of the fishing captain and his subsequent return following Chinese pressure is widely perceived in Japan as a tactical defeat.5 While strictly asserting the legitimacy of its claim, the Japanese government continuously sought policies to prevent the dispute from escalating.6

These descriptions present two puzzles. The first is that the worst affected industries respectively were Japanese cars and Philippine bananas; why these and not others? It is also surprising that overall Japan’s economic relations with China suffered more than the Philippines’. Japan was China’s number one import supplier and number two export customer; China’s trade the Philippines was minuscule by comparison. Accordingly, it should have been costlier for China to

5 Author interviews with numerous Japanese policymakers and observers (Tokyo, June/July 2013) accepted this point. For an editorial perspective, see “Learn Senkaku lessons: Beef up crisis control”, The Daily Yomiuri, January 23, 2011.
6 Jerden and Hagstrom 2012. These include preventing Japanese citizens from visiting the islands and criticizing Diet members who made visits. Most recently, Tokyo’s decision to nationalize the islands in September 2012 was intended to be the least provocative measure after a nationalist politician had threatened to take control of the islands himself. See “Japan's Miscalculations Dashed Hopes for Soft Landing over Senkakus”, Kyodo News, November 8, 2012. This issue will be given extensive treatment in Chapter 4.
disrupt relations with Japan. The second puzzle is why the Philippines appeared to respond more forcefully than Japan. Japan possessed a superior military, much larger economy and stronger security guarantee from the United States regarding conflict over the disputed territory. Across all conventional measures therefore, it should have been relatively more costly to Chinese interests for Beijing to target economic relations with Japan and relatively easier for Tokyo to withstand Chinese pressure.

Different questions emerge when considering the experiences of Singapore and Australia. The two countries share similar strategic contexts, counting China as an important economic partner and lacking any territorial dispute. Yet both are also uncertain of how China’s future conduct will affect the regional order. On the surface, no country has been more economically dependent on China than Australia. After rising steadily for a decade, over 25 percent of Australia’s exports were sent to China from 2010 to 2013—the highest percentage of any country in the region—and the relationship has been concentrated in a single commodity, iron ore. The Australian public and their leaders have routinely acknowledged that China is critical to the prosperity of Australia’s economy, yet Canberra has at times still been willing to defy Beijing, publicly and sometimes bluntly. Australia has self-confidently deepened its security alliance with the United States, publicly criticized Chinese defense policies and blocked Chinese foreign investment in Australian industry—all with strong public support. There has been little trace of economic vulnerability in Australia’s dealings with China.

7 The United States, while remaining neutral over the sovereignty disputes, has been clear in recognizing Japan’s administrative control over the islands and noting that the islands fall within the scope of the 1960 Mutual Defense Treaty which requires the U.S. to assist Japan in the event of an armed attack on “territories under the administration of Japan”. The U.S. has not been as clear on the Philippines situation: Fravel 2010; International Crisis Group 2012b, 9 (fn 79).
A global shipping and trading hub with perhaps the most open economy in the world, Singapore’s direct economic vulnerability towards China appears on its face lower than Australia’s; being economically open to all means being dependent on none. Yet unlike Australia, vulnerability is a central motivator of Singaporean strategy. In contrast to Canberra’s occasional propensity for bold opposition to China, Singapore has conducted itself far more carefully, adopting a very precise and consistent China strategy which pairs deep economic engagement and positive diplomacy with solid but understated security cooperation with the United States. Part of this discipline is driven by Singapore’s history and geo-strategic location but, as will be shown, part of Singapore’s economic and security policy mix comes from its unique experience of economic interdependence with China, in particular the lessons learned from investments by government-linked companies on the mainland. Singapore has rarely challenged Beijing politically, but it has also carefully managed its economic exposure to China and minimized its vulnerability by fostering a diverse portfolio of foreign economic relationships. Although neither country has faced a steep tradeoff between its economic and security interests, both Singapore and Australia have experienced and responded to their interdependence with China in different ways. Understanding why can offer a distinctive insight into the broader phenomenon.

These puzzles elicit the two research questions motivating this project. First, under what conditions can economic interdependence between two states be a source of vulnerability for one and a source of influence and coercive power for the other? Second, can such “economic vulnerability” be so severe that the state will compromise or redefine its security interests; in other words, how far can economic interests intrude into security policies? China is one of the most important economic partners of every state in Asia. Yet Manila has been arguably more
assertive of its territorial claims than Tokyo, despite the fact that according to traditional military and economic measures the Philippines should be the more vulnerable. Australia and Singapore have paired economic engagement with China with robust security cooperation with the United States, yet despite its economy seeming to rely more heavily on China, Australia has been more willing to defy Chinese interests while Singapore has managed its vulnerability with care. This dissertation asks how economic interdependence can generate vulnerability, and whether and how it was a contributing factor in the outcomes described.

1.3 The argument in brief

Consider two states, “sender” and “target”, that are in a relationship of economic interdependence. Both states face costs of exiting the relationship, termed “disruption losses”, which are defined as the magnitude of the losses borne by economic actors in switching to alternatives should existing economic links be disrupted. Existing scholarship on interdependence establishes that an asymmetry in the respective disruption losses faced by the target and sender is the basis of vulnerability and power. Where the target’s disruption losses are higher, it will be vulnerable to the (more powerful) sender.

The major theoretical contribution of this research is to reconceptualize economic interdependence by deriving a new theory which explains how the degree of asymmetry in disruption losses can vary across bilateral economic relationships. Accompanying the theory is an improved measure of relative disruption losses applicable in the context of 21st century East Asia, and in particular states’ bilateral relationships with China. Orthodox measures of

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interdependence inappropriately rely on trade volumes and economic size and cannot account for the reality that East Asian trade has evolved from traditional bilateral movements of final goods to integrated trade in intermediate inputs within a vertically fragmented transnational production network. Within this network, economies are specialized in different production processes; this specialization in turn shapes the character of their trade and investment relationship with China. Simply put, different types of economies interact differently with China, and these differences drive variation in the degree of asymmetric interdependence.

I develop a typology based on an economy’s specialized profile in the transnational production network: “resource” economies primarily export natural resources, “factory” economies primarily export intermediate inputs, and “headquarter” economies manufacture final goods inside China through affiliates, selling these goods under national brands to Chinese consumers. This typology provides the theoretical foundation for a novel operationalization of interdependence and measurement of relative disruption losses. My argument is that relative disruption losses (and thus the degree of states’ asymmetric interdependence with China) vary with each economy’s specialized production profile in the network. This profile determines the specificity of economic relationships and thus the relative cost of switching to alternatives. Asymmetry is thus the first dependent variable in this study, with the new theory of asymmetry generating the hypothesis that resource economies will experience the lowest degree of asymmetry, headquarter economies will face the highest, with factory economies in between.

Examining asymmetry is only half the story. In addition to being economically interdependent, the “sender” and “target” states are also modelled as “competitors” in the sense that they have actual or potentially conflicting security interests. The second question is therefore under what conditions the vulnerability which arises from asymmetry can affect security policy. I argue that
whether asymmetry can empower the sender to coerce or influence the target depends on the relative importance or political salience that the target government attaches to the security interests in dispute. The more highly valued the interests, the less likely the avoidance of disruption losses will motivate accommodating policy.\(^9\) Unlike the asymmetry variable, I do not offer a new theory of security policy, focusing instead on presenting a simple model to explicitly test the hypothesis, debated by scholars and commonly assumed by practitioners, that China’s economic power has affected states’ security behavior.

This dissertation accordingly undertakes two tasks. First, I consider the microfoundations of economic interdependence and derive a new theory of asymmetry which incorporates an improved measure of disruption losses. Second, I build a simple model to test hypotheses relating to the existence of asymmetry and the effect of economic vulnerability on security policy. The notion that economic interdependence may create vulnerability is not new. The contribution of this study is in identifying a new source of domestic variation that influences the degree of asymmetry in economic interdependence. I analyze and test the causal mechanism through which interdependence may affect state behavior, and consider the empirical evidence from East Asia on whether interdependence with China has affected states’ security policies.

This research contributes two key empirical findings. First, the available evidence from East Asia between 2002 and 2013 is consistent with the proposed theory of asymmetry and the claim that an economy’s specialized production profile is a better measure of asymmetry and thus relative vulnerability from economic interdependence. Second, economic interdependence is limited in the extent to which it can affect security policy because security issues are normally of much higher political salience to target governments and publics. Interdependence is not

meaningless—it enters into the strategic calculus of all states as they develop and implement economic and security policies and manage their relationship with China. However, interdependence “matters most when it matters least”. When the stakes are low, it incentivizes states to look to cooperate with China and resolve disputes; but when the stakes are high, interdependence has proven unable to compel states into adopting security policies more accommodating of Chinese interests.

1.4 Existing research on the impact of economic interdependence

Four separate literatures touch on one or more of the issues at the heart of this project: economic interdependence, security policy and the rise of China.

1.4.1 Asian security scholarship on the rise of China: Theories of balancing (and their rejoinders)

China’s rise as both a military and economic power has been a central theme in Asian security scholarship in the 21st century. The dominant discourse has focused on whether Asian states are ‘balancing’ China’s rise. Theories of balancing offer a set of empirical predictions to explain how states respond to the rise of an aspiring major power.10 There is wide disagreement on what responses are possible; some scholars employ the traditional dichotomy of balancing or bandwagoning11, others a continuum of strategies between balancing and bandwagoning that include “binding”, “engaging” and “buck-passing”.12 Yet others use other terminology such as

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10 For example see Ross and Johnston 1999; Kang 2003; Acharya 2003/04; Shambaugh 2004/05; Roy 2005a; Ross 2006; Goh 2007/08; Kuik 2008; Ciorciari 2009; White 2011; Chan 2012; Manicom and O’Neill 2012. The label “theories of balancing” is employed because this set of theories explains the conditions under which states adopt balancing strategies: Nexon 2009, 340.
11 Waltz 1979; Ross (2006, note 25) prefers the term “accommodation” to “bandwagoning”.
12 Schweller 1999.
“hedging” and “accommodation”;\textsuperscript{13} “omni-enmeshment” and “complex balancing”;\textsuperscript{14} “low-intensity balancing”;\textsuperscript{15} and “soft-balancing”.\textsuperscript{16}

Amid this litany of possible strategies lies substantive disagreement along two dimensions. The first is the source of state preferences. Are states primarily motivated by China’s growing military capabilities as a potential threat to their survival, by the lucrative opportunities generated by China’s economic growth, by a uniquely and specifically “Asian” constellation of interests and beliefs, or by some combination of these factors?\textsuperscript{17} The second source of disagreement is empirical; scholars disagree on whether observed country behavior should be coded as being more consistent with the particular “pro-” or “anti-” China strategies they have theorized.\textsuperscript{18}

When attempting to explain states’ responses to China, most authors have acknowledged, if not incorporated, increased levels of economic interdependence into their theories. For example, despite their fundamental disagreement on the source of state preferences, both Ross and Kang acknowledge that economic ties are an incentive and potential source of influence, but both discount interdependence as being a significant factor in motivating state behavior.\textsuperscript{19} Rather than

\textsuperscript{13} Kang 2007.

\textsuperscript{14} Goh 2007/08.

\textsuperscript{15} Roy 2005a.

\textsuperscript{16} Soft-balancing is the use of policy tools that do not entail increasing military capabilities as required by traditional theories of balancing but nevertheless inhibit or undermine great power strategies: Khong 2004; Pape 2005.

\textsuperscript{17} Ross 2006; Roy 2005; Kang 2007; Goh 2007/08. The combination argument is made by Goh (2007/08) who posits that Asian states concerned by the threat of Chinese aggression employ a range of non-traditional balancing strategies that aim at socializing China into accepting a stable order, but an order that satisfies an Asian vision of hierarchy in which China plays a prominent role.

\textsuperscript{18} For example, Kang (2009) and Ross (2006) see South Korea as accommodating China’s rise, though for very different reasons, while Tow and Rigby (2011) see elements of hedging or balancing. In the late 1990s, Green (2001) saw Japan shifting to a “reluctant realism” to hedge against Chinese rising power with Ross (2006) agreeing. In contrast, looking at the entire period 1978-2011, Jerdén and Hagstrom (2012) classify Japanese behavior as accommodating Chinese interests to a great extent, enabling China’s rise. Mochizuki (2007) takes a middle position, seeing evidence of a “mixed strategy” combining balancing (as hedging) and positive engagement.

\textsuperscript{19} Ross 2006, 366; Kang 2009, 4 (in relation to South Korea). Ross (2006, 357-58) believes that the primary motivator of secondary states is the distribution of power capabilities in their immediate vicinity. Kang (2009, 18) argues that South Korea’s policy toward China is driven by a set of discreet non-generalizable interests, in particular North Korea.
being a source of influence for China, Goh identifies economic engagement as part of a conscious strategy by Southeast Asian states to socialize China into believing that regional stability is in its best interests. As Acharya points out however, there is a danger in confusing economic self-interest with some grand strategy to manage China’s rise by accommodating or balancing against it. Most choices to pursue economic ties with China are based on rationalist, absolute gains logic, and of themselves say little about how states decide on security strategies.

Theories of balancing and their rejoinders have sought to fit evidence from Asia into traditional security paradigms, and in doing so may have expanded the balancing concept so that it now describes statecraft generally. As Chan argues, terms such as “soft balancing” and “complex balancing” adopt terminology of balancing without adhering to its essential meaning, serving to fit observed evidence into these theoretical constructs but without adding new theoretical content. Moreover, economic incentives are largely reduced to explaining the trite fact that states face incentives to engage with China which may moderate balancing behavior, but no theoretical precision is provided on the conditions under which economic interests may actually require states to trade-off their security interests or on the mechanism through which this might occur. Theories of balancing thus fall short on the question of how economic interdependence with China shapes state behavior.

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21 Acharya 2003/04, 151.
22 Roy 2005.
23 Chan 2012, 51. Schweller (1999, 17) also acknowledges that in the real world states adopt mixed strategies in which seemingly contradictory acts (such as balancing and bandwagoning) can be conducted to realize different goals.
24 An important note of caution is that China’s rise is incomplete. This means that contemporary theorizing and empirical work is to a large extent speculative. The lack of data points makes evaluation of empirical predictions very difficult, and future events may falsify much existing scholarship. This fact adds to the importance of theoretical precision and the clear specification of causal mechanisms so that, if contrary data subsequently arises, the challenges of revising theories and sustaining a progressive research program are achievable.
1.4.2 The relationship between economic interdependence and conflict

The second body of research has not often touched on the specific case of rising China, nor does it seek to study the alternative strategies states pursue in response to rising powers. This literature focuses instead on the effect of economic interdependence on conflict. A heated empirical debate has raged on whether trade interdependence reduces conflict between states,\(^{25}\) which has been extended to studies on the effects on conflict of openness to capital,\(^{26}\) trade disaggregated by industry,\(^{27}\) trade in strategic goods,\(^{28}\) free trade,\(^{29}\) networked trading communities,\(^{30}\) and asymmetric interdependence.\(^{31}\) Accompanying the large-sample quantitative empirical work that is a feature of this research program has been theorizing which has brought increased precision to the mechanisms through which economic links may affect state behavior.\(^{32}\) These mechanisms are proposed within two core modeling frameworks.

The first framework adopts the assumptions of commercial liberalism, attributing state behavior to the patterns of market incentives facing economic actors, and the pressure they place on domestic governments to facilitate or block transnational economic exchange.\(^{33}\) The logic is that transnational exchanges confer benefits on private actors in the domestic economy, and these actors will thus have a stake in any state-to-state interactions that may threaten (or enhance)

\(^{25}\) See for example Oneal and Russett 1997; Barbieri and Schneider 1999; Mansfield and Pollins 2003.
\(^{26}\) Gartzke and Li 2003.
\(^{27}\) Dorussen 2006.
\(^{28}\) Ripsman and Blanchard 1996; Goenner 2010.
\(^{29}\) McDonald 2004.
\(^{30}\) Lupu and Traag 2013.
\(^{31}\) Crescenzi 2003.
\(^{32}\) Mansfield and Pollins 2003 and especially Chapter 1 for an overview of interdependence and conflict debate.
\(^{33}\) Moravesik 1997, 528.
these benefits, and will lobby governments accordingly.\textsuperscript{34} This framework thus suggests a bottom-up mechanism through which economic interdependence can influence state behavior.

The second framework emerges from endogenizing decisions to engage in transnational commerce on the grounds that economic actors only choose to trade and invest when they expect the threat to economic interests from interstate political conflict is low.\textsuperscript{35} Using game-theoretic models of costly contests between rational states,\textsuperscript{36} economic interdependence is modeled as providing states with new tools, short of fighting, through which they can reveal private information by credibly signaling their resolve over a disputed issue.\textsuperscript{37} These “information” models differ from commercial liberalism models because states are rational unitary actors bargaining over outcomes, and the effect of economic interdependence on state behavior is through its availability as a credible signal.

These two very different frameworks operate at different levels of analysis, but need not be inconsistent since the source of the costly signal could be punishment from domestic audiences. Yet a recent study by Davis and Meunier (2011) offers both quantitative and case-study evidence indicating that neither the domestic lobbying nor costly signal mechanisms have operative effect, and that politics and economics are largely insulated from one another; governments tend not intervene in markets for political reasons, while private actors tend not change their behavior in response to conflict.\textsuperscript{38} Ultimately, the rich theorizing and contradictory empirical findings from this literature strongly suggest that there no unconditional correlations between economic

\textsuperscript{34}This argument dates back to Angell (1933) who argued this reduced the incentives for conflict. Brooks (2005) updates the argument, highlighting the globalization of production has dramatically lowered the benefits of conquest, because the conquered would only control a (devalued and possibly abandoned) fragment of a larger production process.
\textsuperscript{35}Morrow 1999; Gartzke et al 2001.
\textsuperscript{36}Fearon 1995.
\textsuperscript{37}Gartzke et al 2001; Gartzke and Li 2003; Benson and Niou 2007.
\textsuperscript{38}Davis and Meunier 2011.
interdependence and state behavior. At the very least, economic interdependence cuts across levels of analysis and theorizing requires careful specification of the causal mechanisms through which it is posited to have an effect.

1.4.3 Economic sanctions: Are they effective and how do they work?

The third strand of literature also considers state interactions in a bargaining framework, analyzing coercive attempts in the form of economic sanctions and features research on two separate issues. The first is the debate on whether sanctions are effective; that is, whether they have been successful in achieving stated political objectives. This debate is useful insofar as it has generated conditions under which sanctions are more likely to change target state behavior. What is missing is insight on the causal mechanisms through which sanctions work, and this question is taken up by a second strand of research, pioneered by Baldwin (1985, 1999) and developed by Kirshner (1997, 2002). This second research program focuses on the political context in which sanctions are imposed and defied, along with the relative cost/benefit calculus of imposing/defying sanctions versus alternative policies. To do this, Kirshner (1997) unpacks the microfoundations of economic statecraft in general, elucidating an array of factors and complex interactions underlying their use. A critical component of Kirshner’s theorizing is his adoption of commercial liberal assumptions by modeling the state as pluralistic, comprising a central government and those groups whose support the government needs to retain power. This

39 A similar point is made Benson and Niou (2007, 51).
40 The debate was fiercest in the 1990s, primarily pitting Hufbauer et al (1990) and their comprehensive empirical study against Pape (1997); for rejoinders see Elliot (1998) and Pape (1998). For more recent extensions of this literature see Morgan and Schwebach 1997; Brooks 2002; Allen 2005; Marinov 2005; Ang and Peksen 2007; Lektzian and Souva 2007; Allen 2008.
41 Examples include sanctions where there is a large gap in costs between target and sender, sanctions carrying modest goals and sanctions targeted at otherwise friendly states (where expectations of future conflict are low): see Hufbauer et al 2009 and Drezner 1999.
42 See also Blanchard and Ripsman 1999.
43 Kirshner (1997, 34) specifies three contextual variables: the full range of goals of the sanctioning state; the comparative costs of sanctions versus alternative policies; and the value the target state places on non-compliance.
allows his model to differentiate between types of sanctions and, critically, to consider how sanctions affect the interests and incentives of various domestic actors and thus whether economic effects translate into desired political outcomes. Specifying actor preferences facilitates, for example, analysis of the value the target state places on defying the sanctions despite the costs involved. This aspect is obviously critical when considering the tradeoff between economic and security interests that interdependent states may face.

1.4.4 The microfoundations of interdependence

The final strand of research can best be categorized as a case-study approach to studying economic interdependence with an emphasis on causal mechanisms, relying far less on large-sample quantitative analyses than is typical of the interdependence and conflict research program. Like the sanctions research agenda lead by Baldwin and Kirshner, this research adopts the baseline assumptions of commercial liberalism and employs case studies and process tracing to identify the causal mechanism through which economic interdependence influences state behavior.

An early study by Papayoanou argues that both the degree and source of economic interdependence influence states’ balancing strategies. Using case studies from 19th century France and Russia, the World Wars and the Cold War, his theory posits that high interdependence with status quo allies make states more likely to balance revisionist powers,

44 Kirshner 1997, 41. See also Baldwin 1985. Such differentiation facilitates explication of the seemingly counterintuitive finding that sanctions can increase social and political integration inside the target state and thus its capacity to withstand sanctions, for example because of the “rally ‘round the flag” effect from leaders making heroic sacrifices to resist the foreign enemy: Galtung 1967. See also Rowe 2001, Lektzian and Souva 2007.
45 See also Blanchard and Ripsman 1999. As Galtung (1967, 380) writes: “it makes good sense to ask a politician engaged in sanction policies, “if you cannot have both, which outcome would you prefer, punishment without compliance or compliance without punishment?”

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while high interdependence with revisionist states reduces the propensity to balance.\textsuperscript{46} Delving deeper into the microfoundations of state security preferences, Narizny argues that British alignment patterns prior to both world wars correlated with political party differences which stemmed not from ideology, but from the sectoral interests of their constituents which in turn varied with societal groups’ exposure to the international economy.\textsuperscript{47}

Even deeper analysis can be found in Kastner’s recent work on cross-strait relations. Kastner theorizes that political conflict will have less impact on international economic flows when political leaders in each state are accountable to internationalist economic interests.\textsuperscript{48} What distinguishes his contribution is its lengthy treatment of a single-case—the political and economic relationship between China and Taiwan—tracing variation in the political influence enjoyed by Taiwanese business and its correlation with changes in Taiwan’s cross-strait economic policies.\textsuperscript{49} While economic flows are Kastner’s dependent variable, interdependence has a causative effect through the incentive it creates for domestic business interests to pressure their government into non-confrontational behavior. Importantly, as Kastner points out, this effect not only operated in Taiwan, but also inside China, where there was pressure not to use economic relations as leverage because this would weaken the most pro-China actors inside Taiwan (business actors) and empower more hostile forces.

\textsuperscript{46} Papayoanou 1997; Papayoanou 1999. In a related paper, Papayoanou (1996) shows that despite deep but symmetric economic interdependence, Great Britain and Germany adopted different strategies toward each other prior to 1914, by virtue of the interaction between interdependence and coalitions of interest groups and institutions. Interdependence constrained British strategists from responding to Germany’s rise, with the effect of undermining the credibility of its balancing strategy, while it spurred German actors into using aggressive policies to transform the nature of their international economic links.
\textsuperscript{47} Narizny 2003. Buszynski (2009) argues that the degree of representativeness of the regime determines the impact of interdependence.
\textsuperscript{48} Kastner 2009.
\textsuperscript{49} Kastner (2009) conducts brief comparative studies on North-South relations on the Korean Peninsula and relations between India and Pakistan.
1.5 Conclusions and outline

This brief literature review suggests that a strong focus on traditional balance of power issues has caused security scholarship on the rise of China to pay insufficient attention to the mechanisms through which economic interdependence operates. What is missing is an initial inquiry on conditions under which economic vulnerability arises, before examining the dynamics of states’ security choices. The theoretical underpinnings of this question are the seminal works of Hirschman and Keohane and Nye,50 who first identified that vulnerability is a function of the relative costs of alternatives—the condition of asymmetry—within a bargaining relationship. There is very little research that builds on these foundational principles by exploring the microfoundations of vulnerability—i.e. the conditions under which the costs of alternatives vary—or applying the principles to empirical contexts. Identifying these conditions is a necessary step in the causal chain from economic interdependence to security policies, and this dissertation explicitly aims to fill this theoretical and empirical gap.

Chapter 2 develops a model of economic interdependence between “sender” and “target” states and discusses how vulnerability and power emerge from an asymmetry in “disruption losses”, which are themselves a function of the specificity of bilateral economic links. A new theory of asymmetry hypothesizes that variation in the specialized production profiles among East Asian states’ determines the degree of asymmetry and vulnerability between China and each state. I outline a research design to test the hypothesis that production profile explains vulnerability, and to guide how evidence will be collected and organized. I argue the new theory of asymmetry is more theoretically appropriate because it better identifies the conditions under which

50 Hirschman 1945; Keohane and Nye 1977.
interdependence creates vulnerability and power, and further admits a more empirically accurate measure of variation in vulnerability across states.

Chapter 3 extends to model to facilitate the testing of a second hypothesis that economic interdependence can affect security policy. No new theory of security policy is deduced; instead, the model is designed to facilitate the interpretation of evidence drawn from observed state behaviors. I argue that governments’ decision calculus on security is fundamentally driven by the relative political salience of competing interests. Where the security interests are of greater importance, governments will be willing to endure the losses, threatened or actual, from economic disruption, and vice versa.

Chapters 4 through 7 comprise four case studies, loosely structured as paired comparisons, which constitute the evidence of states’ responses to China over the years 2002-2013 against which the hypotheses are tested. The case studies explore whether an economy’s specialized profile in the transnational production network is a good indicator of variation in relative disruption losses and thus asymmetric interdependence and vulnerability, and whether economic vulnerability has affected states’ security policies. A final chapter summarizes the dissertation’s argument and findings and concludes.
2. THEORY: A Theory of Asymmetry and Economic Vulnerability

2.1 Introduction

Under what conditions can economic interdependence create vulnerabilities that could be exploited as a tool of coercion? Through what mechanism does interdependence create these vulnerabilities? And to what extent can economic vulnerabilities actually influence a state’s security policies? Existing research has considered the impact of interdependence across two levels of analysis. At the domestic level, governments feel pressure from economic interest groups to preserve the beneficial relationship. At the international level, asymmetry in interdependence creates unequal bargaining power between states. These mechanisms may influence state policies, but their strength depends on the degree of asymmetry.

This chapter proposes a simple theory that derives the conditions under which bilateral economic interdependence between “sender” and “target” states generates vulnerability in the target. Interdependence means that both states will incur costs should the relationship be disrupted; but when these “disruption losses” are greater for the target, the asymmetry confers a bargaining advantage on the sender, rendering the target vulnerable. Whereas much existing scholarship operationalizes asymmetry using relative trade volumes and economic size, I argue that it is more theoretically appropriate to consider the specificity of economic links as the basis for operationalization and measurement of disruption losses.

Contemporary trade in East Asia has evolved from traditional bilateral movements of final goods to integrated trade in intermediate inputs within a vertically fragmented transnational production

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53 Keohane and Nye 1977.
network. Within this network, individual economies are specialized in different production processes. I argue the level of specificity in bilateral economic relationships varies with the character of these processes and that, accordingly, relative disruption losses are better operationalized (and asymmetry more accurately measured) according to the production profile of each East Asian economy vis-à-vis China. This theory of asymmetry hypothesizes that variation in production profile drives variation in relative disruption losses and thus the relative vulnerability of East Asian states.

2.2 A theory of asymmetry

The seminal work on interdependence remains Keohane and Nye’s *Power and Interdependence*, in which the authors identify asymmetry as the link between interdependence and power; less-dependent states enjoy leverage over more dependent states.\(^{54}\) I build on this insight by proposing a theory of asymmetry which offers a more comprehensive approach to modeling interdependence and operationalizing the relevant variables, with the ultimate goal of developing empirical measures of (and testable hypotheses on) economic vulnerability.

\(^{54}\)Keohane and Nye 1977, 10-11. The authors recognize Albert Hirschman’s *National Power and the Structure of Foreign Trade* 1945 as an early proponent of this idea: Keohane and Nye 1987. See also Galtung 1967; but compare Wagner 1988.
2.2.1. Conceptualizing economic interdependence: Disruption losses and asymmetry

Consider two states, “sender” and “target”, within which private and public actors engage in international economic transactions such as trade and investment with actors in the other state. Assume the two states are in a relationship of economic interdependence, which means that the transactions have reciprocal and significant (though not necessarily symmetric) costly effects, implying that switching to alternatives outside the relationship would be costly for actors on both sides of the transaction.\(^{55}\) I define the term “disruption losses” as the magnitude of the costs borne by economic actors from each state if the interdependent relationship is disrupted. Disruption losses depend upon the availability and costliness of alternatives to the bilateral relationship, which are a function of the degree of specificity of the transactions involved. If an economic actor can no longer do business with its counterpart in the other country, how transferrable are the resources and structures which constitute the transaction? Are alternative buyers or sellers available; can investments be moved or new sources of funding secured? The formal analogue from microeconomic theory is the elasticity of substitution, defined as the relative ease with which a firm can substitute one factor of production for another.\(^{56}\) The same logic applies for interdependence, except that rather than replacing an input, the economic actor must replace its counterpart in an international economic transaction.

While economic interdependence assumes both states face disruption losses, relative magnitudes may differ. Keohane and Nye establish that it is via such asymmetry that interdependence creates power and vulnerability.\(^{57}\) The condition of “asymmetric interdependence” arises when the

\(^{55}\) Keohane and Nye 1977, 9. As the authors point out, where there are no costs there is simply interconnectedness, rather than interdependence.

\(^{56}\) Hicks 1932.

\(^{57}\) High specificity is equivalent to the concept of inelasticity in economics: Hirschman 1945; Keohane and Nye 1977.
target’s disruption losses are greater than the sender’s. Asymmetry creates vulnerability in the target and empowers the sender with a potential source of bargaining leverage. Vulnerability may manifest in a coercive threat or action by the sender to disrupt or end the bilateral relationship, or it may materialize as latent pressure felt by the target to maintain good relations with the sender and avoid creating discord out of concern that economic ties might somehow be affected. Importantly, economic disruption is conceived here as a political act by the sender government, or as a political risk perceived by the target. It includes any threat or action intended to impair or halt the ordinary flow of international economic relations between the two states.\textsuperscript{58}

Disruption may come directly from a policy of the sender government, or through the actions of non-government groups with explicit or implicit government approval.

Changing the target’s behavior requires a credible threat or risk of economic disruption.\textsuperscript{59} For a threat of disruption by the sender to be credible, or for the target to perceive a credible risk of disruption, the sender’s disruption losses—the costs for its economic actors of switching to alternatives—must be relatively less.\textsuperscript{60} In contrast, where the sender’s alternatives are no better than the target’s and disruption losses are equal, the sender cannot credibly threaten what is then a symmetrically interdependent relationship.

\textsuperscript{58} Hufbauer et al (2009, 3) define economic sanctions as “the deliberate, government inspired withdrawal, or threat of withdrawal, of customary trade or financial relations”. Economic disruption is intended to be defined more broadly to include actions by private agents to harm economic relations which have the government’s consent.

\textsuperscript{59} Schelling 1960, ch 2; Fearon 1995.

\textsuperscript{60} Credibility could also derive from the perception that the sender has the resolve to pay the costs of disruption losses no matter their size. This condition is outside the scope of this theory because it is a question of resolve, and asymmetric interdependence is not necessary condition for credible signals of resolve.
2.2.2 Operationalizing economic interdependence using vertical fragmentation

While scholars have not yet agreed on how to operationalize and accurately measure economic interdependence,\textsuperscript{61} two factors are typically emphasized: trade volumes and economic size. Most measures employ aggregate data on the volume of trade flows, with a common approach being to measure dyadic trade (exports plus imports) as a proportion of total trade.\textsuperscript{62} Incorporating economic size into this measure yields dyadic trade as a percentage of GDP.\textsuperscript{63} These and similar methods are vulnerable to the theoretical criticism that aggregates do not reflect the cost and availability of alternatives which is the conceptual basis of disruption losses;\textsuperscript{64} aggregates ignore \textit{what} is being traded between states.\textsuperscript{65} This theoretical shortcoming likely stems from the fact that interdependence is operationalized and measured with economic data which spans decades and even centuries, and thus necessarily assumes a traditional model of international trade dominated by final goods. The reality is that this model is outdated; trade has evolved from bilateral movements of final goods to an extensive trade in intermediate inputs within a vertically fragmented transnational production network.

Vertical fragmentation means splitting up a production process into increasing numbers of stages that can be undertaken in different locations across different countries. Fragmentation is driven by labor cost differentials—firms can cut costs by hiring cheap labor in neighboring countries—and enabled by falling transportation costs. Each stage of the fragmented production process adds value to the final good. Importantly, fragmentation means that over time economies have

\textsuperscript{61} Barbieri 1996, 36.
\textsuperscript{62} Barbieri 1996.
\textsuperscript{63} Oneal and Russett 1997.
\textsuperscript{64} Mansfield and Pollins 2003, 13; Goenner 2010, 547. Notable exceptions to this rule are McDonald 2004, Goenner 2010 and Lupu and Traag 2013.
\textsuperscript{65} Positive attempts to rectify these flaws have focused on trade in strategic goods which are important for fighting wars: Ripsman and Blanchard 1996; Goenner 2010.
come to specialize in different tasks at different points along the production chain. Farthest upstream “resource” economy firms mine, farm and process raw materials and other commodities. “Headquarter” economy firms design products, manufacture the most sophisticated components, outsource lower-skilled production processes such as assembly, and market final goods for sale under national brands. Finally, downstream “factory” economy firms utilize their cheaper labor forces to undertake low-skilled production processes, such as the manufacture of certain intermediate inputs and the assembly of inputs into completed goods. Vertical fragmentation renders measures of interdependence relying on aggregate trade volumes obsolete, because such data records the entire value of the final exported good without subtracting the value added by imported intermediate inputs produced upstream in the production chain. In 2005, over 27 percent of the total value in Chinese exports came from foreign-sourced intermediate inputs and more than half this foreign value-added came from Asia. Moreover, foreign value-added in Chinese exports rises with the technological sophistication of the product; one 2010 study put the Chinese contribution to the $144 production cost of an assembled Apple iPod at as little four dollars. Zooming out to the regional level, by 2008 intermediate inputs from other Asian countries alone constituted approximately 40 percent of Asia’s total imports.

68 IMF 2011, 15. Foreign-sourced export content was 15 percent for Japan and 12 percent for the U.S.
69 Dedrick et al 2010. This price included about $100 in Japanese value added (for the hard drive, display, and battery), and about $15 of U.S. value added (for the processor, controller, and memory). China may have contributed some additional value added in the $22 of unspecified parts: Koopman et al 2010, n 3. For the general proposition that foreign value-added rises with technological sophistication, see Ma and Van Assche 2011.
70 Author’s calculation based on data from WTO and IDE-JETRO 2011. For China specifically, 40 percent of its imports from major East Asian trading partners were inputs in 2006: Ma and Van Assche 2011, 151.
Aggregate export and import data thus give a misleading impression of the influence arising from trading relationships.  

Industrialized firms began vertically fragmenting their production processes in the 1960s to take advantage of low-cost labor in Southeast Asia, but the process expanded and accelerated in the 1990s and 2000s with the rise of China. The result saw individual states become host to geographic concentrations of industries specializing in activities at particular points in an expanding transnational production network. The aggregate effect of firm-level fragmentation and geographic concentration of certain activities is that different economies have become specialized in different tasks at discreet points within the network, creating a novel source of domestic-level variation that this study employs to operationalize economic interdependence and measure relative disruption losses. Naturally, every economy contains a diverse array of industries and firms operating along all points of production networks. Nevertheless, each East Asian economy’s comparative advantages have, over time, brought about a geographic concentration of and specialization in distinct production processes within each state.

Fragmentation is thus responsible for the realization of a sophisticated transnational production network in the 21st century, termed “Factory Asia” by economists. Incorporating this reality enables a more theoretically appropriate and empirically accurate measure of economic interdependence to be devised.

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71 Pula and Peltonen 2011. Athukorala and Yamashita (2006) make a similar point arguing that trade shares likely give a misleading impression of the importance of trade with the region versus the trade with the rest of the world.

72 Baldwin 2008. Intra-East Asian trade is dominated by industries in which components cross borders. In 2007 electronics comprised over 33 percent of intra-East Asian trade, general machinery over 13 percent and chemicals over 11 percent: Paprzycki and Ito 2010, 103.
2.2.3 China’s production profile in the transnational production network

The most prominent example of this specialization is China itself. As noted, the process of production fragmentation involved firms from higher-cost economies (what this study terms “headquarter” economies, such as Japan) setting up local affiliates and subsidiaries in the lower-cost “factory” countries in order to outsource the low-skilled elements of production processes. While fragmentation began in Southeast Asia, China’s economic opening in the 1980s unshackled its enormous and low-cost labor force and by the mid-2000s China had become the regional ‘hub’ of final assembly operations. Foreign affiliates, subsidiaries and joint ventures import intermediate inputs through regional networks and assemble final consumer goods for re-export, thereby transforming China into the largest and most prominent example of a “factory” economy in East Asia. The setting up of China’s vast assembly operations required equally vast amounts of foreign capital, and thus China simultaneously became a very large recipient of FDI.

China’s emergence as the region’s assembly hub dramatically reshaped its own economy as well as its international economic relationships. By 2004, foreign affiliates and subsidiaries accounted for more than 55 percent of China’s exports and imports. China’s rise in foreign trade was very much based on specialization in assembly activities; by 2005, foreign affiliates and subsidiaries handled almost 80 percent of assembly operations in China (constituting 45 percent of China’s total exports). Between 2000 and 2008, China accounted for about 67 percent of re-exports

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73 Petri 2012.
74 WTO and IDE-JETRO 2011, 74.
75 Gaulier et al 2007a, 2007b; Amiti and Freund 2010.
76 Definitional note: typically parent companies hold minority stakes in affiliates, and majority states in subsidiaries.
77 Gaulier et al 2007a, 40-41. Processing trade is the assembly and processing of duty-free imported inputs for the exclusive purposes of re-export. In 2007, over 76 percent of China’s processing imports—imports of inputs made
worldwide (where inputs are imported duty free and assembled for re-export).\textsuperscript{78} In 2010, foreign companies and joint ventures accounted for over 25 percent of China’s industrial output, 39 percent of its apparel exports and 99 percent of its computer exports.\textsuperscript{79} The economic landscape created by FDI in China and the country’s subsequent specialization in assembly operations were thus the catalyst for redefining transnational production in the 2000s; the result being the rapid growth and consolidation of a highly sophisticated network of fragmented production processes. This transformation also served China’s developmental needs well by absorbing surplus labor and powering industrialization and urbanization. Yet both these processes required vast amounts of raw materials, and so from the mid-2000s China also began to invest abroad with a focus on securing access to energy and commodities.\textsuperscript{80}

China’s production profile in the transnational production network since the mid-2000s is thus defined primarily by its status as the regional assembly hub and significant recipient of FDI, and to a minor extent by its nascent investments abroad in energy and natural resources. With this profile established it becomes possible to define the production profile of other East Asian countries \textit{vis-à-vis China} in the transnational production network over this period. I argue that production profiles determine the relative magnitude of disruption losses and thus condition the degree of asymmetry in a bilateral economic relationship. In other words, production profile determines the degree of potential vulnerability for states in interdependent relationships. For the purposes of theory building, I simplify East Asian states into the three ideal-type production profiles already introduced: “resource” economies, “headquarter” economies and “factory” economies.

\textsuperscript{78} World Bank and IDE-JETRO 2011, 131-133.
\textsuperscript{79} Katz 2013.
\textsuperscript{80} Economy and Levi 2014.
2.3.4 Ideal-type production profiles of East Asian states and their relationship with China

Resource economies

Resource economies sit at the periphery of the transnational production network because their comparative advantage is the production and processing of natural resources—minerals, agricultural goods and other commodities—through activities such as mining, farming and refining. Natural resources are relatively homogenous goods which, to varying extents, are sold on a global market, making any single producer or buyer more easily substitutable for alternatives; there is generally a low degree of specificity in the relationship and a diversity of supply and demand.  

This characteristic of the market for natural resources imbues transactions with a greater degree of baseline symmetry compared to other economic relationships described below. Moreover, resource economies can generally control the scope of foreign investments in natural resources, since investments expected to yield profits will attract multiple suitors.

The symmetry in disruption losses does not mean that alternatives are low in cost. China’s economic development makes it one of the largest buyers of natural resources in the world; its ravenous demand in turn fuels the growth of resource economies. However, China’s need to buy resources approximately equals resource economies’ need to sell. Despite being a small proportion of value-added in transnational production processes, natural resources are critical

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81 Dorussen 2006, 91. Certain commodities can be hard to substitute due to a low number of suppliers; the germane example is rare earth elements for which China dominated supply during the 2000s. These are discussed in Chapter 5.

82 The degree of symmetry inevitably varies across resources; buyers and sellers of coal are easier to replace than uranium. Yet this variation across commodities does not significantly detract from the generalization that natural resources are sold on a global market in transactions with a relatively low degree of specificity.

83 This assumption is conditional on baseline levels of development and institutional strength such that the state is not in desperate need of foreign capital and can withstand corruption. Confining the theory’s scope to East Asia where the major resource economies are fully industrialized (Australia and New Zealand) makes this assumption more plausible. As the case of the Philippines in Chapter 5 will illustrate, it is an assumption which must still be interrogated continuously whenever resource investments are an issue.
inputs for China’s domestic industries such as energy and construction, as well as inputs to manufacturing and the larger process of industrialization. Accordingly, both sides face costs in exiting the relationship; the point is that these costs are roughly symmetric.

The theory of asymmetry therefore predicts that resource economies should face relatively symmetric disruption losses vis-à-vis China. Exiting the relationship would be costly for both sides, but in a roughly equal sense, and the global nature of the resources market means that both sides have alternatives, reducing the specificity of individual transactions. The theory predicts that the relative symmetry in economic interdependence means China, as the sender state, would be less able to make credible threats to disrupt the bilateral economic relationship.\(^\text{84}\)

*Headquarter economies*

Headquarter economies are diverse, sophisticated and wealthy industrialized economies with relatively high labor costs and abundant capital. Their comparative advantage is in human capital, advanced technology manufacturing, supply chain management, sales, marketing and R&D, resulting in the most multifaceted bilateral relationship with China of the ideal-types, but which has been dominated by two types of activity. The first is the process of vertical fragmentation: the outsourcing by headquarter economy firms of lower-valued-added production tasks to China (and other factory economies), where FDI-financed affiliates and subsidiaries combine locally-sourced and imported materials and components with local labor to assemble

\(^{84}\) Consistent with the argument that resource supplies have more alternatives, Broda et al (2008) present evidence indicating that the elasticity of export supply is larger for homogenous commodities than differentiated products. A special subcategory of resource economy states are those which are just beginning to compete with China as factory economies due to their low labor costs. These commodity exporters are only just beginning to industrialize and can compete with China in low-wage activities. Vietnam and Indonesia are examples of this category. They are not considered symmetrically but minimally interdependent, and in that sense strictly fall outside the scope of the theory, though the theory’s logic and empirical predictions apply.
final goods. The second is direct commerce with the Chinese domestic market, in particular the sale of national-branded consumer and capital goods. Maturation of their own domestic markets and the emergence of a middle class in China equals a large opportunity for headquarter economy firms to increase sales. Consumer goods sold in China are assembled there by affiliates, while sophisticated capital goods (e.g. machines) and components are often exported from the headquarter economy. In addition to sales, numerous opportunities exist to invest in projects fueling China’s industrialization and urbanization, often through partnering with local SOEs which dominate certain sectors of the Chinese economy.

The theory of asymmetry predicts that headquarter economies should face the highest degree of asymmetry in their disruption losses vis-à-vis China and thus be the most vulnerable. Both the physical operations of affiliates and the attraction of the Chinese market as a source of sales and investment are economic links with a high degree of specificity from the perspective of headquarter economy firms. Setting up production facilities using FDI and cultivating local distribution networks and personal relationships (upon which business in China heavily relies) is costly. These costs are specific to the location of the investment, making them “irreversible investments” that cannot be recouped. Disruption of the bilateral economic relationship can destroy physical assets inside China or render them worthless, as well as devastating networks of specific business relationships. Moreover, final goods sold under national brands can be easily

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85 Local affiliates and subsidiaries assemble products both for export and the domestic Chinese market. For a sample of the burgeoning economic literature on this phenomenon see Athukorala 2006; Gaulier et al 2007a, 2007b; Athukorala 2010; and Yamashita 2010. The most sophisticated components were often imported from the parent in the headquarter economy, while other components came from third countries, usually factory economies.
87 Components exported from headquarter economies are most often used by local affiliates of the exporting parent companies. This is especially true for Japan; see Hatch 2010.
88 See Fisman et al 2013.
89 Chen and Chen 2004.
90 Gowa and Mansfield 2004 use that descriptive phrase and make a similar argument with respect to the specificity required to engage in intra-industry trade. An alternative characterization is that the elasticity of substitution for these firms was low: Dorussen 2006. See also Gartzke and Li 2003.
identified and disrupted through boycotts, jeopardizing a vital source of sales growth for headquarter economy firms and opportunities for investors.\(^9^1\) Disruption can also deprive domestic manufacturers of critical commodities imported from China.

In contrast, the Chinese counterparts of transactions with headquarter economy firms generally face lower specificity in the relationship and thus relatively lower disruption losses. FDI stocks and flows from a particular headquarter economy can be replaced with capital from other sources as long as China’s growing economy remains a compelling investment destination for foreigners. Final goods sold by headquarter economy firms can be substituted with the offerings of competing firms. To argue however that China enjoys an asymmetric advantage in its interdependence is not assert that disrupting the relationship would be costless. Local interests engaged with the headquarter economy firm would undoubtedly suffer losses. The point is that from an economy-wide perspective, Chinese interests enjoy more alternatives. This asymmetry generates coercive bargaining leverage.

*Factory economies*

Factory economies are positioned alongside China in the transnational production network. They are generally lower-to-middle income economies whose early-stage development export base was mostly commodities but which, beginning in the 1970s and 1980s, adopted an outward-oriented growth strategy, specializing in low-skilled manufacturing processes, in particular components for electronics and electrical goods such as semiconductors and hard-disk drives.\(^9^2\) Production capacity was developed through attracting FDI from headquarter economies to

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\(^9^2\) Borrus et al 2000, Rasiah 2009. Between 1969/70 and 2006/07, the share of manufacturing in total exports of developing Asian countries increased from 44.3 percent to 86.2 percent: Athukorala and Hill 2010.
finance local affiliates and subsidiaries of MNEs, though by the 2000s output was being produced by a mix of these and indigenous contract manufacturers.\textsuperscript{93}

The rise of China as a factory economy sparked concerns that factory economies’ growth strategy would be threatened by competition with China for FDI.\textsuperscript{94} However, as MNEs established production bases throughout the region they began to pursue complementary production strategies in which production of similar products became concentrated in a single country to attain economies of scale. This cemented each economy’s production profile in the network and created pan-East Asian complementary trade.\textsuperscript{95} China thus became one of the largest trading partners for factory economies, and intermediate inputs have been the largest percentage of their exports to China.

The theory of asymmetry predicts that sharing the status of “factory economy” with China creates both protections and vulnerabilities for these economies. On one hand, coercive disruption by China of component trade with a factory economy could undermine the stability of entire production networks in a given industry.\textsuperscript{96} Such disruption would potentially harm the interests of a large and diverse group of economic actors throughout the production chain. On the Chinese side these would be the Chinese factories which use imported inputs imported from factory economies to assemble final goods, reducing China’s capacity and willingness to initiate disruptive action.\textsuperscript{97} On the other hand, components are often produced pursuant to precise specifications within established networks of commercial relationships. There is therefore a high

\textsuperscript{93} Yusuf et al 2004; Athukorala 2006. As an indication of the importance of component trade, in 2003 components accounted for 40.6 percent of total manufacturing exports in ASEAN Free Trade Agreement economies, up from 24.7 percent in 1992: Athukorala and Yamashita 2006, 241.

\textsuperscript{94} Freeman and Bartels 2004, Ch. 1.

\textsuperscript{95} Paprzycki and Ito 2010, 108. In other words, China’s growth created demand for the components produced by factory economies: Athukorala 2009a; Athukorala and Kohpaiboon 2013.

\textsuperscript{96} According to the IMF “any disruption of... intraregional trade flows in Asia, could have large negative spillover effects on domestic production in partner countries: IMF 2011, 21.

\textsuperscript{97} Lee (2012, 213-214) makes a similar claim.
degree of specificity in the trading relationship for factory economies as well, and few short-term alternatives.  

Predicting the relative disruption losses factory economies face from economic interdependence with China thus requires balancing opposing pressures. On one hand, it is more difficult for China to credibly threaten economic ties which would destabilize the production network and harm its own interests. On the other, the smaller factory economies rely equally on the network and would pay very high costs from its disruption; they are therefore more likely to perceive risks to the network and not wish to instigate tensions which could lead to its disruption. Specificity is high for both parties in the relationship. The theory of asymmetry therefore predicts that factory economies will enjoy a lower degree of asymmetry than headquarter economies because both sides face high disruption losses. However, because of China’s status as the final assembly hub in the region, factory economies have no real alternative markets, while China would enjoy relatively more options from other factory economies, even though the switch of suppliers would be costly. Accordingly, the theory predicts that factory economies will experience relatively higher levels of asymmetry compared to resource economies, generating a prediction of “medium” asymmetry.

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98 An IMF (2011, 38) report writes: “Fixed production costs and constraints to factor mobility make it burdensome and often unprofitable to move production facilities across countries once they are established”. It is difficult to measure with precision the cost of creating alternative supply chains. Economic modeling by IMF offers a rough approximation by simulating a related “shock”—sharp fluctuations in exchange rates which increase the cost of inputs. The simulations indicate that within a supply chain the elasticity of substitution is low, confirming the intuition that the cost of breaking supply chain relationships is high: Ibid, 44. Rather, firms make adjustments outside the supply chain rather than disrupting it.

99 Athukorala and Kohpaiboon 2013.
2.2.5 Summary and hypothesis

Economic interdependence means states in a bilateral economic relationship both face losses if economic relations are disrupted. This chapter offers a theory linking the level of specificity in the economic relationship to the degree of asymmetry in “disruption losses”, which I argue is the most theoretically appropriate way to conceptualize the vulnerability and power arising from economic interdependence. The “resource”, “headquarter” and “factory” economy typology of East Asian states vis-à-vis China, based on each economy’s specialized profile in the transnational production network, represents a novel operationalization and measure of relative disruption losses. The key advantage of this typology is that it incorporates the condition of asymmetry into the measure, allowing the specification of this dissertation’s primary hypothesis:

Alternative hypothesis 1 ($H_A^1$): The degree of asymmetry in relative disruption losses and economic vulnerability systematically varies with an economy’s specialized profile in the transnational production network.

Null hypothesis 1 ($H_0^1$): The degree of asymmetry in relative disruption losses and economic vulnerability does not vary systematically with an economy’s specialized profile in the transnational production network.

Headquarter economies are hypothesized to face the greatest asymmetry in relative disruption losses, and thus the greatest vulnerability, while resource economies face the least (i.e. are the most symmetrical), with factory economies in between. Determining which ideal-type best fits a state’s economy therefore indicates its hypothesized degree of asymmetry and thus vulnerability vis-à-vis China.
Contemporary East Asian states clearly do not confirm perfectly to these ideal-types. Nevertheless, as evidence presented in later chapters will illustrate, the ideal-types do a reasonable job approximating states’ production profiles over the period under study between 2002 and 2013, allowing the theory’s hypothesis to be tested.\textsuperscript{100} Table 2.1 indicates which ideal-type best describes each East Asian state. The four case study chapters (countries in bold) will discuss and justify their respective country classifications in detail; the other countries are included here for rough comparison.

\textsuperscript{100} China joined the WTO in 2001 and since then both its economy and its cross-border economic ties with the region have accelerated rapidly. This study is therefore bounded by both space and time because it seeks to analyze how economic interdependence shaped the response of East Asian states to China’s rise.
Table 2.1: Economy ideal-types in the transnational production network

<table>
<thead>
<tr>
<th>Network position</th>
<th>Key features</th>
<th>Degree of asymmetry</th>
<th>States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resource economy</td>
<td>• Export natural resources; sold on a global market. Receive some FDI. • Commercial relationships less specific, more substitutable. • Both buyers and sellers have alternatives.</td>
<td>Low</td>
<td>Australia, New Zealand</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Indonesia</td>
</tr>
<tr>
<td>Factory economy</td>
<td>• Export intermediate inputs as part of sophisticated production chains. • Key export to China is electronic components. • Few alternatives, but difficult to disrupt without threatening entire network.</td>
<td>Medium</td>
<td>Vietnam</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Philippines, Malaysia, Thailand, Singapore</td>
</tr>
<tr>
<td>Headquarter economy</td>
<td>• Outsource low-wage processes to China using FDI to create affiliates for assembly operations. • Mature domestic markets mean Chinese market key for sales growth of product brands and investment opportunities. • Investments and relationships specific, high cost of alternatives compared to Chinese side.</td>
<td>High</td>
<td>South Korea Japan</td>
</tr>
</tbody>
</table>

Note: Singapore, Vietnam and Indonesia placed at the boundaries of two categories because they exhibit characteristics of both. Countries in bold are the subject of case studies.

2.3 Measuring asymmetry

While there is a broad support among scholars about conceptualizing interdependence as the degree of vulnerability states experience toward each other, operationalizing interdependence and vulnerability into empirical measures has proven problematic.\(^{101}\) The primary challenge is

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\(^{101}\) Mansfield and Pollins 2003, 11.
consistency—employing measures that can be accurately drawn from all members of the population under study.\textsuperscript{102} This task is made particularly difficult in the case of relative disruption losses because unless disruption actually occurs, the measure is of a counterfactual which is not observed (but merely threatened or perceived). Numerous specific factors influence the size of relative disruption losses that a theory cannot easily incorporate or which cannot plausibly and consistently be measured. These include the short-term availability of alternative buyers, sellers or investors, the cost of adjustment of production processes by firms and workers, and the utility-maximizing choices by consumers. Instead, the theory of asymmetry proposed here offers a categorical measure based on an important insight about the nature of production networks; but as a generalizable simplification the measure cannot identify precise parameters, only a bounded approximation of the true effects.

Since such precise measures are elusive, this study adopts a research design that focuses on systematically collecting a variety of different types of quantitative and qualitative evidence across the case studies, with the goal of measuring as consistently as possible the degree of actual or potential asymmetry in relative disruption losses and the economic vulnerability that results. The research design chosen is process tracing using in-depth case studies, with evidence being organized into “causal-process observations” (CPOs),\textsuperscript{103} in particular mechanism CPOs and auxiliary outcome CPOs.\textsuperscript{104}

\textit{Mechanism CPOs} establish whether a connection exists between the type of economy—resource, headquarter or factory—and the degree of asymmetry vis-à-vis China in disruption

\textsuperscript{102} This is obviously easy for measures based on trade flows which are consistently measured for most states.

\textsuperscript{103} A CPO is defined as “an insight or piece of data that provides information about context, process or mechanism, and that contributes distinctive leverage in causal inference”: Collier et al 2010, 184.

\textsuperscript{104} Mahoney 2010. Mahoney posits a third type of CPO, the “independent variable” CPO, which is less relevant in this case since the key issue is not whether variation in economy type exists—this is readily identifiable.
losses. The types of evidence to be collected are descriptions of Chinese behavior causing economic disruption, statistics indicating firms doing business with China suffering losses, information from firms about how they perceive and measure the risk of disruption to their business operations, and evidence on whether Chinese interests were (or would be) relatively less affected.

**Auxiliary outcome CPOs** are the additional observable implications of a theory, occurring alongside the main outcome of interest. This research design emphasizes the collection of two. The first is industry-level variation in relative disruption losses. Just as the degree of relative disruption losses varies across states, it will vary across industries within a state. Industries with a higher level of specificity in their links with China should suffer greater disruption losses, or express greater concern of the risk of disruption losses and act to diversify their risks. The second auxiliary outcome CPO is the economic policy response of target state governments to the perception of economic vulnerability. Vulnerable states are more likely to act to reduce that vulnerability by searching for alternatives to the economic relationship or otherwise reducing the degree of asymmetry. Such diversification is a rational response to the concentration of risk. States and firms facing relatively low disruption losses should have no such concerns.

Table 2.2 summarizes these CPOs in the cases of East Asian states’ relations with China as a guide to the types of evidence sought in each case study. Evidence collection techniques include interviews with government officials, journalists and other specialists, analysis of public statements and documents, media reporting and other commentary.
Table 2.2: CPOs measuring asymmetry in relative disruption losses

<table>
<thead>
<tr>
<th>Causal process observation (CPO)</th>
<th>Type of evidence</th>
</tr>
</thead>
</table>
| **Mechanism CPOs:** Identifying relative disruption losses | • Descriptions of Chinese behavior causing economic disruption.  
| | • Statistics indicating firms doing business with/in China suffering losses or broader reductions in economic interactions.  
| | • Firm-level info on risks of disruption to business operations and anticipated costs.  
| | • Evidence that Chinese interests are relatively less affected. |
| **Auxiliary outcome CPOs:** Other responses to the existence of economic vulnerability | • Industry level variation in disruption losses: industries with greater specificity face greater actual or potential losses or perceive higher levels of risk.  
| | • Government responses to vulnerability: Seeking to diversify economic relationships, or limiting relationship with China. |

2.4 Conclusion

This chapter specified a model of vulnerability from economic interdependence arising from asymmetry in relative disruption losses, itself a function of the specificity of the bilateral economic relationship. A new theory claims that variation in the specialized profiles of East Asian states’ economies in the transnational production network is associated with variation in the degree of their asymmetry with China. I outline a research design to test the hypothesis that production profile explains vulnerability, and to guide how evidence will be collected and organized. This new theory of asymmetry improves upon existing measures of economic interdependence and better identifies the conditions under which interdependence creates vulnerability and power. The following chapter proposes a framework to test a second, related hypothesis that vulnerability from economic interdependence can influence states’ security policies.
3. COMMERCE WITH COMPETITORS: Testing for the Impact of Economic Vulnerability on Security Policy

3.1 The rise of China and the security response of East Asian states

China’s rapid economic growth has lifted millions out of poverty and thrust the country to the forefront of the global economy. A byproduct of this success has been the deepening of its international economic relationships; by 2011, China was one the largest trading partners of every state in East Asia (often the largest) and a large recipient of foreign investment. Yet China’s economic rise has been accompanied by the modernization of its vast military, an increasing assertiveness in international affairs, the continued dominance of the Chinese Communist Party and, since 2010, an escalation in tensions over maritime boundary disputes. These developments have spawned the questions and concerns: is China a “competitor” which poses a threat to its neighbors’ security interests? Will China’s rise occasion increasing competition in the region and undermine the stability of the U.S.-led regional order?105

The juxtaposed perceptions of contemporary China as a vital economic partner and an actual or potential security competitor have created a conflict between states’ economic and security interests that is the primary motivation for this project. How states have resolved and would resolve this conflict is an important empirical question: is disruption of the economic relationship with China so costly that certain states would rather compromise their security interests than endure the economic losses? In other words, under what circumstances, if any, can economics take precedence over security? Answering this puzzle requires identifying the economic basis of vulnerability, exploring the mechanisms through which such vulnerability could affect security.

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105 Friedberg 2011.
policy, and analyzing the available evidence to determine whether such an effect exists. Yet as argued in Chapter 1, these specific questions have not received detailed attention from international relations scholars, particularly in the context of the challenges posed by China’s rise.

The previous chapter examined the microfoundations of interdependence. It developed a simple model and proposed a theory of asymmetry which specifies how bilateral economic interdependence between a “sender” and “target” state can generate vulnerability in the target. I derived the primary hypothesis that the degree of asymmetry in disruption losses faced by East Asian states vis-à-vis China varies with the specialized profile of their economies in the transnational production network. This chapter expands the model to include state interests and the tradeoffs inherent in governments’ policy choices, with the goal of testing a secondary hypothesis that economic interdependence can affect security policy. Rather than deriving a new theory of security policy, the expanded model is designed to create a framework which facilitates the interpretation of evidence of interdependence and states’ security behavior. My argument is that governments’ decision calculus on security is fundamentally driven by the relative political salience of competing interests. Where security interests are of greater importance, governments will be willing to endure the losses from economic disruption—actual, threatened or perceived. Where the relevant security interests are less salient, economically motivated accommodation of the sender state’s interests is possible.
3.2 Security policy: The dependent variable at the end of the causal chain

The previous chapter developed a simple model of “sender” and “target” states which are economically interdependent. I now extend the model by assuming that the sender and target have security interests which are in actual or potential conflict. This means that, in a vacuum, the target would adopt security policies at odds with the interests of the sender: the sender state is a “competitor” of the target. The target’s security policies are the second dependent variable examined in this research, at the end of a causal chain which begins with bilateral economic relationships, leads to asymmetric disruption losses and vulnerability, and ends with security policy choices.

Studying security policy poses two distinct but interrelated analytical challenges. The first is conceptualization. The most direct and objective metrics of security policy emerge out of a dichotomous conceptualization of security strategy as either balancing or bandwagoning. These alternative strategies are identified and measured through specific security policies: “internal” policies that augment or draw down military capabilities; and “external” policies of alliance formation and dissolution. Yet the term ‘security’ encompasses an array of objectives so diverse that a wide range of policies could be classified as concerning security issues. An exclusive focus on these two conceptualizations and their policy metrics therefore misses a significant percentage of states’ actual security behavior. The first analytical challenge is thus to develop a conceptualization of security that permits study of this wider range of state

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106 This dichotomy is also ordinal since it represents a strategy more or less favorable to the powerful state.
107 Waltz 1979.
108 Wolfers 1962, 150. Even the survival objective can be pursued through a variety of strategies: Waltz 2000, 38-39. See also Schweller 2004.
109 Moreover, the emergence of ‘soft-balancing’ literature further suggests that in reality these metrics have not varied in response to powerful states in the way balance-of-power theories would predict: see Brooks and Wohlfforth 2005/06; Chan 2012 ch 3. See also the discussion in section 1.4.1 above.
behaviors. One approach, common in Asian security scholarship, is to argue that states are pursuing hedging strategies to avoid having to balance or bandwagon. Yet hedging arguments identify little if any variation in security behavior, the result being narrow conclusions that cover only what states are not doing (balancing and bandwagoning). One symptom of this approach is the absence of systematically consistent operational indicators of strategic behavior. Conceptual attention should accordingly shift away from strategies which are unobservable and problematic to the measuring of observable security policies. Yet as both Schelling and Baldwin point out, war and military strategy should be considered in the context of international bargaining processes in which conflict and cooperation are inseparable. This does not mean security policy should be defined so broadly to encompass the entirety of statecraft, but a workable definition should encompass more than just military spending and formal alliances, in order to understand how states actually respond in varying ways to the complex dynamics of the modern security and economic order.

This study adopts a hybrid approach by drawing upon both traditional security and economic sanctions literatures. Starting from a traditional security perspective, I assume that all states seek the objectives of securing their territorial integrity and autonomy of action, and I define security policy as state actions, omissions and statements directed toward these objectives that

110 See section 1.4.1 above and the works cited; see also Medeiros 2005 and Murphy 2010. While many different labels are used with slightly different meanings (engagement, binding, complex balancing) the common denominator of each strategy is the deferral of any decision to side clearly for or against a major power.  
111 The scholarship that does identify variations in state responses to China is that which adheres to the balancing and bandwagoning dichotomy, such as Ross 2006. For a contrary view arguing for the utility of inductive theory-building, see George and Bennett 2005, ch 6.  
112 A further problem highlighted by Wolfers (1962, 68-69) is that it is impossible to distinguish objectives from means, as means are proximate objectives and very few objectives are ultimate. Thus what constitutes means in one context may be an objective in another.  
113 Schelling 1960); Schelling 1966; Baldwin 1995.  
114 Wolfers 1962.
bear directly on the likelihood and character of war.\textsuperscript{115} This definition is broad enough to encompass a variety of behaviors, but places the onus on the researcher to show how a policy relates to security outcomes. Next, because this study concerns vulnerability, influence and coercion arising from economic relations, I follow the sanctions literature\textsuperscript{116} and conceptualize security policy variation by disaggregating the bilateral relationship between two states into individual issues over time, and evaluating the target state’s security policies on a given issue against the sender state’s foreign policy goals.

This conceptualization also resolves the second analytical challenge—measurement. Two qualities are critical in measurement: the measure must generate reliable data by facilitating comparison across units of observation; and it should be the most theoretically appropriate.\textsuperscript{117} These qualities invoke two challenges. The first is that allowing security policies to encompass a wider range of activities means that states’ security policies will rarely be the same, precluding “apples for apples” comparisons. Comparing unlike policies requires a constant reference point. Helpfully, a reference point is provided by conceptualizing security policy variation with reference to the foreign policy goals of the sender state. Target state security policies are judged against the sender’s goals, and a simple dichotomous coding is applied based on whether the policies accommodated these goals or not.\textsuperscript{118} This approach helps resolve the second challenge: a theoretically appropriate measure must define “accommodating” policy with reference to a

\textsuperscript{115} Adapted from Walt 1991.
\textsuperscript{116} In particular the seminal study by Hufbauer et al 2009.
\textsuperscript{117} King et al 1994, chs 1 and 5. While some studies purport to identify observed state behaviors as indicators or an ordinally ranked spectrum of outcomes, too often evidence is drawn selectively from a handful of cases without identifying the entire range of variation in the dependent variable or considering alternative explanations. Ultimately, beyond military budgets and formal alliances, systematic and concrete measures of security policy have proven difficult to construct.
\textsuperscript{118} Hufbauer et al 2009 code four possible outcomes of economic sanctions: failed, unclear but possibly positive, positive, and successful. A simpler dichotomy is preferred here because the cases studied offer far less precision in terms of sender aims, method of disruption and target response.
baseline counterfactual. While the baseline is never observed it can be plausibly identified through several techniques. One is describing the core, non-economic security interests of the target and sender state, and evaluating the sender’s policy choices with reference to those interests. A second technique is available when there has been significant continuity in the target’s security posture over time, and a sudden change is observed in either policy (without a change in the strategic environment) or in the strategic environment (without a change in the policy). A third technique is considering the preferences of domestic interest groups, public opinion and interstate security partners, and evaluating final policy against preferred outcomes. No single technique is perfect, which means that justifying an unobserved baseline is a question of logic and evidence.

3.3 How the target balances its economic and security interests: Political salience

The theory of asymmetry proposed in the previous chapter only establishes the mechanism through which asymmetric interdependence creates potential vulnerability in the target and potential power for the sender. To result in influence, vulnerability must incentivize target state governments to change their policies. This section sketches a theory of the state which posits that when governments deem the benefits of the economic relationship to be more important than the security interests in dispute, they will be sensitive to the possibility of economic disruption

119 This is the same principle applied in regression discontinuity designs.
120 Buszynski (2009, 145-46) recognizes that asymmetric interdependence is simply a deduction from trade inequality which may or may not be relevant to the political relationship—what is missing is the factor of political agency. The existence of asymmetry is insufficient to predict whether and how it will be used. However, East Asian governments clearly do have strong political interests in economic growth because of its importance to their legitimacy: Solingen 2007.
and be more likely to adopt security policies which accommodate the interests of the sender state, compared to a baseline in which no such pressure existed.

The model of the state comprises individuals and private groups which pressure national governments to adopt favorable policies. Governments are assumed to seek to retain office and will adopt economic and security policies to maximize this possibility. The government may thus be willing to compromise other policy objectives when it views the preservation of economic relations with the sender state as politically important. Recall that in addition to being economically interdependent, the sender and target states are modeled as having actual or potential conflicts of security interests. The government of a vulnerable target therefore faces a tradeoff when implementing security policy: accommodate the sender’s security interests (or demands, where they have been made) to protect the economic relationship, or adopt policies at odds with the sender’s interests and risk losses from economic disruption. Both choices generate political costs and benefits because domestic groups with divergent interests will pressure the government to adopt policies favorable to them. Firms and other commercial groups who gain from economic links to the sender state stand to lose if the relationship is disrupted. If disruption causes widespread damage to the domestic economy, job losses and poor GDP growth may follow. On the other hand, national security can be an issue of the greatest importance to a nation’s population. Where the state’s national security is perceived to be

121 This is consistent with the assumptions of commercial liberalism: Moravcsik 1997; Rogowski 1989; Solingen 1998.
123 Schelling 1960, Schelling 1966, Blanchard and Ripsman 1999. This tradeoff may be implicit or, where a direct security dispute exists, the sender state may have made a demand for accommodating policy backed up by the threat or actual disruption of the economic relationship.
124 See Rosecrance 2001 on why state decision-making is often theorized as cost/benefit analysis.
125 Marinov 2005 argues that the destabilizing effect of economic sanctions increases the likelihood that target governments will lose office. For the broad idea that trade based on comparative advantage generates mutual economic gains which leaders will be reluctant to forgo, see Polachek 1980; Russett and Oneal 2001.
126 Ang and Peksen 2007.
under threat from the sender state, the public will reward the government for taking a hardline stance and punish it for conceding;\(^\text{127}\) this is known as the sanctions version of the “rally ‘round the flag” effect.\(^\text{128}\)

Whether the rally ‘round the flag effect will operate depends on the political salience of the issue in dispute. Salience can arise in two ways. The first is the nature of the issue itself and the degree to which it affects core security interests.\(^\text{129}\) If the sender demands territorial concessions or severe restrictions on the target’s autonomy, the government can tap public anxiety about the security threat and ask the population to endure the costs of economic punishment.\(^\text{130}\) But if the issue is minor, less clearly connected to national security interests, or there is perceived to be no real security dispute in existence, harnessing public opinion to resist the sender will be more difficult.\(^\text{131}\)

The second mechanism is the target’s threat perception of the sender. The higher the expectations of future conflict, the more the sender will be perceived as a threat.\(^\text{132}\) The greater the threat perception, the higher the perceived political salience of the issue in dispute, making the target less likely to accommodate the sender’s interests, and more willing to endure the costs of economic disruption. The perception of threat can arise from a number of sources including strong nationalist sentiments,\(^\text{133}\) recent bilateral tensions,\(^\text{134}\) a particular sensitivity regarding a

\(^{129}\) Lektzian and Souva 2007.
\(^{130}\) The target state government in effect characterizes the sanctions as an external security threat: Miyagawa 1992.
\(^{131}\) Both Hufbauer et al (2009) and Drezner (1999) present evidence indicating that economic sanctions with modest political goals are more effective.
\(^{132}\) Drezner (1998, 1999) argues that when future expectations for conflict with the sender of economic sanctions are high, the target will perceive a higher cost for accommodating the demands because of the concern that any concessions could be used against it in future conflict. See also Lektzian and Souva 2007.
\(^{133}\) Nationalism can motivate states to endure large amounts of punishment: Pape 1997, 93.
\(^{134}\) Drezner 1998; Drezner 1999.
specific economic transaction,\textsuperscript{135} or broader uncertainty regarding the sender’s intentions based on its regime type\textsuperscript{136} or violation of international norms.\textsuperscript{137} Government leaders may wish to protect their reputation for tough bargaining positions.\textsuperscript{138} Conversely, positive bilateral relations and a benign international presence by the sender equate to lower levels of anxiety among the target public and a reduced perception that the sender’s interests constitute a serious threat to be resisted. Rather, opposing the sender is seen as protecting only minor interests at high economic cost.

For economic interdependence to influence security policy therefore, it must be politically acceptable for the target government to trade off security for economics. High salience issues—when accommodating the sender’s interests would directly affect an issue of fundamental national security or when the sender state is perceived as threatening—will cause the target public to “rally ‘round the flag” and interdependence will have little effect. As the political salience of the issue declines, economic interests will be more likely to influence the target government’s choice.

3.4 Connecting asymmetry to security policy: A hypothesis

The theory of asymmetry developed in the previous chapter identified a new source of variation as driving the degree of a state’s asymmetry in relative disruption losses vis-à-vis China: the economy’s specialized profile within the transnational production network. The theory

\textsuperscript{135} Examples include trade which involves the transfer of a specific technological capability to the sender state (Blanchard and Ripsman 1996) and inward foreign investment from that state which causes a loss of control of strategic assets (Kim 2007). In these situations, the direct security cost of the economic transaction is more likely to outweigh the economic benefit and thus be restricted by the government.

\textsuperscript{136} Farnham 2003.

\textsuperscript{137} Cohen 1979.

\textsuperscript{138} Drezner 1998; Drezner 1999.
hypothesized that headquarter economies face the highest asymmetry in relative disruption losses, followed by factory economies, with resource economies facing the lowest (Hypothesis 1). Combing this logic with the logic of political salience in the determination of security policy yields a secondary hypothesis:

**Alternative hypothesis 2 (H_A^2):** The extent to which a state will accommodate Chinese interests in its security policy (compared to a baseline) varies systematically with its economy’s specialized production profile.

**Null hypothesis 2 (H_0^2):** The security policies of states towards China do not vary systematically with their economy’s specialized production profile.

**Figure 3.1: The causal mechanism linking interdependence to security policy**

*Theory of asymmetry*

<table>
<thead>
<tr>
<th>Production profile in transnational production network</th>
<th>DV_1: Asymmetric disruption losses; vulnerability</th>
</tr>
</thead>
</table>

*Hypothesis 1*

<table>
<thead>
<tr>
<th>Political salience of security interests in dispute</th>
</tr>
</thead>
</table>

*Hypothesis 2*

| DV_2: Accommodating security policy |

Figure 3.1 illustrates the expanded model’s causal chain noting the points at which Hypotheses 1 and 2 will be tested. Hypothesis 1 tests the predictions of the theory of asymmetry that an economy’s specialized production profile determines the degree of asymmetry in its relative disruption losses (and thus its vulnerability), which is the first dependent variable (DV_1) in this study. Hypothesis 2 tests the claim that economic vulnerability can cause accommodation in the second dependent variable, the target state’s security policy (DV_2). Importantly, the political
salience of the issues in dispute is a significant intervening variable, which may cancel out the effect of vulnerability and generate a null funding.

Structuring the model this way carries two important implications. First, even a null finding on Hypothesis 2 would be an important empirical result, as it would challenge the assumption that China has been able to leverage economic interdependence to achieve strategic goals in the security sphere. Second, determining whether a null finding is the result of the inherent impotence of economic vulnerability to affect security policy, or the neutralizing effect of political salience, cannot be determined by measuring on the dependent variable alone. Isolating any effect from economic vulnerability can only be accomplished through careful process tracing of the causal mechanism and the accumulation of causal process observations to interrogate the logic of the theory.

3.5 Research design: Measuring security policy and testing the causal mechanism

This study assumes that states’ fundamental security objectives are territorial integrity and autonomy of action, and defines security policies as state actions, omissions and statements in pursuit of these objectives that bear directly on the likelihood and character of war. Target state security policies are “data-set observations” (DSOs) which must be coded as being more or less accommodating towards the interests of the sender state relative to a baseline counterfactual. These observations are collected by defining the issues in dispute between the two states, the interests of the sender, and a baseline policy expectation for the target calculated from its interests in the issue. Next, the target state’s actual policy choices are evaluated relative to these

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139 As security policy is the dependent variable, DSOs of security policy are the equivalent to “observations” in the normal statistical sense: Collier et al 2010, 184.
two poles. Hypothesis testing requires coding observed security policies as either accommodating or not accommodating of the sender’s (China’s) interests. Coding requires subjective judgment and is inherently imprecise, but to minimize bias I draw upon and triangulate the qualitative conclusions on individual issues and episodes reached by practitioners, scholars, and journalists.140

As introduced in the previous chapter, this study employs a research design of process tracing using in-depth case studies. Evidence for the causal mechanism is obtained through the collection of CPOs. Testing Hypothesis 2 mostly requires the collection of “mechanism” CPOs, which establish whether a connection exists between economic vulnerability in the form of asymmetric disruption losses, and security policy which accommodates Chinese interests.

Mechanism CPOs include evidence which shows that harmful economic losses motivated lobbying by economic actors to preserve the China relationship, or evidence that economic considerations were a relevant factor in the making of security policy decisions. Evidence for a null finding would come from the opinions of politicians, officials and the public that the political salience of an issue trumped economic interests. One must ask how a policy was publicly justified and what alternatives were possible. Security issues are often high-profile and policy proposals publicly debated; analyzing how a government justifies a policy will shed light on underlying motives and constraints. Accommodating policy is signified by an inability to provide an effective security rationale for the enacted policy, as would the availability and advocacy of credible alternatives (less-accommodating to Chinese interests) that were ignored. Another CPO is consistency in “hawkish criticism”; given that actual policy decisions are widely

140 This strategy is also employed by Hufbauer et al 2009, 49. The authors recognize that such assessments entail much subjective evaluation; recourse to the views of other analysts minimizes the bias from the researcher’s personal views.
scrutinized and criticized by politicians, experts and the media, policies which give priority to
economic and not security interests should receive near unanimous criticism stemming from a
‘hawkish’ source, i.e. that the policy is ‘weak’ on security. Table 3.2 lists the CPOs for
Hypothesis 2.

Without doubt, if economic interests have shaped a target state’s security policies, proving this
causal link is a significant challenge, as is accounting for the intervention of political salience.
Ultimately, there are so many influences on government policy; it is near-impossible to identify
the decisive cause of any given decision. This task is made harder studying contemporary
affairs because classified documents are unavailable. Nevertheless, plausible measurement is
possible through the precise specification of competing interests and careful collection and
organization of CPOs.

Table 3.2: CPOs for Hypothesis 2: East Asian security policies toward China

<table>
<thead>
<tr>
<th>Causal process observation (CPO)</th>
<th>Type of evidence</th>
</tr>
</thead>
</table>
| Mechanism CPOs: Influence of economic interests on security policy | • Business industry lobbying to preserve the economic relationship with China.  
• Direct evidence that economic interests motivated security policy.  
• Direct evidence that the political salience of the security issue took precedence over economic interests.  
• Degree of plausibility of the security rationale for policies and availability of alternatives.  
• Consistently hawkish criticism of target stage security policies. |

141 This problem would remain so even with infinite data points because much of what influences policy can never be accurately quantified and measured and thus controlled for, creating the identification problem: Manski 2007.
3.6 Case selection

Whereas vertically fragmented transnational production is increasingly a global phenomenon, East Asia is the only region that is both highly fragmented economically but also riven by political disputes which may escalate into more serious conflict. We may divide target states into two categories: those engaging in ongoing security disputes with the sender, and those which perceive only the potential for future conflict. In East Asia, the former category are states which have territorial disputes with China—Japan, the Philippines and Vietnam in particular—though these fluctuated in their intensity over the 2002-2013 period.\footnote{Malaysia and China do have conflicting claims over parts of the South China Sea; however as of late 2013 these claims had not brought the two countries into public confrontations of any kind. If this situation changed, Malaysia would join the Philippines in its category.} For these states, the tradeoff between economic and security interests is likely to be starkest. Separating these states from the rest facilitates the use of “controlled comparisons”, comparing two states that differ in their production profile and thus hypothesized economic vulnerability, but holding the existence of a territorial dispute constant.\footnote{George and Bennett 2005, 81 and ch 8.} Table 3.3 divides states accordingly (only underlined states will be covered by the case studies).

<table>
<thead>
<tr>
<th></th>
<th>High predicted asymmetry</th>
<th>Medium predicted asymmetry</th>
<th>Low predicted asymmetry</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ongoing territorial dispute</strong></td>
<td>Japan</td>
<td>Philippines</td>
<td>Vietnam</td>
</tr>
<tr>
<td><strong>No dispute</strong></td>
<td>South Korea</td>
<td>Singapore, Malaysia, Thailand, Indonesia</td>
<td>Australia, New Zealand</td>
</tr>
</tbody>
</table>

Note: Underlined states are the subject of case studies below.
3.7 Alternative explanations

The motivation for this project is how China’s rise is purported to be creating a tradeoff for East Asian states between their economic and security interests. Yet an examination of existing literature on economic interdependence yields theories and empirical measures which fall short of properly examining microfoundations and thus miss the reality of the modern international economy. Moreover, insufficient theoretical and empirical attention has been paid to the causal mechanism through which economic vulnerability translates into power and influence over states’ security policies. Nevertheless, the orthodox operationalization of interdependence based on trade volumes and economic size represents the primary alternative explanation for and measurement of the impact of interdependence. Accordingly, each case study will outline the predictions this approach makes regarding vulnerability.

This dissertation takes an agnostic but inquisitive approach to the larger theoretical debate on the sources of state behavior. Inevitably, presenting evidence to test the claim that economic interdependence has a meaningful influence on state policy in the security sphere will speak to the debate whether economic interests ‘matter’ for the big questions of ‘high politics’. My aim is not to specifically test competing paradigmatic claims about what drives state behavior, but to contribute research speaking to how economic interdependence generates incentives and pressures that in turn create conflicts and tradeoffs for policymakers to manage. In doing so, I aim to contribute to the question of ‘how’, rather than ‘whether’, interdependence can influence behavior.
3.8 Conclusion and limitations of the research design

The previous chapter proposed a new theory of asymmetry which I argue utilizes the most theoretically appropriate and empirically accurate operationalization and measurement of the vulnerability that can arise from economic interdependence. This chapter incorporated the theory of asymmetry in laying the groundwork for an empirical contribution by extending the model to test the hypothesis that economic interdependence affects security policy. In the four case studies which follow, evidence is presented to evaluate the theory of asymmetry and test Hypothesis 1 and Hypothesis 2.

The considerable space devoted above to describing challenges with research design and proposed resolutions is indicator enough of the limitations of this research design. The issue of measurement perhaps looms largest, and is the primary reason why large-sample quantitative studies are not feasible for this project—developing accurate measures from quantitative and qualitative data for a handful of case studies will be sufficiently challenging! Equally demanding is analyzing the mechanism through which interdependence is theorized to influence state behavior—the pressure on governments to preserve economic benefits. Even if the precise costs of adjustment were known, do these costs consistently and monotonically translate into political influence? And how do officials trade off these costs against the second counterfactual—the security costs of making political concessions for the sake of the economic relationship? These challenges are daunting and suggest at least that the search for improved measurements of economic interdependence is only one step in the process of determining its influence on state behavior.
A second limitation is the necessarily exploratory nature of the evidence presented, which relies on interviews and open source material such as public statements, media reporting, long-form investigative journalism and commentaries by observers. While every effort has been made to triangulate sources to increase confidence in the conclusions drawn, it is not possible to verify the accuracy of all open-source material cited or fact-check every statement made in interviews. A necessary tradeoff in researching contemporary events is that information on the conduct, experiences and motivations of actors is incomplete and of uncertain bias, meaning the conclusions drawn must remain tentative.

A final point worth repeating is to highlight this study’s reliance on strong simplifying assumptions in order to devise a workable identification strategy and research design. Without these assumptions, no interesting conclusions can be drawn from the available data, but they are made at the cost of moving further from reality. Manski’s “law of decreasing credibility” is recalled: “The credibility of inference decreases with the strength of the assumptions maintained”.\textsuperscript{144} This study attempts to employ the weakest possible assumptions that allow meaningful inferences to be drawn from the empirical evidence.

\textsuperscript{144} Manski 2007, 3.
4. JAPAN: The Waning of “Cold Politics, Hot Economics”

4.1 Introduction

The bilateral relationship between Japan and China is perhaps the paradigmatic case of economic interdependence between security rivals in the 21st century. By the mid-2000s the two countries were the world’s second (Japan) and third (China) largest economies, swapping places in 2010. Bilateral trade took off in the 1990s and in 2006 China overtook the United States to become Japan’s largest trading partner. Japan continues to be China’s second largest trading partner (behind the United States) and in 2011 was the largest source of both flows and overall stock of FDI after Hong Kong.145 The economic relationship has flourished despite long-standing political tensions, sourced primarily in historical grievances arising from two Sino-Japanese wars (1894-1895 and 1937-1945), irritated by regional competition and flashpoints such as Taiwan and United Nations Security Council membership, and seriously inflamed from late 2010 onwards by a territorial dispute over sovereignty of the Senkaku/Diaoyu Islands and exclusive economic zone border demarcation in the East China Sea.

At first glance, the economic interdependence between these two large economies appears symmetric since both constitute a significant proportion of the other’s trade flows, implying that disrupting the bilateral relationship would be immensely costly for both countries.146 The theory of asymmetry makes the opposite prediction. Japan is classified as a “headquarter” economy in the transnational production network, and is thus expected to experience the greatest asymmetry in its relative disruption losses vis-à-vis China, exposing the country to the highest degree of vulnerability. Hypothesis 1 tests the prediction that Japan has been more vulnerable than the

145 Davies 2012. It is difficult to gauge the geographic distribution of inward FDI because so much is channeled through Hong Kong and tax havens such as the British Virgin Islands.
146 Katz 2013.
Philippines, a smaller and ostensibly weaker country with a different production profile, that of a “factory economy”.

Yet the territorial and other sensitive issues behind Sino-Japanese tensions are of high political salience. While the theory of asymmetry predicts that Japan’s economic vulnerability is relatively high, Hypothesis 2 tests whether economic interdependence has had an actual impact on security policy. If political salience neutralizes economic vulnerability, observed security policies will not vary and Hypothesis 2 will return a null funding (see Figure 3.1 and discussion). As foreshadowed in Chapter 3, the strong possibility of a null result makes isolating the effect of economic vulnerability a greater challenge. This reinforces the value of properly collecting, organizing and carefully analyzing causal process observations to maximize the leverage the case study can offer.

### 4.2 Unpacking interdependence between Japan and China

The level of interdependence between Japan and China in the early 21st century according to traditional measures is represented in Table 4.1. China began the period as a much smaller economy and Japan was its largest trading partner. A decade of rapid growth saw China overtake Japan to become the world’s second largest economy in 2010. This growth caused China to be responsible for an increasingly larger percentage of Japan’s exports and imports, while the share of Chinese trade accounted for by Japan slowly declined. But because China began from such a low baseline, by 2011 interdependence appeared to be relatively symmetric; bilateral trade as a percentage of GDP was similar for both countries. China constituted a larger percentage of
Japan’s overall trade, but trade was a larger overall component of China’s GDP. Moreover, Japan remained China’s largest source of imports and second largest export customer.

These figures thus tell a story of interdependence between the two countries being asymmetrically in favor of Japan at the beginning of the period, and becoming symmetric over time. By the end, both countries appear to have been of roughly equal importance to the other.

Of course, what these statistics do not show is whether alternatives to the relationship existed or the magnitude of the costs borne by either side if trade and investment links were disrupted.

Table 4.1: Merchandise Trade between Japan and China, 2001-2011

<table>
<thead>
<tr>
<th>Japan</th>
<th>2001 (rank)</th>
<th>2006 (rank)</th>
<th>2011 (rank)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports to China as a % of all Japanese exports</td>
<td>7.7 (2)</td>
<td>14.3 (2)</td>
<td>19.7 (1)</td>
</tr>
<tr>
<td>Imports from China as a % of all Japanese imports</td>
<td>16.6 (2)</td>
<td>20.5 (1)</td>
<td>21.5 (1)</td>
</tr>
<tr>
<td>Trade with China (EX + IM) as a % of Japanese GDP</td>
<td>2.1</td>
<td>4.8</td>
<td>5.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>China</th>
<th>2001 (rank)</th>
<th>2006 (rank)</th>
<th>2011 (rank)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports to Japan as a % of all Chinese exports</td>
<td>16.9 (1)</td>
<td>9.5 (2)</td>
<td>7.8 (2)</td>
</tr>
<tr>
<td>Imports from Japan as a % of all Chinese imports</td>
<td>17.6 (1)</td>
<td>14.6 (1)</td>
<td>11.2 (1)</td>
</tr>
<tr>
<td>Trade with Japan (EX + IM) as a % of Chinese GDP</td>
<td>6.6</td>
<td>7.7</td>
<td>4.7</td>
</tr>
</tbody>
</table>

Sources: Author calculations based on: IMF, Direction of Trade Statistics; World Bank, World Development Indicators. China excludes Hong Kong.
4.3 Japan as a “headquarter” economy

The emergence of the transnational production network in East Asia was, in large part, initiated by the actions of Japanese firms. The 1985 Plaza Accord (which triggered a sharp yen appreciation) and strong growth in Japanese incomes and wages in the 1980s and 1990s eroded the domestic economy’s comparative advantage in manufacturing. Firms reduced costs by offshoring labor-intensive processes to cheaper locations throughout Asia. Offshoring was achieved through FDI; Japanese firms founded affiliates (either wholly owned or joint ventures with local interests) and invested capital to construct production facilities.

This process transformed Japan into one of the world’s leading capital exporters. In the years 1985-1990 alone, the stock of outward FDI held by Japan increased from 6.4 percent of the world’s total to 11.8 percent (almost half the U.S. share of 25.5 percent). This trend gathered pace in the 1990s as the Japanese domestic economy slowed. Japanese FDI built export platforms designed to assemble final goods, using as inputs capital goods such as machines and high-value components imported from Japan. The final product was then re-exported to the United States, Europe, or back to Japan. This ‘triangular’ pattern of trade dominated four machinery sectors in particular—electronics, automobiles, general machinery and precision machinery—which, in the 1990s, represented over 70 percent of Japanese manufacturing FDI in Asia. By 2000, more than 60 percent of Japanese manufacturing affiliates and about 70 percent of Japanese firms’ manufacturing facilities were in Asia.

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147 Dowling and Cheang 2000.
148 Baldwin 2008; Paprzycki and Ito 2010.
149 Hatch 2010, 75.
150 General machinery is capital goods, including machine tools, engines and turbines and construction and mining machinery. Precision machinery includes cameras, watches, and medical devices. Electronics is the largest sector,
Observers labeled this phenomenon the “hollowing out” of the Japanese economy, yet it realized a deliberate strategic objective of both Japanese industry and government to create a regional division of labor in Asia based on differential factor endowments, industrial structures and technological capabilities, and economically integrated through flows of goods, capital and technology. Foreign investment came not just from primary manufacturers; Japanese component suppliers were also convinced to follow their manufacturer customers in a process known as “agglomeration”. For example, when the automobile firm Toyota built an assembly plant in Tianjin in 2000, it convinced most of its major subcontractors to build parts production facilities nearby. The transfer of production of intermediate inputs out of Japan into Asia was an inevitable step in the drive by firms to minimize costs, and eventually Japanese affiliates began to source parts from non-affiliated suppliers both locally and from third countries in Asia. This progression expanded and solidified the transnational production network. The economies of South Korea and Taiwan emerged in the 2000s to join Japan as headquarter economies and network leaders.

constituting 60 percent of all foreign invested firms’ exports from China in 2007 (which was also 90 percent of China’s exports in this sector): Gaulier et al 2011, 20.

151 Hatch 2010, 75-79. Much of this investment was promoted by the Japanese government through the Japan Export-Import Bank, which provided $72 billion in public loans for overseas investment (over 10 percent of Japanese FDI) between 1953-1999: Solis 2004, 15.

152 Baldwin 2008, 454. A similar process occurred in other headquarter economies such as Taiwan and South Korea.

153 IMF 2011, 21, 23. This “flying geese” pattern of regional economic development was conceptualized by Japanese scholars as a tightly-linked V-shaped pattern with Japan as the “lead goose” followed first by the Asian Newly Industrialized Economies (NIEs), and second by ASEAN and China: Hatch 2010, 81-82. This division of labor was supposed to yield a dynamic process of “industrial sequencing” through which lower-valued added processes were passed down from industrialized economies to developing economies which enjoyed a comparative advantage in labor costs.

154 Hatch 2010, 93.

4.4 Japan and China in the transnational production network

China took off as an assembly hub in the mid-1990s and its successful weathering of the 1997 Asian Financial Crisis and accession to the WTO in 2001 further compelled the orientation of investment and production strategies of Japanese firms in its direction.\(^{156}\) The incorporation of China into the transnational production network followed the same pattern as elsewhere in Asia but in much larger scale: Japanese firms— both MNEs and increasingly SMEs—built facilities in China to engage in low-cost labor assembly processes, using capital goods imported from Japan as well as a combination of local and imported intermediate inputs, with much of the final product being re-exported.\(^ {157}\) By 1999, China already hosted over 20 percent of the total number of Japanese international affiliates, the largest of any single country.\(^ {158}\) By 2005, Japanese affiliates employed almost one million workers in China (almost twice the number employed by U.S. affiliates) concentrated overwhelmingly in manufacturing (over 90 percent), with electronics and other electrical equipment (35 percent) and transport (19 percent) the largest sectors.\(^ {159}\) Japanese FDI in China mirrored this pattern: almost 83 percent funded manufacturing industries in 2004, with the transport sector capturing 36 percent of this total.\(^ {160}\)

As the 2000s progressed, the outsourcing, FDI and agglomeration activities in China by Japanese and other foreign firms supercharged the development of the Chinese economy. Rising employment increased wages and the purchasing power of Chinese consumers, offering new opportunities for Japanese companies to expand local sales, and creating a virtuous circle which

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\(^{156}\) Paprzycki and Ito 2011, 107.  
\(^{157}\) Gaulier et al 2007a. In 2007, 72 percent of China’s imports from Japan went to foreign affiliates, and over 56 percent of China’s exports to Japan contained these imported inputs: Dean et al 2009, 599, 602. In 2002, half the inputs imported from Japan were re-exported by China following assembly: Dean et al 2009, 604.  
\(^{158}\) Hatch 2010, 77-78.  
\(^{159}\) Greaney and Li 2009, 620-624.  
\(^{160}\) Ibid.
encouraged greater Japanese investment. Consumer goods manufacturers came to see China as an essential profit center not just through outsourcing to reduce costs, but as a growing consumer market.\textsuperscript{161} Japanese investment also helped China develop advanced technologies, such that China also began to export intermediate inputs of increasing technological complexity to Japan,\textsuperscript{162} in addition to certain key commodities such as rare earth elements (which it had long supplied to Japan’s high-tech industries). Table 4.2 documents the increased importance of China as a production base: in 2003 Chinese subsidiaries accounted for barely 10 percent of Japan’s global sales of subsidiary-produced goods; by 2011 this had risen to over 23 percent. This trend would be retarded in 2012 due to the political tensions discussed in the following section.

As the 2000s progressed, the production fragmentation process and regional division of labor became even more refined. Low-skilled and low value-added production processes were outsourced by Japanese firms wherever possible, and China was the largest destination for these tasks. Annual Japanese FDI flows averaged double those of the U.S. and South Korea.\textsuperscript{163}

\textsuperscript{161} Fujita and Hamaguchi 2006. In 2004 the president of Japanese retailer Aeon described China as Japan’s “treasure mountain”, a common view at the time that China was bailing out Japan from economic stagnation: “Crossing the Divide”. Financial Times, March 30, 2004, 19.

\textsuperscript{162} IMF 2011, 19. One study based on Chinese customs data estimates that of China’s exports to Japan in 2007, over 50 percent were inputs used in further production: Ma and Van Assche 2011, 134.

Table 4.2: Sales of Japanese overseas subsidiaries by location, as a percentage of sales by all Japanese subsidiaries 2003-2012

Source: Government of Japan, Ministry of Economy, Trade and Industry. *Trends in Overseas Subsidiaries: Quarterly Survey*. Notes: ASEAN4 means Indonesia, Malaysia, the Philippines and Thailand. Subsidiaries must have at least 50 percent of capital coming from parent company.

In 2009-2010, 1,800 listed Japanese firms (out of about 3,000) had over 6,300 Chinese subsidiaries; data from 2007-2008 indicates that 4,700 unlisted firms had over 8,400 Chinese subsidiaries. In 2011, Japan had the highest number of subsidiaries operating in China of any country. In 2012, the number of Japanese-affiliated companies in China was between 22,000-25,000, employing as many as 10 million Chinese workers by 2012 and paying millions in local taxes. With so much final assembly occurring in China, intermediate inputs comprised well

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164 Fisman et al 2013, 4-5.
166 “Boycott Hits Output Of Japanese Products In China”. *Nikkei Report*, October 24, 2012. The *Nikkei* article cites a figure of 25,000 companies, while figures provided to the author by the Japanese Ministry of Foreign Affairs give a figure of 22,790 companies, almost 8 percent of all foreign companies in China in 2012.
over half of Japan’s exports to the mainland;\textsuperscript{167} in 2012, the six Japanese firms which had the highest proportion of their total sales going to China were all parts suppliers.\textsuperscript{168}

Simultaneously, China was an increasingly attractive consumer market.\textsuperscript{169} The Chinese units of Japanese manufacturers enjoyed sales of almost ¥35 trillion in 2012 (approximately $300 billion), of which only 34 percent was exported. The remainder was sold in China, though up to 40 percent of sales went other Japanese companies, presumably as inputs.\textsuperscript{170} Table 4.3 illustrates this trend: in 2003 nearly a third of Chinese subsidiary production was exported back to Japan while 44 percent was sold in China. By 2010 these numbers were 22 and 64 percent respectively.

The two economies also engaged in large people-to-people exchanges, almost five million tourists and 105,000 students moving back and forth in 2012, while over 140,000 Japanese nationals lived in China.\textsuperscript{171}

The automobile industry is the archetypal example of how the fragmentation of production evolved over time. In 2011, China accounted for a meaningful, if not dominant, proportion of global sales for the big three Japanese automobile manufacturers Toyota (11 percent), Nissan (17

\textsuperscript{167} Fully 60 percent of Japan’s exports to China were re-exported out of China; this figure does not include components used in goods sold to Chinese consumers: “Japan Car Makers Pull Back amid Chinese Chill”. \textit{Wall Street Journal}, September 26, 2012. Another estimate put machinery and parts at 60-70 percent of total Japanese exports to China: Katz 2013.

\textsuperscript{168} These firms were Rohm (semiconductors) which made 27.1 percent of its sales in China, TDK (electronic materials and components) 26.8 percent, Minebea (bearings and machine components) 24.4 percent, NOK (industrial equipment and parts) 24.4 percent, Alps Electric (electric materials and components) 20.2 percent and Koito (mechanical equipment and parts) 19.9 percent: Harner 2012.

\textsuperscript{169} The process was aided by impact of the global financial crisis in western economies, the March 11, 2011 “triple disaster” (earthquake, tsunami and nuclear crisis) which devastated Japan, and the continuing maturation of the Japanese economy: “China, Japan See Fortunes Becoming More Intertwined”. \textit{International Herald Tribune-Asahi Shimbun}, July 22, 2011.

\textsuperscript{170} Ministry of Economy, Trade and Industry (Japan), \textit{Dai-42-kai Kaigai Jigyo Katsudo Kihon Chosa} [The 42\textsuperscript{nd} Basic Survey of Overseas Business Activities of Japanese Companies] (conducted in July 2012), Tokyo: April 2013, Table 2-14.

\textsuperscript{171} Japanese Ministry of Foreign Affairs, First & Second China-Mongolia Division. \textit{Japan-China Relations}. Presentation Slides, June 2013 [Copy on File with Author].
percent) and Honda (20 percent). In total, approximately 3.5 million Japanese-brand cars were sold in China in 2011, equal to a 20 percent share of the domestic market. Of those, 90 percent were manufactured in China with 90 percent locally produced parts; Japanese-brand cars were essentially made in China, not exported from Japan. Car components—whether procured locally or imported from Japan—were predominantly made by Japanese firms, as well as the factory and machine tools used in production processes.

Table 4.3: Destination of goods produced by Japanese subsidiaries in China, as a percentage of total sales, 2003-2012

![Graph showing sales to local Chinese market and sales back to Japan from 2003 to 2012]

Source: Government of Japan, Ministry of Economy, Trade and Industry. Trends in Overseas Subsidiaries: Quarterly Survey. Note: Subsidiaries must have at least 50 percent of capital coming from parent company.

This description of Sino-Japanese economic interdependence demonstrates how the aggregate trade and investment figures normally employed to describe the relationship between the two

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174 Japanese auto parts producers sent 60 percent of their products of Japanese car companies in 2011. The percentage for parts makers based in China was likely even higher: “Senkaku Crisis Still Hurts Japanese Auto Parts Makers”. Nikkei Business Daily, April 19, 2013.
giant economies obscure a complex process in which each economy has played a discreet role in a larger transnational production network. Thousands of Japanese firms invested in China to build subsidiaries that utilized low-cost labor to assemble Japanese brand goods, using components imported from Japan (and elsewhere) or sourced locally from predominantly Japanese suppliers. These assembled goods were then either re-exported overseas to consumer markets in Japan, the United States and Europe or, increasingly, sold to Chinese consumers. Growing sales in the domestic market also created further incentive to locate production facilities inside China to reduce transportation costs. While Japan’s specialized production profile vis-à-vis China was not the sole characteristic of Sino-Japanese economic relations during this period, its centrality justifies “headquarter” economy status.

**Theoretical predictions:** The theory of asymmetry predicts “headquarter” economies will face the greatest asymmetry in relative disruption losses and thus be the most vulnerable. Foreign direct investments are specific to their location and not easily transferrable. This logic applies both to physical assets and intangibles such as trained staff and external relationships with customers, suppliers and public officials; shifting operations would require recreating these intangibles anew.¹⁷⁵ Chinese interests would suffer losses too, but the theory expects these to be smaller and more diffuse to the extent that other sources of investment are available and displaced workers can find alternative jobs. The second source of asymmetry is the production by headquarter economy firms of final goods under national brands. To the extent that branded goods are substitutable for alternatives, Japanese products can be locked out of the Chinese market at minimal cost to Chinese consumers. Hypothesis 1 tests for these claimed effects.

¹⁷⁵ As the Japanese business media group Nikkei wrote in 2010: “In China, where various problems occur on a daily basis, it is vital to have good relationships not just with one’s business connections and employees but also with the public security bureau, customs service and local governments”; “Japanese Companies in a Difficult Position over the Senkaku Islands Dispute”. *Nikkei Business*, October 5, 2010.
High asymmetry generates the expectation that Japanese policymakers should be under the most pressure to accommodate Chinese interests in Japan’s security policy in order to protect the economic relationship. This expectation is tested by Hypothesis 2. However, this pressure may be neutralized by the high political salience of the security issues in dispute, in which case observed security policies will not vary and Hypothesis 2 will return a null funding. In this case, the focus shifts to evidence which substantiates the hypothesized causal mechanism, in an attempt to isolate and gauge the pressures created by economic vulnerability.

4.5 Economic interdependence in Sino-Japanese political relations: Part I

Japan’s notoriously unstable domestic politics saw seven different individuals serve as Prime Minister during the years 2002-2013. Throughout, Tokyo was torn between complex and competing pressures in managing relations with Beijing. For the business community, positive political relations were vital to buttress lucrative and fast-growing economic links. For most other Japanese, multifaceted questions concerning Japan’s controversial history, dominant pacifist ideology and contemporary decline, in addition to lurking sovereignty disputes, combined to generate a fickle and increasingly pessimistic perception of China. While economic ties continued to flourish, political relations would be punctuated with episodes of heightened tension and occasional warmth, until relations turned indefinitely cold in September 2012.

The existence of clear lines of discord between the two states and open debate within Japan regarding the merits of alternative policy options permits a research design which juxtaposes the interests of the two states and the dynamics of their disputes against observed economic and

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176 Abe Shinzo served twice in this period, from September 2006 to September 2007 and from December 2012 onward.
policy outcomes. The goal is to measure the extent to which Japan was vulnerable to disruption of the bilateral economic relationship, and to evaluate whether Japanese security policies were more accommodating of Chinese interests that a baseline expectation. The period is divided into two: 2002 to August 2010, and from September 2010 to September 2013.

**First period (2002-2010): “Cold politics, hot economics”**

4.5.1 Nature of dispute and Chinese interests

Political relations between Japan and China struggled throughout the tenure of Prime Minister Koizumi Junichiro (2001-2006), with the sources of tension falling into three broad categories.\(^{177}\) The first concerned history and Japan’s wartime legacy, manifested in visits by the Prime Minister to the controversial Yasukuni Shrine in Tokyo (the site of internment of 14 Class A war criminals) and the approval for selection by local school districts of textbooks produced by an organization with revisionist historical views. From the Chinese perspective, the Yasukuni visits and textbook approvals showed a lack of repentance for, and indeed glorification of, Japan’s controversial past.\(^{178}\) The second category was an increased assertiveness in foreign and defense policy slowly emerging in Tokyo which threatened Chinese interests.\(^{179}\) It manifested in Japan’s campaign for a permanent seat on the United Nations Security Council,\(^{180}\) initial steps towards relaxing postwar constraints on Japan’s military forces,\(^{181}\) and an increased willingness to speak

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\(^{177}\) For comprehensive list of issues as of May 2005, see Shiraishi, Takashi. “Cool Heads Needed to Solve Japan-China Problems”. *Daily Yomiuri*, May 29, 2005.

\(^{178}\) “Koizumi-Hu Talks Display Depth of Divide”. *Daily Yomiuri*, November 24, 2004. The history issue was likely behind the fact that no high-level summits occurred between leaders of the two countries during Koizumi’s tenure.

\(^{179}\) Roy (2005) argues this assertiveness was driven by structural pressures that policymakers believed mandated a more pro-active posture, such as the North Korea threat, China’s rise and Japan’s decade-long economic malaise.

\(^{180}\) An online petition against Japan joining the Security Council was said to have collected over ten million signatures: Kokubun 2007, 138. The period also saw increasing advocacy for the removal of postwar constraints on Japan’s military forces.

\(^{181}\) Roy 2005, 193.
out about the Taiwan issue.\textsuperscript{182} The third category of tensions was the resurfacing of longstanding territorial disputes. In 2002 the Japanese government leased three of the disputed Senkaku/Diaoyu Islands from a private citizen, renewing the lease in 2004 over strong Chinese protests.\textsuperscript{183} In 2003 and 2004 Chinese activists made four attempts at a symbolic landing on the islands, succeeding in March 2004 before being arrested by Japanese police and deported, to strong Chinese displeasure.\textsuperscript{184} Conversely, Tokyo constantly protested Chinese exploration activities in the Chunxiao/Shirakaba gas field which straddles the median line of the two countries’ overlapping EEZs in the East China Sea.\textsuperscript{185}

4.5.2 Chinese non-economic measures

This array of tensions reached boiling point in April 2005 with an outbreak of large-scale anti-Japan protests across several Chinese cities.\textsuperscript{186} Protesters damaged the Japanese embassy in Beijing and consulate in Shanghai and vandalized Japanese supermarkets and department stores.\textsuperscript{187} When asked about the demonstrations Chinese Premier Wen Jiabao stated that “only the country that respects the past and assumes responsibility for history will be trusted by the peoples of Asia and the world, and can play a big, responsible role in international society”.\textsuperscript{188}

\textsuperscript{182} Japan issued an unprecedented joint statement with the United States in February 2005 declaring that “peaceful resolution of issues concerning the Taiwan Strait” was a “common strategic objective”, a move interpreted by China as a direct challenge to its Anti-Secession Law: “Riots Foretell Rivalry between China and Japan-U.S. Alliance”. \textit{Nikkei Weekly}, May 23, 2005.
\textsuperscript{184} Japan felt it had made a concession by not prosecuting the activists, but China did not see it this way: Roy 2005, 199.
\textsuperscript{185} In addition, Tokyo sought ways to bolster its own exploration capacity: “Energy Resources Put Japan-China Ties under Strain”. \textit{Financial Times}, February 1, 2005.
\textsuperscript{186} The proximate trigger was an “unrepentant” Japan seeking permanent Security Council membership, but this was just the spark to the broad and deep array of smoldering tensions: “Riots Foretell Rivalry Between China and Japan-U.S. Alliance”. \textit{Nikkei Weekly}, May 23, 2005. The main slogans used were “boycott Japanese products”, “oppose Japan becoming a permanent member of the UN Security Council” and “object to Japanese history textbooks”: Kokubun 2007, 139.
\textsuperscript{187} Reports stated that supermarkets were pulling Japanese products off shelves: Fisman et al 2013, 7.
4.5.3 Chinese economic measures

China’s economic importance to Japan during this period was clear; Chinese demand for its exports had fuelled Japan’s economic recovery in recent years.\(^{189}\) Yet there is little evidence that economic relations were meaningfully harmed by these tensions or that Japan felt any sense of economic vulnerability. Calls for widespread boycotts during the 2005 protests never manifested into action. For Japanese firms operating in China, some contracts were cancelled and other small-scale difficulties arose, but according to a senior member of the leading Japanese business lobby, Keidanren (Japan Business Federation), the incidents were sporadic and not damaging to overall Japanese interests.\(^{190}\) A survey of business operations issued by the Japan Bank for International Cooperation reached a similar conclusion.\(^{191}\) Instead, that year (2005) bilateral trade continued to grow strongly and Japanese investment in China reached a record high.\(^{192}\)

The reality was that China did not want the political disputes to affect the economic relationship.\(^{193}\) After endorsing the demonstrations in Beijing as legal on April 10, the Chinese government reversed course less than two weeks later, stating that unapproved demonstrations were illegal\(^ {194}\) and mobilizing law enforcement personnel throughout the country to suppress protests.\(^{195}\) Moreover, a more conciliatory tone was struck in comments from ministry officials that “cold economics” would be in no-one’s interest. State-run media began to emphasize the positive aspects of relations with Japan and how many Chinese jobs depended upon Japanese

\(^{190}\) “Japan Asks China to Protect its Businesses”. Financial Times, April 5, 2005.
\(^{191}\) The survey of over 500 firms found that only one percent of companies were “severely affected” and nine percent “affected”. Less than 5 percent of companies changed their business plans as a result: JBIC 2010, 34.
\(^{192}\) “Business Booming 1 Year after Riots”. Nikkei Weekly, April 10, 2006. FDI in China did however decline as a percentage of overall Japanese FDI in Asia (40 percent from 56 percent in 2004 according to JETRO data) but much of this was due to FDI more than doubling in Hong Kong, much of which may have been destined for the mainland.
\(^{193}\) Roy 2005, 206.
\(^{194}\) Fisman et al 2013, 7.
\(^{195}\) Kokubun 2007, 140.
investment. Beijing also agreed to repair the embassy and consulate buildings damaged by the protests. More generally, while loudly criticizing Koizumi on the Yasukuni issue, Beijing was careful to avoid further damaging relations while awaiting Koizumi’s departure. China’s pragmatic desire for Japanese investment and expertise overrode political concerns. Even the city of Nanjing, the site of the infamous “Rape of Nanjing” by Japanese forces in 1937, had sent a trade delegation to Japan in 2003 following concerns it was falling behind other cities in developing ties.

4.5.4 Japanese interests and policy responses

At no time during Koizumi’s term did Tokyo appear willing to back down or substantially accommodate Beijing’s security demands. Koizumi continued visiting the Yasukuni Shrine, having pledged prior to his election as Prime Minister to do so annually. And if anything, Japan’s security policies toward China were more assertive. When a Chinese submarine intruded into its territorial waters in November 2004, Japan gave chase and openly criticized China, surprising and delighting Japanese conservatives and U.S. officials. The following month, the

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197 Though refused to apologize or pay reparations: “Li Agrees to Repair Missions; But China Refuses Apologies, Damages”. Daily Yomiuri, May 8, 2005.
200 Koizumi’s Shrine visits were most likely made out of personal conviction and for domestic political reasons (maintaining conservative support and signaling credibility), rather than an intention to disrespect China: Cheung 2010. Koizumi’s public justification for the visits was that they were a matter of individual freedom and intended only to honor those who had given their lives in the service of Japan, rather than to glorify war or militarism. Koizumi did try to stabilize relations at difficult times, repeating an apology for Japan’s colonial past amid the violent protests in April 2005. He continued to visit the Shrine nonetheless, though in October 2005 attempted to reduce the provocation by scaling back the nature of the visit by making a simple monetary offering without entering the shrine: Kokubun 2007.
2004 National Defense Program Guidelines were updated to describe China as a potential threat, a development “unthinkable” a few years prior.\textsuperscript{201}

This assertiveness was no doubt bolstered by historically low levels of positive feelings towards China among the Japanese public,\textsuperscript{202} in addition to a broader trend of “normalization” of Japanese security policy and rising influence of politicians who wanted Japan to be more assertive.\textsuperscript{203} Yet none of these activities appeared to disrupt the flourishing economic relationship. Moreover, while Japanese firms undoubtedly preferred their Prime Minister refrain from visiting the Shrine, sustained domestic pressure to reconcile with China for economic reasons appeared absent. At times business leaders were willing to make public criticisms\textsuperscript{204} but at other points downplayed any negative impact.\textsuperscript{205} While some firms began to diversify away from China to avoid over-concentrating their overseas operations, this was more to address operational risks than those from high politics.\textsuperscript{206} Moreover, diversification was limited by the fact that opportunities in China were too compelling to ignore, causing Japanese government economists to conclude in 2006 that the risk of “not being in China” was as big as any risk of “being in China”.\textsuperscript{207}

\textsuperscript{206} Including labor shortages, revaluation of the renminbi, infrastructure bottlenecks, rule of law and institutional uncertainty: Fujita and Hamaguchi 2006.
\textsuperscript{207} Fujita and Hamaguchi 2006.
4.5.5 Conclusion

Despite the political tensions of the Koizumi years, there is little evidence suggesting either that Japan was vulnerable to economic disruption or that Japanese security policy was meaningfully affected by economic interdependence with China. The phrase “cold politics, hot economics”—a popular description of Sino-Japanese relations at the time—is an apt characterization of the fact that the economic and political relationships remained largely isolated. While the separation of economics and politics undoubtedly had multiple causes, symmetry in disruption losses between the two countries must have played an important role. At this time, China stood to lose as much and perhaps more from disruption of the economic relationship. While China was pivotal in the recovery of Japan’s economy, Japanese trade, investment and expertise were equally as important for China’s development. Accordingly, Japan was never made to face a tradeoff between its economic and security interests.

Although economic interdependence was not sufficiently potent during this period to alter Japanese security policy, this does not mean it had no influence. As the Koizumi years progressed, both mass media and public opinion shifted against the Yasukuni Shrine visits to align with the business community, viewing them as unnecessarily provocative toward China. It became clear after Koizumi’s departure that relations needed to be repaired, and despite his nationalist credentials and known suspicions of China, the next Prime Minister Abe Shinzo (2006-07) made Beijing his first overseas destination in October 2006. From that point, Tokyo

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208 Taniguchi 2005. Several Japanese foreign policy officials insisted in author interviews (Tokyo, June/July 2013) that the Japanese government never officially embraced this term.
210 The role played by the business lobby Keidanren and business-associated public interest group Keizai Doyukai should be acknowledged, as their petitioning during the leadership battle to succeed Koizumi turned a policy of
began to refer to Sino-Japanese ties as a “mutually beneficial strategic partnership”, and leaders from both sides made subsequent visits, including Chinese President Hu Jintao’s “warm spring” summit with Prime Minister Fukuda Yasuo (2007-08) in Tokyo in May 2008. Relations improved even further with the election of the Democratic Party of Japan (DPJ) and Prime Minister Hatoyama Yukio (2009-10), who entered office promising to improve relations with China and increase Japan’s independence from the United States. No prime minister visited the Yasukuni Shrine in this period.

The fact that leaders from both countries made efforts to restore good political relations was undoubtedly motivated by economic interests, and levels of trade and investment duly continued to grow. In the absence of countervailing political tensions, economic interdependence encouraged China and Japan to improve relations. In this cordial atmosphere, Japan was not faced with any meaningful conflicts between economics and security. Both sides had strong interests in growing the economic relationship, and no disagreements were significant enough to intervene. Moreover, despite the warmth of both economic and political relations, there is little evidence that Japanese security policy veered away from the nation’s fundamental interests. Rather, Tokyo sought ways to insure against China’s rise. Prime Minister Abe (in his first term) worked to bolster the U.S. alliance and articulated a vision of an “Arc of Freedom and Prosperity” which would link nations sharing “universal” values of democracy and liberalism.

\[\text{rapprochement}\] into a source of political capital among the rival factions: Hemmings and Kuroki 2013, 59. Abe’s visit saw the first bilateral summit between Japan and China in five years.\(^{211}\) Shortly after he became Prime Minister, Abe was quoted in an interview with the Financial Times saying, “especially in economics, we need each other. The Chinese were strongly aware of that and they probably deemed that, if they allowed the political tension to persist, that could have a negative impact on the Chinese economy”: “New Friends, Always Rivals”. Financial Times, November 6, 2006. This did not mean a complete absence of security tensions—in December 2008 for example two Chinese survey ships spent nearly nine hours in Japanese territorial waters off the Senkaku/Diaoyu Islands. The Japanese lodged diplomatic protests while the Chinese denied any provocation. The matter was raised less than a week later when Prime Minister Aso of Japan and President Hu of China met at a trilateral forum (with South Korea), but did not escalate into more serious tensions.
Public opinion remained skeptical of China,\textsuperscript{212} and the discourse in Diet debates increasingly reflected insecurity about China’s rise.\textsuperscript{213} Even the DPJ, once elected, was willing to pressure China on issues such as food safety, North Korea, military transparency and resolving the East China Sea dispute.\textsuperscript{214} Accordingly, while economic interdependence brought some warmth back into political relations between 2006 and 2010, it did not inhibit the gradual reorientation in Japanese security policy towards recognition of increasing competition with China. In September 2010 the first incident would occur to bring security and economic interests into direct conflict.

4.6 Economic interdependence in Sino-Japanese political relations: Part II

Second period (2010-2013): Tensions in the East China Sea and the 2010 collision

4.6.1 Nature of dispute

The period of warmer political relations came to an end in September 2010, from this point Japan would face a more substantial tradeoff between its economic relationship with China and its security interests. On September 7, 2010 a Chinese trawler collided with two Japan Coast Guard (JCG) patrol ships that had been trying to chase it away from waters around the Senkaku Islands.\textsuperscript{215} The captain and crew of the trawler were arrested and the vessel confiscated. On September 13, Japan released the crew and vessel but retained custody of the captain to determine whether he should be indicted. A court decided on September 19 to extend his detention for a further ten days, but he was released just five days later on September 24. The

\textsuperscript{212} Polling in early 2008 had 67 percent of people unfavorable towards China. This was not helped by a gyoza dumpling contamination scare: “Less Toxic Relations between Japan and China”. \textit{Financial Times}, February 6, 2008
\textsuperscript{213} Hagstrom and Jerden 2010.
\textsuperscript{214} Hook et al 2012, 183. See also Bush 2010, 212.
\textsuperscript{215} Japan and China disagree on who was at fault in the collision. After carefully considering the available evidence, Drifte (2013, 30) opines that it seems to indicate an intentional ramming by the Chinese captain.
deputy prosecutor responsible cited the impact of the case on the “future of Japan-China relations” as influencing the decision.216

4.6.2 Chinese interests

This incident was treated extremely seriously by China for several reasons. First, Chinese leaders believed that not releasing the trawler captain early on was unusually provocative behavior, since the two governments had reached an implicit understanding to deport private citizens picked up in and around the islands.217 Second, China perceived Japan’s arrest and moves to prosecute the trawler captain to be a public assertion of sovereignty over the islands and a violation of an understanding reached in the 1970s to “shelve” the territorial dispute.218 Unhelpfully, the extension of the captain’s detention on September 19 occurred one day after the anniversary of the Mukden Incident, which marked Japan’s invasion of northeastern China in 1931.219 Accordingly, and with their domestic audience in mind, Chinese interests in this crisis were to secure the captain’s release, to obtain acknowledgement from Japan that sovereignty over the islands was disputed and that the arrest of the captain was wrongful (a Chinese foreign ministry spokeswomen called for both an apology and compensation),220 and to deter Japan from similar actions in the future. To achieve these goals China employed a multifaceted response employing diplomatic, political and economic tools of statecraft.

4.6.3 Chinese non-economic measures

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216 Hagstrom 2012, 273.
218 Drifte 2013, 32. The Chinese also could not initially fathom why a small fishing trawler would ram two larger Coast Guard vessels: Takahara 2011.
219 Johnston (2013, 22) states that Chinese leaders were likely worried that if the captain was not released before the September 18 anniversary, China would look diplomatically weak.

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On the diplomatic and political front, Japan’s ambassador to China, Niwa Uichiro, was summoned six times by the Chinese between September 8 and 19 including late one evening. Following the handover by the JCG of the captain to prosecutors for possible indictment on September 10, China began to cancel ministerial meetings, negotiations, and other exchanges. Anti-Japan rallies occurred on September 16 in three Chinese cities. On September 20, the day after the court extended the captain’s detention, Chinese authorities detained four Japanese citizens and employees of the Japanese company Fujita alleging they had entered a restricted military area in Hebei province. The four had been sent as part of a Japanese project to reclaim WWII chemical weapons left by Japan’s Imperial Army.221

4.6.4 Chinese economic measures

Attracting the most attention was the apparent use by China of economic measures to apply pressure to Japan. Chinese tourists began exercising “self-restrictions”, cancelling trips to Japan which by later estimation reduced Japan’s consumption by ¥31.8 billion ($400m).222 The week the captain was released reports emerged that China was blocking shipments of rare earth elements to Japan, commodities which are critical components in a variety of industrial processes.223 At the time, China mined 93 percent of the world's rare earths, and Japan’s Minister of State for Economic and Fiscal Policy Kaieda Banri acknowledged that “the de facto ban on rare earths export that China has imposed could have a very big impact on Japan’s economy”.224 China had actually begun to limit its exports of rare earths earlier that year on the belief that the

222 “Standoff over Senkakus could stall growth in both nations”. Japan Times, October 4, 2012.
country’s stock of rare earths was being sold too cheaply,\textsuperscript{225} and to encourage Japanese firms to relocate advanced production processes using rare earths to China.\textsuperscript{226} Yet the September actions were still perceived by Japan as a distinct ban; over the next month, only two of 30 Japanese importers reported receipt of rare earth shipments,\textsuperscript{227} and difficulties were still being reported by mid-November.\textsuperscript{228} While Chinese officials did not publicly acknowledge an embargo, the absence of an official policy may have been a deliberate tactic to avoid the risk of complaints to the WTO, which prohibits unilateral export restrictions.\textsuperscript{229}

In addition to the rare earths embargo, some firms found the business environment in China more hostile. Reports emerged that the frequency and length of customs inspections increased, causing costly delays in shipments between the two countries. In some cases, customs officials took the highly unusual step of looking at every item in a container instead of the orthodox practice of checking a small sample.\textsuperscript{230} Over 30 percent of firms surveyed by business media group Nikkei

\textsuperscript{225} “Japan Scrambles for Rare Earth‖. \textit{Wall Street Journal}, October 15, 2010.
\textsuperscript{226} Author interview with Japanese officials with knowledge of the rare earths issue, Tokyo, July 2013.
\textsuperscript{227} “China’s rare earth blockage taking a toll on businesses‖. \textit{International Herald Tribune-Asahi Shimbun}, October 22, 2010. The article tells of officials at a Japanese trading company asking their Chinese supplier to reroute rare earth shipments through South Korea, but the supplier declined, citing concerns about repercussions that could arise if authorities found out the shipments were destined for Japan.
\textsuperscript{228} “China Still Bans Rare Earths for Japan, Executives Say‖. \textit{New York Times}, November 11, 2010. Customs officials had abruptly started granting approvals on October 28, but resumed blocking them on October 29 after high-level Japan-China talks in Vietnam had failed to improve relations. Johnston (2013) cites Japanese import data for rare earths from August to December 2010 suggesting that there is no pattern of reductions consistent with a centrally determined and enforced Chinese embargo. Morrison and Tang (2012) cite Chinese data indicating a sharp drop in exports in October and November. Author interviews with several Japanese officials indicate that the Japanese government believed that supply was being disrupted, and the records of the Ministry of Economy, Trade and Industry (METI) detail six meetings between METI officials and Chinese counterparts between October 2 and November 13, 2012 regarding the rare earths issue: Author interview with Japanese officials with knowledge of the rare earths issue, Tokyo, July 2013.
\textsuperscript{229} “China Is Blocking Minerals, Executives Say‖. \textit{New York Times}, September 24, 2010, 1. China’s Commerce Minister at the time, Chen Deming, gave a TV interview stating that the government had complied with WTO rules because it had not issued a ban, but acknowledged that disruption may have happened regardless saying “I believe entrepreneurs, they will have their own feelings, and will do their own thing‖: “Block on Minerals Called Threat to Japan’s Economy‖. \textit{New York Times}, September 29, 2010, 1.
\textsuperscript{230} “China, Japan Take New Jabs at Each Other‖. \textit{Wall Street Journal}, September 27, 2010. Shipping companies reported that inspection rates were 50 percent compared to 10 percent or 20 percent normally, though perishable goods such as fruits and vegetables caused no delays.
said their business was affected by the tougher customs procedures. Chinese state-run media ran opinion pieces arguing Japanese companies should be excluded from bidding on environmental projects. However this anecdotal evidence should not be overstated; evidence of widespread or significant disruption cannot be found in overall trade or specific industry figures. Japanese foreign investment in China hit a record high in 2010 before skyrocketing a further 50 percent in 2011, and monthly trade figures between September 2010 and January 2011 continued to reflect healthy growth.

4.6.5 Japanese interests and security policy

The Japanese government’s handling of the crisis came under vocal criticism and with hindsight is widely considered within Japan to be a tactical defeat. The government’s biggest problem was indecisiveness. The decision to prolong the captain’s detention but still release him prematurely suggested that it was cautious political logic rather than orthodox legal procedure which was driving decision-making. While political intervention in the prosecutorial process was denied at the time, three years later in 2013 the Chief Cabinet Secretary during the crisis, Sengoku Yoshito, conceded that the government had stepped in. The indecisiveness extended

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231 “Japan Firms in China Wary of Policy Change”. *Nikkei Report*, December 16, 2010. In a survey conducted by the Japan Bank for International Cooperation, 22.6 percent of companies were affected in some way, the effects most often cited were customs delays and procurement of rare earths: JBIC 2010, 33-34.


234 This fact was acknowledged by numerous Japanese officials in author interviews, Tokyo, June/July 2013.

235 “Sengoku Reveals Politics of China Skipper’s Release”. *Japan Times*, September 23, 2013. Moreover, the prosecutor’s citation of diplomatic considerations suggests political involvement because—as reporting rightly pointed out—assessing the Sino-Japanese relationship was well beyond the prosecutor’s job description. There was essentially unanimous agreement between the *Yomiuri Shimbun*, *Nikkei Shimbun*, *Mainichi Shimbun* and *Asahi Shimbun* that there must have been high-level involvement from the Kan government: “Japan-China Tensions Enter New Phase”. *Wall Street Journal*, September 26, 2010.
to the question of whether to publicly release video footage of the collision taken by the JCG. Reluctant to do so out of concern that it might further inflame tensions, the government would look even weaker after the footage was leaked by a disgruntled officer of the JCG. Naturally, the officer’s audacity in defying orders in order to tell the JCG’s side of the story to the world made authorities seem even less capable of standing up to Chinese pressure and was the subject of heated parliamentary debate.

Throughout, the ruling DPJ government of Prime Minister Kan Naoto was paralyzed by internal divisions and under constant criticism by media and opposition groups for being weak, indecisive, and diplomatically ineffective. The public agreed, with successive polls taken in October and November 2010 found that over 70 percent of the public believed the Kan government had not handed the situation well and that Japan risked sending the message that it would fold under Chinese pressure. By early November, support for the cabinet had crashed from a high of 71 percent in September to 33 percent. The dominant narrative was that Tokyo’s clumsy management of the situation reflected China’s rising power and Japan’s weakness and decline.

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237 There was specific concern for the continued well-being of the one Fujita employee who at that point had still not been released.
239 Smith 2012, 378.
241 Smith 2012, 378-79. The same polls indicated the public wanted the video footage released.
242 Tiberghien 2010. 74 percent blamed their disapproval on misguided foreign policy.
243 Hagstrom 2012, 275-280. This is despite getting an assurance from the United States that although it did not take a position on sovereignty issues, the Senkaku Islands and their waters would be covered by the U.S.-Japan Security Treaty.
Yet it is unlikely that economic considerations played a decisive role in these events. The initial decision to release the captain was made before the economic impact of the rare earths embargo and other disruptions could be felt. Moreover, the government’s indecisiveness on whether to release the collision footage seems more consistent with a government reacting to a situation that was out of its control rather than yielding to economic pressure.

The crisis brought the Senkaku issue to the attention of the Japanese public, providing a platform for China anxiety and nationalist sentiment that would be stoked again in 2012. Right-wing groups became more willing to speak up; following the captain’s release, a group of 100 conservative politicians led by former Prime Minister Abe adopted a harshly worded statement criticizing the move. Japanese security policy also continued its trend of responding to the increased perception of a Chinese threat. In December 2010, less than three months after the crisis, the 2010 National Defense Program Guidelines further relocated defense capabilities from Japan’s north to its southwest, a move designed to respond to “gray zone” conflicts arising from disputes over “territory, sovereignty and economic interests”.

244 It is more likely that the arrest of the Fujita employees influenced his release, although author interviews with both Japanese government officials and observers (Tokyo, June/July 2013) on this question were divided. A majority believed the Fujita arrests more than the rare earth embargoes were a source of greater concern at the time. Drifte (2013, 31) describes the arrests as the “final straw” to release the captain. Hagstrom (2012) points to evidence that the four employees had entered a restricted military zone and that Chinese authorities had not orchestrated the incident, suggesting that there is uncertainty about what happened. What is undeniable is that the combination of the different measures created a highly pressurized situation and difficult situation for an inexperienced DPJ government to navigate. “Japanese Companies in a Difficult Position over the Senkaku Islands Dispute”. Nikkei Business, October 5, 2010.


246 Fouset 2011; Berkofsky 2011. The guidelines state that “China is stepping up and expanding maritime activities in the region’s surrounding waters, and these activities, coupled with the lack of transparency shrouding China’s military and security aims are of concern to the regional and global community.”
focus on perceived security needs by concentrating resources on “truly necessary functions”. Economic considerations do not appear to have constrained the evolution of these security policies.

4.6.6 Japan’s economic response

In the aftermath of the immediate crisis both Japanese business and the government concluded that the rare earth issue was a vulnerability that needed to be addressed. Companies looked to revive rare earth mining outside China, and also develop replacement materials and production processes which required fewer rare earths. The government developed a plan to allocate $1.2 billion in subsidies to improve rare earth supplies, roughly half of which was allocated to overseas mining projects. And less than a week after China resumed exports in November 2010, the lead Japanese trading company in rare earths, Sojitz, announced a $250 million procurement deal with Australian company Lynas. Accordingly, while prices spiked in the first half of 2011 as China continued to tighten exports, by 2012 they had cratered as companies adapted and new sources came online. For this reason, many Japanese officials in interviews described the rare earths embargo as a “tactical victory but strategic defeat” for China since it can never again use rare earths as a coercive lever.

4.6.7 Conclusion

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247 Fouse 2011, 490-91.
248 While certain recommendations had been excluded, such the relaxation of arms exports, this was due to domestic political opposition rather than a concern about China’s response: Fouse 2011. It should be noted however that the specific Senkaku Islands policy of the DPJ had remained very restrained, focusing on the maintenance of the status quo. Only one extra patrol boat had been added to the coast guard unit.
253 “Rare Earths not Quite as Rare”. Reuters, October 15, 2012.
An overall assessment of the 2010 crisis yields the following conclusions. First, Chinese pressure was able to compel political intervention in the Japanese legal process—a not insignificant intrusion on Japanese autonomy—though less through economic levers and more through diplomatic and political tools, particularly the Fujita employee arrests, while taking advantage of a government inexperienced in foreign policy.

Second, the economic link targeted by China highlights how economic vulnerabilities can be very narrow. Not all types of rare earths were disrupted—the halted shipments involved rare earth oxides, salts and pure rare earth metals—all of which were tracked closely by Chinese customs officials for compliance with government export quotas. In contrast, shipments of various alloys containing rare earths continued. These would have been difficult to stop since they did not ordinarily receive attention from customs officials. An industry expert commented that “they picked on things for which it’s relatively easy because they’ve got a quota”. Moreover, China’s coercion was limited to one sectoral asymmetry in rare earths. The fact that negative impacts elsewhere in the economic relationship barely registered suggests that China continued to be either unwilling or unable to threaten the broader (more symmetrical) interdependent relationship. This meant that, apart from rare earths, neither Japanese business nor government carried substantial ongoing concern about economic vulnerability forward into 2011, and economic interests continued to have little impact on Japan’s security policy.

Third, the rare earths incident does not fall strictly within the scope of the theory of asymmetry, though the theory’s logic is consistent with the facts. China undoubtedly exploited an asymmetry and was able to inflict large costs on Japan at almost no (short term) cost to itself. However, the nature of this vulnerability did not arise from the specialized production profiles of the two

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countries. While Japan’s demand for rare earths was a function of its hi-tech manufacturing base (typical of a headquarter economy), China’s supply of rare earths was not a function of its broader production profile. Nevertheless, as an auxiliary causal process observation this episode confirms the underlying logic of the theory of asymmetry and further challenges the logic of aggregate trade flows as adequate measures of interdependence.

Finally, the seemingly aggressive use by Beijing of economic measures during a diplomatic dispute greatly influenced perceptions in Japan, and indeed worldwide, about China’s willingness to use its growing economic power to assert its interests more forcefully, helping convince the Japanese public of the need to enhance Japan’s security capabilities. Bringing the Senkaku issue to the forefront of the public mind increased its political salience, suggesting future attempts to pressure Japanese governments over the Senkaku issue would face even greater resistance.

4.7 Economic interdependence in Sino-Japanese political relations: Part III

Second period (2010-2013): The Senkaku nationalization—‘Weaponizing’ economics?

4.7.1 Nature of dispute

The year 2011 would be a difficult one for Japan. The March 11 triple disaster of an earthquake, tsunami and nuclear emergency devastated the country and shocked the Japanese people. The economy struggled with deflation and the ruling DPJ government, having lost control of the upper house in 2010 to an LDP-led coalition, struggled to assert itself. In September Noda Yoshihiko became the third DPJ Prime Minister and Japan’s sixth in five years and, along with
his new foreign minister Gemba Koichiro, brought a more skeptical view of China’s growing power and assertiveness. The policy of positive engagement first promoted by the DPJ when it entered office was gone.\textsuperscript{255} Noda relaxed Japan’s longstanding restrictions on arms exports in December 2011 and a few months later enhanced the law enforcement powers of the JCG in territorial waters. In March 2012, the government formally named 39 islands, including four in the Senkaku group, as part of a broader plan to strengthen its legal and maritime control. Beijing responded immediately with its own names for all the Diaoyu Islands\textsuperscript{256} and China’s State Oceanic Administration announced on March 16 that it had begun patrols. That same day, a Chinese Marine Service vessel entered the territorial waters of the islands, triggering a formal protest from Japan over this “extremely serious” incursion.\textsuperscript{257}

Amid these simmering tensions the controversial governor of Tokyo, Ishihara Shintaro, frustrated by what he saw as the DPJ’s failure to protect Japanese sovereignty, announced on April 16, 2012 that the Tokyo Metropolitan Government (TMG) was negotiating the purchase of three of the four privately-owned Senkaku Islands. Highlighting the seriousness of the situation, Japan’s ambassador to China, former business executive Niwa Uichiro, gave an unprecedented interview with the \textit{Financial Times} in June warning of a grave crisis if the TMG purchased the islands.\textsuperscript{258} The Noda government agreed, and began to explore the possibility of “nationalization” whereby it would purchase the islands instead.\textsuperscript{259} The government’s hand was reportedly forced by Ishihara’s moves to send a survey team to the islands, and nationalization

\textsuperscript{256} “Japan, China Need to Focus on Importance of Friendly Ties”. \textit{International Herald Tribune-Asahi Shimbun}, March 8, 2012.
\textsuperscript{257} “Japan Protests China’s Island Incursion”, \textit{Financial Times}, March 16, 2012.
\textsuperscript{258} “Tokyo Warned over Plans to Buy Islands”. \textit{Financial Times}, June 6, 2012. Ambassador Niwa was chastised by Tokyo for his controversial comments, and subsequently recalled.
was announced on September 11, 2012.\textsuperscript{260} What Noda did not expect was the extent of China’s anger at the purchase, the strength of countermeasures and the resultant deterioration in bilateral relations that would far exceed the lows of 2010.\textsuperscript{261}

### 4.7.2 Chinese interests

A significant amount of reporting and analysis already exists covering the period leading up to the announcement of the purchase on September 11, including what communications may have passed between Tokyo and Beijing, whether the islands were considered (at the time) to be one of China’s “core interests”, and whether the Noda government should have anticipated how seriously the Chinese would respond.\textsuperscript{262} What matters is that by September 2012 the steady accumulation of tensions had shifted Chinese public opinion to a point of extreme hostility toward Japan. With the upcoming National Party Congress and leadership transition in China, the Senkaku/Diaoyu issue was a matter of political legitimacy and survival for the Chinese government.\textsuperscript{263} The decision by Japan to purchase the three islands was therefore an unacceptable change of the status quo. Evidence suggests that Beijing devised a plan to pressure Japan to force it to admit, at a minimum, that a territorial dispute exited. Incoming president Xi Jinping was reportedly made head of a new “Office to Respond to the Diaoyu Crisis” shortly after the nationalization announcement.\textsuperscript{264} These moves illustrate the resolve with which China would pursue its interests to advance its sovereignty claim over the islands.

### 4.7.3 Chinese non-economic measures

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\textsuperscript{263} Tiberghien 2012.

\textsuperscript{264} Jakobson, Linda. “How Involved is Xi Jinping in the Diaoyu Crisis”. \textit{The Diplomat}, February 8, 2013.
As in 2010, China’s response was multifaceted. On the security front, China upped its maritime presence around the disputed islands by sending regular vessels on patrols both into the outer contiguous zone and Japanese territorial waters. Rhetorically, officials claimed both that the islands had been part of China for centuries, while also highlighting Japan’s victimization of China since the late 19th century. The nationalization was said to be a denial by Japan of the “anti-fascist war” (World War II).\footnote{Drifte 2013, 43.} Political sanctions began with the cancellation of official visits and ceremonial events to mark the 40th anniversary of the normalization of relations, the publication of maps and regular weather forecasts for the islands, and a submission to the United Nations Continental Shelf Commission in December.\footnote{Submission by the People’s Republic of China concerning the Outer Limits of the Continental Shelf beyond 200 Nautical Miles in Part of the East China Sea. Available from: <http://www.un.org/depts/los/clcs_new/submissions_files/submission_chn_63_2012.htm>. Accessed October 3, 2013.} October visits by China’s finance minister and central bank governor to Tokyo to attend International Monetary Fund and World Bank meetings were cancelled and by mid-2013 Japanese officials above the director level were still unable to meet with their Chinese counterparts.\footnote{Author interview with Japanese official with knowledge of Sino-Japanese relations, Tokyo, July 2013. The official explained how this was a marked change from the tensions under Prime Minister Koizumi, where despite the absence of meetings at the highest level, meetings between the two governments continued at upper levels throughout. In the official’s opinion, this was because Chinese officials were unwilling to take the risk to meet even if they saw merit in doing so.}

It was mass protests and the violence they occasioned that distinguished the immediate crisis. Protests had begun in mid-August with the landing and subsequent arrest of Hong Kong activists on the islands,\footnote{Evidence suggests that Chinese government tried to calm the August protests, given an article in China’s Youth Daily headlined “Smashing Japanese Automobiles is not an Act of Patriotism” followed by little coverage in the days that followed: Przystup 2013a.} but spread to over 100 Chinese cities in the aftermath of the nationalization announcement. A rally in Shanghai attracted 16,000 protesters and about 5,000 demonstrated in
front of the Japanese Embassy in Beijing.\textsuperscript{269} With the protests came riots and violence, occasioning the destruction of Japanese shopping centers, businesses, factories and cars, causing millions in damage and forcing temporary closures and the urging of expatriate employees to evacuate the country.\textsuperscript{270} Production sites run by companies such as Panasonic, Nintendo and Mitsumi sustained damage and many operations were forced to close their doors for protection.\textsuperscript{271}

While the Chinese government denied any official involvement, reports suggested that protesters were encouraged and perhaps materially supported by the Chinese Communist Party.\textsuperscript{272} Color photographs of protests printed on the front pages of state-run newspapers—a rarity in China—were also evidence that senior leaders approved of the demonstrations.\textsuperscript{273} Numerous Japanese websites including a government ministry, courts and a hospital came under cyber-attack.\textsuperscript{274} After the protests reached their peak on September 18—the anniversary of the Mukden Incident—the Chinese government moved to calm tensions, deploying riot police around the Japanese embassy in Beijing on September 19.\textsuperscript{275} But as the violence was ending the economic response was beginning.

\textsuperscript{272} Tiberghien 2012.
\textsuperscript{274} “Chinese Cyber Attacks hit Japan over Islands Dispute”. \textit{Globe and Mail}, September 19, 2012.
4.7.4 Chinese economic measures

It is important to document the extent of the protests since in many ways they laid the foundations of the economic “weapons” deployed against Japanese economic interests over the following weeks. A survey of over 300 companies of all sizes in November 2012 conducted by the Japan Bank of International Cooperation identified 11 different economic effects experienced by companies doing business in China. The five effects reported with the highest frequency are discussed in detail below. Each of these effects is an example of the disruption losses suffered by Japanese firms.

“Sales influenced by boycotts of Japanese goods”: The animosity felt by much of the Chinese public fed into consumer boycotts, incited by government officials, state-run media and online activists. Some businesses had actually experienced sales declines since the landing by Hong Kong activists in August, but the protests both massively increased the scale of boycotts and exacerbated their effects. To avoid the worst of the violence, Japanese companies were forced to close hundreds of stores, factories and offices in the week following the September 11 announcement. The firms affected were high profile brands inextricably linked with Japan and therefore prominent targets for an angry public, including car companies like Toyota, Nissan and Honda, retailers such as 7-11, Uniqlo and Aeon, and electronics brands such as Panasonic and

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276 A commentary published on September 17, 2012, in the People’s Daily, the flagship newspaper of the Chinese Communist party, referred to economic punishments of Japan as the “gun” in the hands of the Chinese government: “People’s Daily Implies Economic Measures against Japan”. Xinhua, September 17, 2012.
277 JBIC 2012, 76. The ordering is not from most to least frequent, but adheres to a logic tracing how the effects spread outward from the protests. The other categories were: sabotage by local employees; local manufacturer’s refusal of delivery; damages caused by riots; others; delayed delivery from local manufacturers; and impacts caused by the repatriation of Japanese staff.
278 In other words, each effect is a distinct independent variable CPO (see section 2.3) establishing the serious magnitude of the disruption losses suffered by Japan and accordingly its economic vulnerability.
280 For example, 60 of 169 Uniqlo clothing stores were closed from September 14-24 for fear of attacks from protesters: “China-Japan Dispute Takes Rising Toll on Top Asian Economies”. Bloomberg News, January 9, 2013.
This meant that fewer goods were being produced and made available for purchase. Moreover, the severity of the violence intimidated consumers who might otherwise have been willing to continue buying Japanese products. In both cases, it was recognizably Japanese brands that were affected.

The automobile industry was worst hit. Rioters smashed Japanese cars and arsonists torched dealerships, forcing the closure of many showrooms and plants. In a widely reported incident in Xian, a Chinese man driving past an anti-Japanese demonstration was dragged from his Toyota Corolla and brutally beaten, causing paralysis. Sales plummeted. Japanese exports of automobiles (including parts) fell 44.5 percent in September 2012 compared to the same month in 2011. Japanese automakers’ share of the Chinese market fell to 14 percent in November 2012 from 23 percent before September. Firms responded by scaling back production in China to match the slowdown and, at one point, Chinese production of Japanese cars was cut by half. By September 2013, one year after the protests, sales of Japanese cars had recovered in relatively more friendly provinces like southern Guangdong, but continued to struggle in high-growth markets such as the eastern provinces of Shandong, Zhejiang and Jiangsu, locations of greater historical animosity.

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281 “Japan Brand Name Firms Shut China Plants After Protest Violence”. Reuters, September 17, 2012.
In addition to cars, Chinese consumers avoided famous Japanese brands sold at large retailers. In November and early December 2012, a poll taken of residents of five major provinces found that 66 percent had refrained from buying Japanese products since the September nationalization. Shopping malls put up signs saying they were refraining from selling Japanese goods. Cosmetics and electronics were notable victims. Shiseido, a cosmetics company that at the time derived 10 percent of its overall sales from China, reported that September sales recorded a 10 percent year-on-year drop after double-digit growth in previous months. Cosmetics are popular gifts in China; shoppers were likely wary of buying Japanese products for others. Shiseido sales counters in larger stores were also destroyed by rioters and, by early November, 250 of the company’s 6000 stores remained closed. Electronics maker Panasonic reported in November that it expected a large drop in revenue because of the dispute, rival Sony described a similar situation and bellwether exporter Canon also reported drops in sales.

The other major boycott was tourism to Japan. An estimated 193,000 tourists visited Japan from mainland China in August 2012, a record high and the second largest source country (after South Korea). Chinese tourists are heavy shoppers and accounted for a large proportion of sales for many local businesses. In the weeks following the nationalization, tens of thousands of flight reservations and tour bookings were cancelled, and the number of Chinese tourists over the

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290 Katz 2013.
period September-December 2012 fell by 44 percent over 2011. January 2013 figures recorded a 47.6 percent drop over January 2012 and in March the equivalent fall was 22.5 percent.294

“Production and sales indirectly influenced by affected business partners”: The problems Japanese brands faced in automobiles and consumer goods flowed through to their upstream suppliers of intermediate inputs—predominantly Japanese companies. A high percentage of steel, general machinery and oil and rubber producers reported declines in sales.295

Semiconductor maker Rohm, which drew the highest percentage of sales from the Chinese market of any major company,296 forecast a decline in orders caused by the losses of automakers,297 as did Mitsumi Electric, an electronic parts maker, adjusting its forecasts from an expected profit of ¥1 billion to a loss of ¥12.5 billion.298 Koito, a major headlamp maker, froze construction of a new plant in Guangzhou.299

Doing business with Chinese partners also became more difficult for Japanese firms. In a similar dynamic to the consumer boycotts, certain Chinese businesses—often SOEs due to their close connection to the central government—refused to work or transact with Japanese partners, while others felt pressure to stay away. The evidence in these areas is more anecdotal that systematic.

Public offices stopped buying office equipment made by Japanese companies.300 Advertising agencies’ attempts at placing advertisements on television and in newspapers were refused.301

Japanese pharmaceutical companies reported an increase in products being returned from

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296 Harner 2012.
297 “Toyota China Sales Tumble as Islands Row Hits Japan Inc”. Reuters, October 5, 2012.
298 “Firms cutting outlooks as China risks start to weigh”. Nikkei Weekly, November 5, 2012.
Chinese hospitals and refusals of contract renewals. Chinese construction companies refused to use Japanese construction materials or install Japanese-made elevators.\(^{302}\) This tactic has been described by Chinese scholars as “purchasing diplomacy”, in which SOEs make or forego purchases of prominent commercial goods from other states as rewards or punishments.\(^{303}\)

“\emph{Delay in export and import procedures}”: As in the 2010 crisis, customs authorities strengthened inspections of imports from and exports to Japan causing delays,\(^{304}\) though these difficulties do not seem to have lasted more than a month.

“\emph{Delay in various permissions}”: The evidence here is also more anecdotal than systematic. Some Japanese companies reported experiencing delays in obtaining working visas for Japanese employees.\(^{305}\) Others were barred from trade exhibitions, making it hard to reach customers.\(^{306}\) Merger approvals were delayed, and firms were obstructed in, or outright prohibited from, bidding for contracts.\(^{307}\) Interview evidence indicates that tendering for contracts was generally more difficult when dealing with government procurement and SOEs; the closer the enterprise to central authorities, the more difficult it was to do business.\(^{308}\)

“\emph{Overall operations influenced by the voluntary restraint of business trips from Japan to China and within China}”: In such a poor climate, many opportunities for business-to-business

\(^{302}\) Przystup 2013a.
\(^{303}\) Reilly 2013, 5 & n 25.
\(^{305}\) “Japan PM Warns China on Dispute”. \textit{Wall Street Journal Online}, September 25, 2012.
\(^{308}\) Author interviews with several Japanese economic officials, Tokyo, June/July 2013. Fisman et al (2013) demonstrate that Japanese firms operating in industries that are dominated by SOEs suffered negative abnormal returns declines in market value during 2005/2010 tensions suggesting that the Chinese government has greater incentive and ability to intercede in these industries.
interactions often became impossible. Japan’s leading business lobby Keidanren had to cancel a
delegation visit to China in May 2013, saying that meetings with officials in such a hostile
climate would be difficult. While the economic damage of these cancelled trips is difficult to
measure, they at least contributed to the feeling that, aside from the outright damage, additional
economic opportunities were being lost due to the political tensions.

Summary: Official Japanese figures reported a 10.4 percent drop exports to China in 2012.
Growth in exports had been over eight percent the previous year. The protests plus boycotts cost
Japanese firms over $100m according to one government estimate. Sixty-five percent of
companies in one survey said the tensions adversely affected their business, with over 50 percent
experiencing a loss of sales. The year-on-year decline in exports actually accelerated in the
first half of 2013 with Japan’s exports to China falling to a four-year low. This decline was partly
a continuation of the September crisis, and partly a slowdown in the Chinese economy.
Reflecting these trends, the United States overtook China to become Japan’s number one export
destination in April 2013. Investment also fell over 31 percent between January-June 2013
compared with a year earlier.

310 Standard and Poors estimated that a 30 percent drop in Japanese exports to China over the course of an entire
year could slice 0.6 percent off Japanese nominal GDP: “China Row Hangs over Japanese GDP”. Wall Street
Journal, October 13, 2012. An estimate in October 2012 stated that a one-month suspension of exports to China
would cut Japan’s real GDP by ¥2.2 trillion or 0.2 percent, while Chinese affiliates of Japanese companies would
see sales revenue drop by ¥1.7 trillion.
312 JBIC 2012, 73-81.
313 “With Exports At 4-Year Low, Is Japan Missing Boat to China?”. Wall Street Journal (Japan Real Time), August
15, 2013.
315 “With Exports At 4-Year Low, Is Japan Missing Boat to China?” Wall Street Journal (Japan Real Time), August
15, 2013. Figures for all of 2013 indicated a 4.3 percent decline: “Foreign Direct Investment in China Rebounds
5.3% in 2013”. Agence-France Presse, January 16, 2014.
4.7.5 Observations of symmetric interdependence

There were important exceptions to the economic disruption arising out of the 2012 crisis.

**Highest quality products:** According to one Japanese official, the less competitive the product, the more it was affected by political tensions.\(^{316}\) Japanese products of the highest quality—for which there were no local alternatives—were immune from politics. Examples included high-end pianos, single-lens reflex cameras, diapers and air conditioners and purifiers.\(^{317}\) In February 2013, year-on-year sales of air purifiers produced by Panasonic had doubled and those of Daikin quadrupled.\(^{318}\) Japanese food and drink products, prized for their safety, also largely escaped losses.\(^{319}\) Firms reported that markets dominated by wealthier and more cosmopolitan consumers suffered less because these consumers as a rule seek higher quality products and had less regard for the politics of their purchases.\(^{320}\)

**Invested interests operating at the local level:** There was a sharp distinction between central government authorities who froze out Japanese business and local authorities who generally did what they could to work with the Japanese government and encourage firms to stay and even make new investments. Interviews with both firm representatives and economic officials identified several reasons for this. The first was a need for new sources of tax revenue. China’s ongoing economic slowdown had caused a fall in the growth of government tax receipts from

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\(^{316}\) Author interview with Japanese economic official, Tokyo, June 2013.

\(^{317}\) “Some firms weather territorial backlash.” *Nikkei Weekly*, November 12, 2012. Yamaha Corp, a maker of high-end pianos which cost twice as much as rival Chinese brands, was taking requests for midnight delivery of its pianos in mid-September 2012. Unicharm Corp. paper diapers, according to the firm’s president, are seen by consumers as “a reliable brand rather than a Japanese product”. In the wake of suffocating air pollution in many Chinese cities, sales of Japanese air purifies increased: “Cloud Over China Forcing Gov’t To Act”. *Nikkei Asian Review*, March 20, 2013.

\(^{318}\) Katz 2013.


\(^{320}\) This fact was repeated in multiple author interviews with business representatives and economic officials, Tokyo, June/July 2013.
22.6 percent in 2011 to 12.1 percent in 2012. As local company earnings softened, city officials looked for ways to maintain high tax revenue growth, such as by attracting new foreign investment.\textsuperscript{321}

The second reason was the clear impact that reduced Japanese production had on local economies. Workers faced reduced hours and layoffs, while service industries such as hospitality, reliant on the presence of large factories, also suffered.\textsuperscript{322} The city of Qingdao, where at least 10 businesses with direct links to Japan were attacked on September 15, reported a marked fall in the number of companies visiting the city to consider potential investments.\textsuperscript{323} In response, local authorities took actions such as paying for repairs at a Qingdao Nissan dealership that had been trashed. Officials in Dongguan, site of 500 Japanese companies, also offered assistance fearing that the Japanese companies would leave.\textsuperscript{324}

The extreme version of this phenomenon was the far north east city of Dalian which effectively suffered no protests at all, despite hosting many Japanese companies and even a consular office. Japanese restaurants did not need to conceal their signs and Japanese vehicles did not need to display a Chinese flag (common practices elsewhere). The reason was the patently heavy reliance of the city’s economy on Japanese businesses. A third of foreign companies at the time were Japanese and constituted a significant source of tax revenues for the local government.

\textsuperscript{321}“Despite Tension, Cities Court Japanese Companies”. \textit{Nikkei Weekly}, March 11, 2013. Macro figures tell a contradictory story regarding FDI. On one hand, overall FDI in China declined in 2012 by 3.7 percent, while Japanese companies increased their investments by 16.3 percent. On the other, investment in the period January-June 2013 declined 31 percent compared to the same period in 2012: “With Exports At 4-Year Low, Is Japan Missing Boat to China?” \textit{Wall Street Journal (Japan Real Time)}, August 15, 2013


About 200,000 of city’s six million residents studied Japanese, and many citizens had either first-hand knowledge of or a personal connection to Japan.  

It was not completely smooth sailing at the local level, since local governments still faced a tradeoff between their desire for Japanese investment and the political risks of being seen dealing with Japanese interests. The consequence was that at the height of tensions in September and October 2012, local government officials would be willing to talk in private, but unwilling to be seen publicly doing business with Japanese partners. Nevertheless, a unanimous observation made in all interviews with Japanese business representatives and government officials was that Chinese local governments had divergent interests from the central authorities and throughout the crisis worked to retain Japanese business and investment, even though they were constrained from fully cooperating during the worst of the tensions.

**Summary**: The observations that certain types of Japanese products and channels for commercial cooperation did not suffer greatly during the Senkaku nationalization crisis confirm the principle that economic vulnerability derives from asymmetry. They are auxiliary causal process observations which providing further evidence in favor of the mechanism proposed by the theory of asymmetry. In each of these cases, the Chinese side needed the economic relationship as much as the Japanese, to a great extent immunizing the transaction from disruption. These examples of symmetry, caused largely by the parochial interests of local governments for investment and consumers for quality products, acted as a powerful buffer against economic disruption.

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326 Author interview with Japanese economic official, Tokyo, June 2013.
4.7.6 Japanese interests and security policy

Both the decision by the Noda government to purchase the Senkaku Islands, and Japan’s security policy response to the subsequent protests, violence and economic disruption, need to be evaluated in light of three factors influencing Japanese politics at the time. Each factor would play an important role in undermining the mechanism through which economic interdependence could translate into leverage over Japanese security policy.

The first factor was the memory the 2010 crisis, and the consensus view that Japan had displayed weakness during that episode and been humiliated by China. There was widespread concern that further displays of weakness would only encourage China to act with more aggressiveness. While most policymakers did not want to inflame the situation unnecessarily, they were equally determined to act with greater resolve the second time around.  

The second factor was public opinion and the upcoming lower house elections. Japanese attitudes towards China had steadily deteriorated since 2010, worsening further once the 2012 crisis began. A record 80.6 percent of people polled by the Cabinet Office in late September / early October 2012 said they “do not feel close to China”, up by 9.2 percent since the 2011 survey.  

Another poll found 56 percent of respondents favoring a “strong stance” towards Chinese incursions into Japan’s territorial waters. Japanese public opinion may matter less under normal circumstances, but during times of crisis it can put the ruling party on the defensive and pressure them into a robust policy response. This was even truer with lower house

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327 This sentiment was average response in author interviews with dozens of senior and mid-level government officials in Tokyo over June/July 2013. See also Drifte 2013, 61.
328 “Record 80% Don't Feel Close to China, Poll Says”. Daily Yomiuri, November 26, 2012.
329 Przystup 2013a. Forty-seven percent preferred efforts to “consider better relations”.
330 Bush 2010, 222. In a public opinion survey by the Mainichi Shimbun, 82 percent said the Japanese government had not protested strongly enough to Beijing over the anti-Japan protests: Drifte 2013, 45.
elections scheduled for December, and the crisis duly elevated national security as a key campaign issue. Politicians had to avoid being seen as soft on China, and reporting during the campaign identified a shift in mainstream security discourse towards increased hawkishness.\textsuperscript{331}

Both the memory of 2010 and hostile public opinion increased the \textit{political salience} of the Senkaku issue in Japan, increasing the domestic political cost of making concessions to China to resolve the crisis. Economic interests would accordingly require even greater potency to shift Japanese policy. However, a third factor actually had the opposite effect, weakening the channels of economic influence and diluting an important “mechanism” causal process observation. Throughout the 2012-13 Senkaku crisis, Japanese business took a relatively low profile in the public debate, and there was little concrete evidence that commercial interests were putting pressure on the government behind the scenes to end the crisis.\textsuperscript{332} In author interviews with government officials, business representatives and other observers, three reasons for this were consistently cited. First, the recognition that strong anti-China sentiment among the public meant that advocating \textit{rapprochement}, especially for economic reasons, would damage the business community’s reputation in Japan. Moreover, many businesspeople simply believed that Japan

\textsuperscript{331} “A Worrisome Tilt to the Right in Mainstream Politics”. \textit{International Herald Tribune-Asahi Shimbun}, November 24, 2012. See also: Japan’s Nationalist Movement Strengthens”. \textit{Wall Street Journal}, August 14, 2012; “Islands Reflect Japanese Fear of China’s Rise”. \textit{New York Times}, August 22, 2012; “With China’s Rise, Japan Shifts to the Right”. \textit{Washington Post}, September 20, 2012. Such a shift was also arguably evidenced by relative lack of criticism inside Japan of Governor Ishihara’s initial plan to purchase the Senkaku Islands on behalf of the Tokyo Metropolitan Government. On the other hand, it is difficult to separate whether this shift was due to increased anxiety about China rather than changed beliefs about Japan’s security policy.

\textsuperscript{332} This was a view expressed by a broad spectrum of subjects interviewed in Tokyo in June/July 2013, including officials working in the cabinet, ministries, academics and business representatives. The major exception was when Yonekura Hiromasa, Chairman of Japan’s largest business lobby group Keidanren, blasted the Noda government’s handling of the issue while on a trip to Beijing on September 29, opining that it defied common sense to argue that there was no territorial dispute: “Keidanren Chief Blasts Handling of Senkaku Islands Issue”. \textit{International Herald Tribune-Asahi Shimbun}, September 29, 2012. In author interviews with several business representatives, it was suggested that Mr. Yonekura was voicing his own opinion rather than that of a business lobby that was largely unified in support of Japan’s territorial claim.
should assert its sovereign interests, despite the economic cost, and others were frustrated with what they saw as unreasonable and arrogant Chinese behavior that seemed uninterested in finding a resolution.

Second, the timing of the crisis coincided with a downturn in the Chinese economy, generating concerns that structural weaknesses could impair future economic growth. In every interview conducted by the author with firm representatives and business journalists, the point was made that political risk from Sino-Japanese tensions—while concerning—was less of a long-term fear than the operational risks associated with a “hard landing” of the Chinese economy. The gain from resolving political tensions was therefore not necessarily worth the cost of taking such a domestically controversial stance, given that operational risks would remain.

Finally, a factor not mentioned directly in interviews with senior businesspeople but raised by observers and acknowledged by less senior employees, was the reluctance of many individual business leaders to speak out because of personal intimidation. Thuggish tactics had been used by Japanese ultra-nationalists in 2005-2006 against business leaders who criticized Prime

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334 Author interview with Japanese government official who regularly interacted with business leaders to discuss Sino-Japanese relations, Tokyo, July 2013. These sentiments were repeated in other interviews with both government officials and business representatives and was never contradicted.

335 The economic losses predicted from a slowdown in the Chinese economy also varied by industry. The industries which would have been worst it were those which rely on robust capital expenditures, such as construction equipment and machine tools. “China Looms As a Bigger Risk to Earnings than in ’05”. *Nikkei Veritas*, September 23, 2012; “Firms Cutting Outlooks as China Risks Start to Weigh”. *Nikkei Weekly*, November 5, 2012. Of course, these are different to those industries most at risk from political tensions.

336 After the LDP retook power under Prime Minister Abe in 2012, the economic stimulus program “Abenomics” brought about a sharp depreciation of the Yen in the first half of 2013. This was very helpful to Japanese exporters and further reduced the imperative to push the new government for further improvements in Sino-Japanese relations: Author interview with senior executive official, Tokyo, July 2013.
Ministerial visits to the Yasukuni Shrine. This time around, business executives did not want to court such trouble.

Therefore, at the time of the 2012 crisis, conditions were ripe for a prolonged dispute. While the Japanese side did not want war with China, the Senkaku dispute and the need to show resolve were matters of high political salience for both the Japanese government and public. Meanwhile, the business community refrained from strongly advocating for a resolution of the tensions. Ultimately, while economic interdependence could restrain actions that would unnecessarily inflame tensions or provoke China, it would be very hard to influence Japan’s fundamental position on Senkaku issue. For these reasons, Japanese security policy during the 2012-13 Senkaku tensions is best described as being firm in defense of Japan’s fundamental security interests, while attempting to minimize the degree of provocation. There is practically no evidence to suggest that the economic component of China’s strategy meaningfully constrained Japanese actions in the security arena.

4.7.7 Security policy responses to the 2012 crisis

From the Japanese perspective, attempts were made to minimize the level of provocation in handling the Senkaku issue. The intention behind the decision to “nationalize” via central government purchase was to prevent Governor Ishihara from gaining control. The Noda government knew that if he gained control Ishihara would likely do something highly provocative. The government drew up as many as eight different plans for use of the islands,

337 In September 2004 Kobayashi Yotaro, chairman of Fuji Xerox, criticized PM Koizumi’s Yasukuni visits and suffered substantial harassment and intimidation, including receiving live bullets in a letter. That same year Kakutaro Kitashiro, head of business lobby group Keizai Doyukai, was also harassed for criticizing Yasukuni visits. LDP politician and President of the Japan-China Friendship Association, Kato Koichi, had his house burned down in August 2006 and spoke of being the constant target of rightwing vitriol: Hagstrom 2008/09, 237; Onishi, Norimitsu. “The Japan-China Stew: Sweet and Sour”. New York Times, January 19, 2005; “Koizumi Ignores Protests in Final Shrine Visit”. Guardian, August 16, 2006, 16. Author interviews (Tokyo, June/July 2013) with individuals close to certain business leaders confirmed that a sense of personal intimidation was felt among these individuals.
including the repair of a lighthouse, but Noda opted to do nothing.\textsuperscript{338} For the Japanese government, nationalization was an attempt to maintain the status quo.\textsuperscript{339} Governor Ishihara made a specific request to Noda (to build a wharf) which was rejected, the Prime Minister specifically citing the importance of maintaining positive relations with China.\textsuperscript{340} Noda and his team hoped that finalizing the Senkaku issue would allow Japan to repair relations once China’s leadership transition was complete.\textsuperscript{341} The decision to nationalize was broadly supported by the mainstream media, including the center-left newspaper \textit{Asahi Shimbun}\textsuperscript{342} and center-right newspaper \textit{Yomiuri Shimbun}.\textsuperscript{343}

The security element of China’s multipronged response to the nationalization was directed towards demonstrating that Japan could no longer claim de facto control of the islands, escalating pressure on the Japanese government and forcing Tokyo to admit the existence of a dispute.\textsuperscript{344} It began with continuous and regular entries into both the contiguous zone and territorial waters of the islands by vessels from both the Fisheries Law Enforcement Command (FLEC) and the China Marine Service (CMS). On September 20, a record total of 16 Chinese surveillance ships were reported in the area.\textsuperscript{345} By December 13, the JCG reported that Chinese government ships had intruded into Japanese territorial waters 17 times since September 11 and

\begin{itemize}
  \item \textsuperscript{338} “Government Drew Up Multiple Plans for Senkaku Use”. \textit{Daily Yomiuri}, September 13, 2012.
  \item \textsuperscript{339} This was the consistent line taken in dozens of author interviews with Japanese officials (Tokyo, June/July 2013). While it is obvious that the Chinese side did not see the purchase as status-quo maintaining, a number of Western observers also wonder whether other actions may have been less provocative: see e.g. Drifte 2013, 40. This sentiment was echoed in author discussions with Western analysts, while certain Japanese business representatives described the decision to nationalize as an “error”.
  \item \textsuperscript{340} Sunohara, Tsuyoshi. “Secret Chat Steeled Noda’s Resolve”. \textit{Nikkei Weekly}, April 15, 2013. Sunohara writes that a remark from Governor Ishihara during the conversation to the effect that war with China may be inevitable steeled Noda’s resolve that the Tokyo governor could not be permitted to purchase the islands.
  \item \textsuperscript{341} “Japan Tried but Failed to Avert Disaster in China Dispute”. \textit{International Herald Tribune-Asahi Shimbun}, September 26, 2012.
  \item \textsuperscript{343} “No Need to Pander to China over Senkaku Islands”. \textit{Daily Yomirui}, June 13, 2012.
  \item \textsuperscript{344} Drifte 2013, 48-49.
  \item \textsuperscript{345} “In Shark-Infested Waters, Resolve of Two Giants Is Tested”. \textit{New York Times}, September 23, 2012.
\end{itemize}
the Chinese government announced on September 11, 2013—the one year anniversary of nationalization—that Chinese vessels carried out 59 patrols since the announcement.\footnote{346}{“Japan on High Alert Year After Senkaku Nationalization”. \textit{Japan Times}, September 11, 2013.}

The danger of escalation became more acute in early 2013 with reports from the Japan Maritime Self Defense Force (MSDF) that a Chinese frigate’s target radar locked onto a MSDF helicopter on January 19th, while another frigate sailing close to an MSDF destroyer did likewise on January 30th.\footnote{347}{“Radar Target Practice Raises Heat around the Senakus”. \textit{Financial Times}, February 7, 2013, 8.} While the Japanese government believed that these incidents originated from individual decisions by a mid-level commander and were not intended by China’s leadership,\footnote{348}{Author interview with Japanese government official with knowledge of the China relationship, Tokyo, July 2013.} they came at a time when broader tensions in the East China Sea were causing Japan’s Air Self Defense Force (ASDF) to scramble fighter jets against Chinese aircraft a record number of times.\footnote{349}{The number almost doubled to 306 in the year ending March 2013, almost half of which (146) came in the January-March 2013 quarter: “Japan Sharply Increased Scrambling Jets against Chinese Planes”. \textit{Wall Street Journal Online}, April 17, 2013.}

How did Japanese security forces handle this escalated pressure? From one perspective, Japan was either unwilling or unable to prevent the escalated deployments of Chinese vessels into disputed maritime territory, meaning that China achieved its preliminary goal of demonstrating that Japan no longer completely controlled the islands. The JCG avoided any physical confrontation or contact, limiting its response to shadowing CMS and FLEC vessels, informing them they are violating Japan’s contiguous zone or territorial waters, and asking (but not forcing) them to leave, followed by diplomatic protests.\footnote{350}{Drifte 2013, 50-51. In response Chinese vessels would simply state they were patrolling Chinese waters and the JCG ships were operating illegally.} Yet it could equally be argued that Japan simply adopted tactics of maintaining effective control while ensuring its forces conducted themselves with extreme care to avoid accidental escalation—the United States urged Japanese
restraint throughout—with the goal of highlighting Chinese recklessness as the true danger. Caution and restraint do not equate to accommodation according to this argument.

On December 16, 2012, the LDP won general elections and returned to government, led again by Abe Shinzo in his second stint as Prime Minister. Abe entered office commenting that he favored a “mutually beneficial partnership based on common strategic interests” (echoing language he had used in 2007), and in late January 2013 sent the leader of coalition partner New Komeito Party—Yamaguchi Natsuo—to Beijing in the hope that a diplomatic breakthrough might be achieved. It was expected that during the early months of Abe’s term the government would avoid diplomatic controversy ahead of upper house elections in July 2013, where the LDP hoped to gain a clear majority and win control both houses of the Japanese Diet.

Yet the new Abe government opened its tenure by announcing in January 2013 the first year-on-year increase in Japan’s defense budget (0.8 percent) in 11 years, making specific allocations to bolster the MSDF, JCG and Japan’s capabilities to secure the Senkaku Islands. Abe also sought to give more operational flexibility to Japanese security and law enforcement forces. In April 2013 new maritime policy guidelines were unveiled to expand patrol and information gathering capabilities amid continual intrusions by Chinese sea vessels and aircraft. The LDP also increased its cooperation with other states. In March 2013, Japan began talks with United

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351 Hemmings and Kuroki 2013.
354 Under Prime Minister Noda, the MSDF had been ordered to increase the distance its vessels maintained when monitoring ships in the East China Sea, in order to avoid provocation. Abe revised the policy back to the original distance of three kilometers with the criticism that Noda had “excessively restricted” the MSDF’s activities: “Noda Told MSDF to Stay Away”. *Yomirui Shimbun / Asia News Network*, March 9, 2013.
States on operational plans in case of armed conflict over the islands. In June, Japanese forces participated in unprecedented military exercises with U.S. troops aimed at improving Japan’s amphibious attack abilities.

Tokyo also struck a deal with Taipei on fishing rights in the East China Sea, allowing Taiwanese trawlers to fish around the disputed islands, a move later recognized by the Prime Minister as precluding Taiwan joining forces with China over the Senkaku issue. Each of these moves however was less deliberately aggressive but rather a broadening of tactical options to maintain a resolute security posture.

To the public, the LDP presented the continued entering of Chinese vessels onto Japanese territorial waters near the Senkakus in 2013 as a serious security challenge. On April 23, Abe commented that “there is no room to negotiate since [the islands] are inherent parts of Japan's territory”, insisted that Japan would never allow China to land on the islands, and noted that his government was considering the stationing of public officials and the construction of ship facilities. At the same meeting he also raised doubts about honoring the 1995 Murayama Statement which expressed an apology and remorse over Japan’s past colonization of Korean Peninsula and invasion of China and other countries. Such a hardline stance ahead of crucial upper house elections was surprising, but reflected the increasingly skeptical perception of China within Abe’s inner circle.

359 Przystup 2013b.
360 Przystup 2013b; “Abe Returns to Hard-line Approach in Response to Beijing, Seoul”. International Herald Tribune-Asahi Shimbun, April 24, 2013. This came after Deputy Prime Minister and Finance Minister Aso Taro visited the Yasukuni Shrine.
4.7.8 Japan’s economic response

The 2012-2013 Sino-Japanese tensions demonstrated to both Japanese business and government that political disputes can cause significant economic disruption and economic losses. In response, both firms and policymakers took actions aimed at reducing the risk of future losses.

From the firm perspective, respondents in author interviews emphasized repeatedly that political risk from Sino-Japanese tensions was one of many risks firms must deal with when doing business in foreign locations. Other operational risks—such as rising labor costs, stagnant economic growth, bottlenecks in infrastructure and energy supply and institutional uncertainty—tended to pose greater overall threats to profitability. The increase in political risk from the Senkaku tensions did not fundamentally alter the business outlook for China; firms did not and would not leave the country in large numbers. Rather, the effect was marginal and would be balanced against other risks and ongoing opportunities inherent in the Chinese market.\(^{361}\)

Nevertheless, macroeconomic data, surveys and interview evidence suggest that firms adopted two strategies in response to the tensions. The clearest was a reinvigoration of the “China-plus-one” strategy first developed in the mid-2000s to diversify risk by establishing a production base in at least one other location, typically Southeast Asia.\(^{362}\) An October 2012 survey found that

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\(^{361}\) The evidence on this point is mixed. A survey conducted in December 2012 indicated that nearly 80 percent of respondents previously saw China as a crucial production site but did not think this would be the case in the future, and over 80 percent cited political risk as the reason for a cautious stance on China: “China Growing Less Crucial To Japanese Businesses: Survey”. *Nikkei Report*, January 17, 2013. Opinion Survey on China-Japan Relations, Overview. January 17, 2013. Available from: <http://www.csis-nikkei.com/doc/japan_china_survey_summary_en.pdf>. Accessed: October 4, 2013. On the other hand, survey evidence from the Japanese government from the same time suggested that the overwhelming majority of companies believed the growing Chinese market will continue to provide opportunities for sales growth: Author interview with senior economic official, Tokyo, June 2013. In addition, China continued to be ranked the most promising destination for business expansion over the medium term by the November 2012 JBIC survey: JBIC 2012, 78. Of the companies surveyed by JBIC however, over 60 percent nevertheless opined that business operations in China needed to be rethought or closely monitored.

\(^{362}\) Fujita and Hamaguchi 2006. Seventy-five percent of firms polled in November 2012 recognized the importance of risk diversification: JBIC 2012, 74.
almost a quarter of Japanese manufacturers were rethinking investment plans in China and considering shifting production elsewhere. Data from mid-2013 appeared to confirm this; Japanese firms spent a record $8.2 billion on mergers and acquisitions in Southeast Asia in the first seven months of 2013, over ten times the $614 million spent at the same time in 2012, and already more than the highest full-year total of $7.6 billion in 2006.\footnote{\textit{Japan Firms Spend Records Amounts in Southeast Asia". Agence-France Presse, July 24, 2013.}} In contrast, investment in China fell over 31 percent between January-June 2013 compared with 2012.\footnote{\textit{“With Exports At 4-Year Low, Is Japan Missing Boat to China?” Wall Street Journal (Japan Real Time), August 15, 2013. Though part of this decrease would have been due to the depreciation of the Yen in 2013, just as the steady appreciation of the Yen from the middle of 2010 was a strong element in the spike in FDI into China in 2011 and 2012.}} Note that these figures record \textit{new investments}; very few firms could relocate their existing business away from China due to asset specificity.\footnote{Moreover, the manufacturers most likely to move in the medium to long term are low-margin businesses (such as textiles) where rising labor costs were already increasing the attractiveness of alternative production locations.} Firms that depended on Chinese sales or on established supplier networks, such as car companies, had no choice but to slow production and wait until tensions subsided.\footnote{\textit{“Firms Move Some Eggs Out of China Basket”. Japan Times, December 19, 2012; “As China Tensions Simmer, Japan Pulls Back From ‘World's Factory’”. Reuters, October 23, 2012; “Not All, but Sundry Find Niche in China”. Japan Times, January 4, 2013. In an author interview with several senior business representatives (Tokyo, July 2013), the notion of “waiting” (for tensions to subside) was emphasized several times as the primary response of Japanese industry to the political tensions. The diversification for parts producers based on China has been to supply non-Japanese customers, such as automobile manufacturers Volkswagen and General Motors: “Senkaku Crisis Still Hurts Japanese Auto Parts Makers”. \textit{Nikkei Business Daily}, April 19, 2013.}}

The second firm strategy was to increase the quantity and quality of ties with Chinese business partners, to align local interests with those of the Japanese firm. The principle of this strategy is that if future political risk threatens the firm’s profitability, it would be in the interests of local partners to work to minimize the impact on the business. Historically, Japanese firms have not been as successful as American and European firms at this process of “localization”, which meant they had fewer local advocates acting on their behalf when tensions arose in 2012. To redress this shortfall, firms have since engaged in a variety of actions, including expanding joint
ventures with Chinese partners, procuring more locally-produced parts, and recruiting and training Chinese executives. The retailer Heiwado tells of how local employees negotiated with local police and tenants to smooth the way for business operations to resume after the 2012 protests had died down. The company resolved to have Chinese managers at all of its outlets. Unlike the “China-plus-one” approach, this strategy is available to all industry types.

Identifying business strategies to reduce political risk offers important insight into how governments can reduce their economic vulnerability. If firms face fewer risks, governments do too. While individual businesses must take responsibility for managing their own risks, the Japanese government has recognized it can provide support on a several levels. On the tactical level, policymakers acknowledge that the government must work closely with businesses during crises to help them navigate tensions on the ground, primarily by sharing information and intelligence and staying in regular contact. This does not imply that business interests take precedence over security concerns, rather that communication and collaboration are always important to minimizing economic losses during political crises.

On the strategic level, political leaders can develop new pathways for Japanese firms by improving bilateral relationships with neighboring countries and concluding agreements to create the institutional support for Japanese industry to expand its presence in these alternative

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368 “Despite Calm, Hints of Anti-Japanese Sentiment Still Below Surface in China”. *Asahi Shimbun*, September 12, 2013. An alternative approach was to reduce the overtly “Japanese” appearance of the business, for example by acquiring western brands that already had successful presences, thereby reducing the likelihood that the business could be targeted: “Some Firms Weather Territorial Backlash”. *Nikkei Weekly*, November 12, 2012; author interview with business executive, Tokyo, June 2013.
369 And while it may go without saying, a related strategy raised by all business representatives in interviews is simply to ensure only the highest quality products—which cannot easily be substituted—are sold by Japanese firms.
370 As one official explained, “it’s the job of government to devise strategy and avoid conflicts”: Author interview with Japanese economic official, Tokyo, June 2013. This view was representative of a plurality of both government officials and business executives (Author interviews, Tokyo, June/July 2013).
371 This point was made consistently by Japanese government officials working on foreign policy, economic policy and China relations (Author interviews, Tokyo, June/July 2013).
The incoming LDP government appeared to embrace this policy early in its term; after his election in December 2012, Prime Minister Abe made three overseas trips to a total of seven Southeast Asian countries within his first seven months in office, an unprecedented expansion of ties and widely perceived to be a response to difficulties in the China relationship. While Japanese officials insisted in interviews that “China-plus-one” has never been an official policy, the facts strongly suggest the government is actively promoting business risk diversification.

Strengthening ties with third countries has a second benefit—sending a signal to China that Japan is responding to the economic disruption by reducing its vulnerability. To the extent that Japanese diversification harms Chinese interests, an incentive to resolve the political dispute may be created in addition to a deterrent to future disruptions. Accordingly, both an economic logic and security logic attach to efforts to improve bilateral relations with other countries in the region.

A second government strategy emerges from the recognition that local governments and officials expressed, to a certain extent, conflicting preferences to those of the central government during the 2012 crisis. This conflict was identified by some Japanese officials in interviews as highlighting an opportunity to reduce economic vulnerability by strengthening relations with, and the capacity of, local governments; a “divide and rule” strategy as one official described it.

The more important Japanese economic relations are to local governments, the more willing they

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372 In an interview, a senior official working on international issues specifically described free trade agreements as a tool of risk hedging because they expand market access in context of China plus one: Author interview, Tokyo, July 2013.
374 Reflective of this perception was the comment of a senior Japanese multinational executive who described the Southeast Asian outreach by PM Abe as helping encourage China to engage in cooperative behavior: Author interview, Tokyo, July 2013.
will be to work with and shield Japanese firms from disruption losses when high-level political tensions arise. Accordingly, assisting Japanese businesses as they look to increase the quantity and quality of their links with Chinese partners can be an effective policy response.

For Japanese firms, risk management is simply a process which helps maximize firm profitability. For the Japanese government, the policy objective is both to reduce the costs of alternative economic relationships, and increase the importance of Japanese relations to Chinese interests, with the ultimate goals of reducing the disruption losses faced by firms and improving the level of symmetry in the interdependent economic relationship with China. Achieving symmetric economic interdependence would eliminate a key source of Chinese leverage during political disputes. Accordingly, the firm and governmental strategies to reduce risk constitute auxiliary causal process observations which provide additional evidence in favor of the economic vulnerability mechanism.

4.8 Conclusion

The “cold politics, warm economics” paradigm that characterized Sino-Japanese relations in the mid-2000s meant that economic interdependence would be unaffected by politics. The implication was that economic linkages could not, or at least would not, be targeted as leverage in political disputes—economics and politics were separate. There are two conditions that likely made this separation possible in the 2000s. First, the degree of political discord was not exceedingly severe; indeed, relations were warm following Koizumi’s departure from office, and even during his premiership it is arguable that the level of discord was not at the level it would subsequently reach after 2010. Second, disruption losses were symmetric—China’s post-WTO
export-driven take-off was still in its early stages and, as its largest trading partner, replacing Japanese trade and investment was simply not feasible for Beijing. Both sides had an interest in keeping economic relations growing, and once the source of tensions subsided following Koizumi’s departure, leaders were quick to inject warmth into the political relationship. While this analysis is consistent with the logic of the theory of asymmetry, it also demonstrates that the theory’s scope is confined to situations where the Chinese economy is large enough that it enjoys alternatives to existing trade and investment relationships. Absent this scope condition, China’s profile as assembly hub and growing consumer market cannot yield the asymmetry in disruption losses which could confer economic leverage.

The tensions which began with the maritime collision in 2010 and escalated with the nationalization crisis in 2012 tell a story of Japanese vulnerability that is consistent with the theory. Where Japanese economic actors had few alternatives to links with China—manufacturing on the mainland, sales to Chinese consumers and the unique case of rare earths—disruption losses were asymmetric and vulnerability arose, offering strong support for Hypothesis 1. Both the descriptive and statistical evidence reveals Japanese losses in sales, production levels and investment, with the firms and the government subsequently responding to these losses with attempts to reduce future vulnerability.

However, the evidence also yielded surprising and significant evidence of symmetry in disruption losses under certain conditions, most prominently in the efforts of local Chinese actors to protect Japanese economic relations because it was in their parochial interest to do so. This evidence indicates that even the economy hypothesized to be the most vulnerable in this research project enjoyed certain sources of vulnerability. It further suggests that targeting economic relations was more often prohibitively costly for China than is commonly understood, with this
symmetry in interdependence reflected by industry- and product-level variation in the losses suffered by Japanese actors.

Finally, there was very little conclusive evidence of security policy accommodation despite the clear exposure of Japanese vulnerabilities, yielding a null funding for Hypothesis 2. The security issues in dispute related to fundamental interests such as sovereignty and territory and were thus too salient to Japanese political leaders and the public to justify accommodation on economic grounds. Moreover, the constituency expected to be most in favor of accommodation—the business community—was resigned to this fact and acceptant of the losses and in many cases expressed full support of Japan’s security interests. This is not to say that Japan sought conflict—interdependence makes resolution of differences preferable in principle—but not at the cost of substantive compromise on these salient political issues.
5. PHILIPPINES: Limited Vulnerability amid Territorial Tensions

5.1 Introduction

On the surface, Sino-Philippine relations look less like a relationship of interdependence and more like one of strength and weakness. By traditional measures of military and economic capability, the Philippines is smaller, poorer and more politically dysfunctional. During the 2000s the driving force behind the country’s response to China was said to be internal political instability due to weak institutions, entrenched patterns of patronage and cronyism, fragmented political coalitions and domestic insurgencies.\(^{375}\) A 2008 RAND study concluded that “these weaknesses, combined with the prospect of China-oriented economic growth, have produced a policy of general accommodation toward China—an orientation that is likely to continue”.\(^{376}\)

Juxtaposing the bilateral relationships the Philippines and Japan have had with China compares two states in similar situations but with a large disparity in capabilities. Since the early 2000s both have counted China as an increasingly vital economic partner while simultaneously managing disputes over maritime territory which at times have become heated, including physical confrontations at sea in 2012. Both countries are also alliance partners of the United States. Yet the Philippines’ internal troubles combined with the clear disparity in economic and military size would lead many (if not most) to expect that China’s ability to use economic leverage would be stronger and, compared to Japan, result in more accommodating security policy.

\(^{375}\) Medeiros et al 2008; Lum 2012. The consequence is foreign policy tends to focus on individual issues without prior formulation of a grand strategy or coordinated goals: Baviera 2012.

\(^{376}\) Medeiros et al 2008, 97.
The theory of asymmetry expects otherwise. The Philippines is a “factory” economy whose economic relationship with China is dominated by its role as a producer of intermediate inputs in the transnational production network. The theory predicts that the relative disruption losses faced by the Philippines are more symmetric (compared to the “headquarter” economy Japan) because the cost to China of disrupting Philippine economic links is higher, resulting in the Philippines being less vulnerable. This prediction is tested in Hypothesis 1.

The second question is what this entails for security policy. The expectation of lower vulnerability implies that the Philippines’ security behavior should be less susceptible than Japan’s to economic leverage and thus be less accommodating—as predicted by Hypothesis 2. However, because both countries have been engaged in ongoing territorial disputes, the political salience of these interests may operate as an intervening variable which neutralizes the impact of vulnerability and generates a null funding. This was indeed the finding in the Japanese case in Chapter 4. The likelihood that political salience plays a similar role in the Philippines’ case accentuates the need for process tracing and the accumulation of causal process observations as research strategies to test the causal mechanism and evaluate the relative strength of economic vulnerability and political salience on security policy.

5.2 Unpacking interdependence between the Philippines and China

The level of interdependence between the Philippines and China in the early 21st century according to traditional measures is represented in Table 5.1. The disparity in economic size dominates these statistics. As China’s economy grew over the 2000s it became a larger trading partner for the Philippines, jumping from the 11th largest export destination and 7th largest source
of imports in 2001 to third in both categories by 2011. If Hong Kong were counted with China, the combination was the Philippines’ largest trading partner in 2011, surpassing Japan and the United States. In contrast, the Philippines fell outside China’s top 20 trading partners in 2011, with two-way trade constituting less than a half a percentage point of Chinese GDP. Trade with China was over ten times larger at 5.43 percent of Philippine GDP. These orthodox measures suggest that economic interdependence between the two countries is highly asymmetric, conferring power on China and rendering the Philippines relatively more vulnerable, especially compared to the larger economy of Japan.

| Table 5.1: Merchandise Trade between the Philippines and China, 2001-2011 |
|-------------------------------------------------|-----------------|-----------------|-----------------|
| Philippines                                     | 2001 (rank)     | 2006 (rank)     | 2011 (rank)     |
| **Exports to China as a % of all Philippine exports** | 2.47 (11)       | 9.89 (3)        | 12.7 (3)        |
| **Imports from China as a % of all Philippine imports** | 2.95 (7)        | 6.27 (3)        | 10.07 (3)       |
| **Trade with China (EX + IM) as a % of Philippine GDP** | 2.31            | 5.76            | 5.43            |
| China                                           | 2001 (rank)     | 2006 (rank)     | 2011 (rank)     |
| **Exports to Philippines as a % of all Chinese exports** | 0.61 (22)       | 0.59 (26)       | 0.75 (27)       |
| **Imports from Philippines as a % of all Chinese imports** | 0.79 (20)       | 2.23 (8)        | 1.03 (21)       |
| **Trade with Philippines (EX + IM) as a % of Chinese GDP** | 0.26            | 0.88            | 0.44            |

Sources: Author calculations based on: IMF, *Direction of Trade Statistics*; World Bank, *World Development Indicators*. China excludes Hong Kong.

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377 China and Hong Kong combined accounted for almost 21 percent of Philippine exports in 2011, compared with 19 percent for Japan and 14.2 percent for the United States (figures not shown).
5.3 The Philippines as a “factory” economy: The dominance of semiconductors

The Philippine economy was based primarily on agriculture and natural resources for most of the 20th century, until the 1970s when labor-intensive manufacturing—primarily the electronics industry—began to grow until eventually it dominated the country’s exports.\(^{378}\) In 1970, electronics comprised three percent of exports and agriculture 49 percent;\(^{379}\) in 1996, electronics surpassed agriculture as the top export earner for the Philippines,\(^{380}\) and over the period 2000-2010, its average export share was 66.7 percent.\(^{381}\)

Unlike the developmental states in Northeast Asia which used industrial policies to build internationally competitive firms, the electronics industry in the Philippines (and indeed elsewhere in Southeast Asia) has always been reliant on FDI and technology to transition from exporting agriculture and other natural resources to more capital-intensive industries.\(^{382}\) As described in Chapters 2 and 4, MNEs in industrialized economies fragmented their production processes to take advantage of foreign locations where labor costs were low.\(^{383}\) Within the production chain, the Philippines became a specialist producer of labor-intensive intermediate inputs, in particular the assembly and testing of semiconductors.\(^{384}\) MNEs set up affiliates which use imported materials and local labor to manufacture components which are then re-exported. In 2008, the Philippines had the highest share of import content in its exports (meaning the lowest

\(^{378}\) The trend toward electronics actually began in the 1950s when U.S. electrical companies began producing home appliances in the Philippines: Reyes-Macasaquit 2010.

\(^{379}\) Santiago 2011.

\(^{380}\) Reyes-Macasaquit 2010,145.

\(^{381}\) Board of Investments (Philippines) 2011, 4.

\(^{382}\) McKay 2006 52-53.

\(^{383}\) Abe 2009, 2-3. Abe calculates the degree of intra-industry trade, finding it to be very high for electronics (98 percent) but much lower once electronics is disaggregated into sub-industries (20 percent at the 5-digit level classification). This means that the Philippines’ electronics imports and exports occurred different stages of the production chain, illustrating the high degree of fragmentation in Philippines electronics.

\(^{384}\) Austria 2006; Board of Investments (Philippines) 2011; Reyes-Macasaquit 2010. By 2002, 70 percent of electronics exports were semiconductors and 24 percent were computer hardware: McKay 2006, 48. In a survey of Japanese firms 78 cited “production network” as the reason for investing in the Philippines: Abe 2009, 11.
value-added) of all countries in East Asia at about 70 percent.\textsuperscript{385} Despite some production of computer hardware and peripherals, exports have remained highly concentrated in semiconductors.\textsuperscript{386} In 2007, the Philippines engaged in ten percent of the world’s semiconductor manufacturing.\textsuperscript{387}

The electronics industry in the Philippines is dominated by MNEs. In 2011, the industry comprised 959 firms of which 72 percent were MNEs, roughly the same proportion as in 2003.\textsuperscript{388} Eight of the world’s 20 largest chipmakers operate facilities in the country.\textsuperscript{389} Moreover, the majority of sales of electronics firms are made by affiliates to their parent companies, demonstrating the great extent to which the Philippines has exported electronics \textit{within a well-defined and fragmented production network}.\textsuperscript{390} The main source of inward FDI has been the United States, followed by the European Union and Japan, with the electronics industry being the primary recipient.

While the electronics industry has led export revenues, its employment levels have been relatively lower. The decline in agriculture’s labor share was entirely absorbed by the services sector, which in 2007 accounted for close to half the workforce and GDP.\textsuperscript{391} In 2011, ‘Overseas Filipino Workers’ alone sent remittances home totaling around 12 percent of GDP. Business Process Outsourcing (BPO) also employed more workers than electronics (600,000 versus

\textsuperscript{385} World Bank and IDE-JETRO 2011, 101.
\textsuperscript{386} Semiconductors were over 70 percent of electronics exports in 2010: Usui 2012.
\textsuperscript{387} Reyes-Macasaquit 2010, 157. According to Semiconductor and Electronics Industries in the Philippines, Inc, by 2010 exports of semiconductors were roughly equal to Japan, China and the United States (all around 15 percent of total).
\textsuperscript{388} Santiago 2011; Austria 2006, 9-11.
\textsuperscript{389} Santiago 2011. Many of the major global players in electronics are invested: Intel and Texas Instruments from the United States, Siemens and Phillips from Europe, Sony, Toshiba, Hitachi and Fujitsu from Japan; Samsung and Goldstar from South Korea and Acer from Taiwan.
\textsuperscript{390} Board of Investments (Philippines) 2011, 10.
\textsuperscript{391} Usui 2011, 6.
In 2011, but only contributed five percent to GDP, while electronics exports were around 10 percent of GDP.

The supremacy of the electronics industry in Philippine exports is the reason why the theory of asymmetry codes it as a “factory” economy within the transnational production network. The country’s revealed comparative advantage in the 2000s was similar to other factory economies such as Malaysia, Thailand and Singapore, and to a certain extent China. In 2004, the share of components in manufacturing exports was over 80 percent in the Philippines, Malaysia and Singapore. The industry is commonly perceived to be vital to the Philippines’ future. The country has long faced chronic economic problems of high unemployment, sluggish poverty reduction and low rates of investment. The failure of the electronics industry to achieve productivity growth, attract more foreign investment and spark broader diversification into more skill- and research-intensive products is cited as a major reason why the Philippines remains one of the poorest economies in South East Asia. In other words, the industry is perceived both as one of the main causes behind, and pathways out of, the long-term stagnation of the Philippine economy.

393 Author calculations based upon data provided by the World Bank and the Philippines National Statistics Office.
394 Abe 2009, 8-9. Revealed comparative advantage is the proportion of a country’s exports of a given type (e.g. electronics) as a percentage of the proportion of the world’s exports of that type. It is a simple measure of comparative advantage based on trade flows.
395 Athukorala 2006, 9. The equivalent proportion in Thailand was over two-thirds.
396 Usui 2011; Usui 2012.
5.4 The Philippines and China in the transnational production network

The bilateral economic relationship between the Philippines and China is dominated by the relative position of the two economies in the transnational production network. The previous section described how electronics, in particular semiconductors, came to dominate Philippine exports. While the U.S., Japan, the Netherlands and Hong Kong were formerly the traditional destinations for Philippine electronics, the rise of China as an assembly hub saw it become the number one destination for Philippine electronics exports in 2008, with Hong Kong second.\footnote{Reyes-Macasaquit 2010, 156.}

Given that the bulk of Philippine exports are made by foreign firms to their affiliates, this shift is consistent with the growth of fragmented production as MNEs moved their final assembly operations to China. Thus, the dominant economic link—defining the Philippines as a “factory” economy—is its export to China of intermediate inputs to be assembled into final goods on the mainland. In 2011, electronics constituted at least 54 percent of exports to China; the second highest export was copper at about 6.6 percent.\footnote{Philippines Department of Trade and Industry, Philippine Merchandise Exports to People’s Republic of China. Available at: <http://www.dti.gov.ph/uploads/DownloadableForms/Phl%20Exports%20to%20China.pdf>. Accessed October 31, 2013. Figures from the United Nations \textit{Comtrade} database suggest this percentage may have been even higher, indicating that electronics were closer to 80 percent of all Philippine exports to China in 2006, and 60 percent in 2001. The electronics industry’s performance can fluctuate significantly in the short term based on headline economic conditions (the financial crisis in 2008-09 hit the industry hard), the development cycle of products and firms’ inventory management.} Figure 5.2 illustrates how electronics maintained their status as the largest export category in the Philippines over the 2000s. For China, Philippine electronics make up a sizeable though not large part of their processing imports, roughly 3.5 percent in 2007.\footnote{Ma and Van Assche 2011, 132. Processing imports are inputs imported under a special customs regime designed for assembly of goods that will be re-exported. In comparison, Japan accounted for 23.7 percent of processing imports, the United States 7.7 percent, Malaysia 4.5 percent and Thailand 2.8 percent. These figures include transshipments through Hong Kong.}
While exports of electronics have consistently played the largest role in Sino-Philippine economic interdependence, other merchandise is also exported to China. In 2011, natural resources comprised over 15 percent of exports, primarily copper, nickel and coal. Fresh food was about 1.4 percent, with bananas constituting around 90 percent of this total.\(^{400}\) That year, growth in overall trade with China was almost 18 percent, much higher than both Japan (5.5 percent) and the United States (1.33 percent).\(^{401}\)

There are two other dimensions to the bilateral economic relationship: FDI flows and official development assistance. Surprisingly, a significantly larger stock of capital has been invested by Filipinos in China ($2.78 billion in 2010) than the reverse ($125 million in July 2011).\(^{402}\)

\(^{400}\) “China Barrier Unlikely (Electronics, mineral exporters banking on demand)”. BusinessWorld, May 17, 2012.

\(^{401}\) Author calculation based in IMF, Direction of Trade Statistics.

major industries in China attracting Philippine investment are property and food and are overwhelmingly dominated by the Filipino-Chinese community. For example, in 2012 four Chinese malls contributed almost 15 percent to the bottom line of SM Prime, the mall unit of SM Group, one of the Philippines’ largest conglomerates. In 2012, 350 stores in China provided 11 percent of the worldwide sales of Jollibee, the Philippines’ largest food service company.\footnote{SM, Jollibee Outline Bold China Plans”. BusinessWorld, August 31, 2012, 6.} Both companies are run by Filipino-Chinese businessmen. The major sectors of Chinese investment in the Philippines are power, mining and manufacturing, but, a major limiting factor on FDI into the Philippines is constitutional rules which cap foreign ownership at 40 percent.\footnote{Gov’t Urged to Relax Foreign Ownership Rule”. Philippine Daily Inquirer, September 11, 2013.} Most of the capital from China has thus come in the form of loans (discussed further below), rather than long-term investments in ongoing business ventures.\footnote{As one Filipino official pointed out, when a Chinese loan is repaid, China’s commitment is complete and it can leave. In contrast, Filipino capital in China is fixed in specific investments which have ongoing positive effects on the local economy: Author interview with Philippine government official with knowledge of public finance, Manila, November 2013.}

The other facet is ODA from China to the Philippines. As bilateral trade was expanding rapidly between 2003 and 2008, China emerged as the second largest country donor to the Philippines, albeit still a fraction of frontrunner Japan, comprising approximately 5.5 percent of total ODA commitments.\footnote{Kang 2010, 21. The other largest donors were Japan (49 percent), the World Bank (14.4 percent) and the Asian Development Bank (13.5 percent).} However, the bulk of Chinese aid (93 percent) came in the form of concessional loans rather than grants, and 97 percent of the total funded just six large infrastructure projects.\footnote{Kang 2010, 38-39; “Other China-funded Projects under Scrutiny”. Philippine Daily Inquirer, March 9, 2008.} The years 2003-2008 would be the highpoint of Chinese ODA during the 2002-2013 period, as Chinese aid would subsequently became embroiled in controversy following allegations of contract irregularities and suspected corruption, causing high levels of public
resentment. This controversy, to be discussed in the following section, saw several projects collapse and Chinese ODA recede in prominence,\(^{408}\) forming a useful discontinuity when considering the impact of ODA on broader Philippine policy.

**Theoretical predictions:** The theory of asymmetry predicts that the dominant facet of Sino-Philippine economic relations—“factory” economy exports of electronics by the Philippines—should experience relatively lower disruption losses than the dominant “headquarter” economy features of Sino-Japanese relations. Trade in intermediate inputs within a vertically fragmented production network is less likely to experience disruption because the costs of doing so for China are high. The integrity of the network is vital to keep Chinese factories and workers busy manufacturing goods for export, and thus despite the modest size of the Philippine economy, the theory expects this trade to be too costly to disrupt. Extending this logic to the security policy dependent variable, Hypothesis 2 predicts the Philippines to be relatively less accommodating of Chinese interests in its security policy than Japan, conditional on the intervening variable of political salience.

The Sino-Philippine bilateral relationship has been the most variable of the four countries studied in this research. As described in the following section, fluctuations over time occurred both in the warmth of political relations and in flows of FDI and ODA. This variation provides the opportunity to analyze other facets of the economic relationship—such as the impact of FDI and ODA on security policy—gathering additional causal process observations to test in more depth the logic of the theorized causal mechanism.

5.5 Economic interdependence in Sino-Philippine political relations: Part I

As one of the poorest countries in East Asia, international security and foreign policy issues have not typically been high on the list of priorities of the Filipino people or their elected representatives. The country’s famously fragmented, personality-driven and often chaotic politics have instead focused exclusively inward on economic development, poverty alleviation and domestic security. Internationally, the Philippines is well aware of its limitations, and the famously affable Filipinos would simply rather be friends with everyone. Accordingly, the optimal strategy for Manila to manage any clashes between its economic and security interests is to avoid conflicts more generally with other countries. This principle was on display in the 2000s, as Manila and Beijing set aside the territorial disputes that poisoned relations in the 1990s to focus on flourishing economic ties as the basis for constructive political cooperation.

The positive political relations of the 2000s did not endure into the 2010s, with a downward trend that began with corruption scandals deteriorating rapidly from 2011 with the reemergence of longstanding territorial disputes in the South China Sea (SCS). Over the 2002-2013 period the Philippines thus experienced economic interdependence under contrasting political conditions—amity and animosity—and the analysis proceeds by separating the two: 2002 to March 2011, and from March 2011 to the final months of 2013.

First period (2002-2011): A “golden age” marred by controversy

Throughout the 1990s, Sino-Philippine relations were marred by an ongoing dispute surrounding overlapping sovereignty claims in the SCS. China built structures on Mischief Reef within the Philippine-claimed portion of the Spratly Islands in 1995, replacing the original structures in
1998 with a three-story concrete building. Yet by the end of the decade both sides appeared to shift their focus away from the maritime dispute and relations began a swift upward trajectory with Gloria Macapagal-Arroyo’s ascension to the Presidency in 2001. Numerous high level visits from both sides followed, headlined by Chinese President Hu Jintao’s visit to the Philippines in April 2005, during which Arroyo declared that Sino-Philippine relations had entered “a golden age”.

5.5.1 Chinese interests and economic diplomacy

Rapid economic growth during the 2000s allowed China to strategically use trade, investment, ODA and the appeal of its economic model as part of a “charm offensive” to acquire influence and pursue its specific foreign policy interests. China simultaneously downplayed territorial disputes, seeking to reassure the ASEAN nations that its rise did not threaten regional stability. In 2002, China and ASEAN signed the “Declaration on the Conduct of Parties in the South China Sea” which sought to retain the status quo and envisaged the claimants engaging in confidence building measures to reduce tensions. In the case of the Philippines, the Arroyo administration’s withdrawal of military personnel from Iraq in July 2004 and the temporary souring of relations with the United States that followed created an opportunity for China to accelerate the growth of its influence. Economic diplomacy was the major pillar of this charm offensive.

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409 The Mischief Reef construction probably contributed to the decision made later in 1995 by President Fidel Ramos to invite United States military forces back onto Philippine soil on a limited basis, despite the closure of the Subic and Clark bases in 1991: Lum 2012, 14. See also Storey 1999.
410 Kurlantzick 2007.
411 Storey 2006.
412 The decision was made under pressure from Iraqi insurgents who had kidnapped and threatened to execute a Filipino truck driver.
413 Storey 2006.
Complementing the rapidly growing trade between the two countries—which grew 433 percent between 2000 and 2005—Chinese economic diplomacy was led by ODA, specifically the financing of large infrastructure projects with concessional loans provided by China’s Export-Import Bank. The two most high profile projects were NorthRail and the National Broadband Network (NBN). NorthRail was a US$503 million project to rehabilitate the railway linking Manila to the northern Pampanga Province for which the China Export-Import Bank was to loan $400 million. The NBN project, signed by President Arroyo in China in April 2007, involved a similar $329.5 million loan offered on the condition that the Chinese company Zhong Xing Telecomm Equipment Corporation (ZTE) be the exclusive provider and supplier.

These and other China-sponsored projects were widely criticized for their lack of transparency and perceived overpricing. After a time, allegations of kickbacks were leveled against government officials and their Chinese partners. The NBN in particular was plagued by exposés of corruption and a full-blown scandal implicating both the President and her husband, forcing Arroyo to suspend and ultimately cancel the deal in October 2007, barely six months after its signing. The cancellation of the NBN had a domino effect, shutting down other projects funded by Chinese loans. Public sentiment toward China became more suspicious and skeptical; the golden age had come to an end.

### 5.5.2 Philippine interests and economic policy

The core principals behind the policies of the Arroyo administration are best characterized not as a pure reaction to Chinese economic diplomacy but a realization of independently shared

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414 By which time China was the Philippines fourth largest trading partner: Storey 2006.
interests. Arroyo assumed the presidency with a strong focus on economic development and poverty reduction and viewed “development diplomacy” as an important strategy in achieving this goal.\textsuperscript{417} China was an obvious potential partner, and building a cooperative relationship with the Chinese government was a policy any government could reasonably have sought. The administration cannot be criticized simply for promoting an economic partnership that China was equally keen to develop.

Cooperating with the Chinese government also afforded greater flexibility compared to working with other international partners. Prior to a visit by Chinese Premier Wen Jiabao in 2006, Beijing offered the Philippines loans from its Export-Import Bank of $2 billion a year until 2010. To put this in context, the Philippine government was also negotiating smaller loans from the World Bank ($200 million) and Japan ($1 billion) but which had stricter conditions attached. Unfortunately, as hindsight revealed, while the lack of conditionality was a great strength of Chinese ODA, it also provided opportunities for corrupt behavior.\textsuperscript{418}

Accordingly, whether or not the allegations against Arroyo and her colleagues are true, it seems clear that close cooperation with China in this instance allowed individual officials to circumvent orthodox procedures, such as requiring projects to be subject to competitive bidding. The consequence was the finalizing of agreements that, with the benefit of hindsight, appear even from an economic perspective to have been less than the best possible deal for the Filipino people.

\textsuperscript{417} De Castro 2010.  
\textsuperscript{418} Baviera 2012, 18-19.
5.5.3 Philippine interests and security policy

In asking whether economic interdependence affected Philippine security policy during this period it is difficult to separate the allegations of corruption from the deeper question of whether the nature of bilateral economic links created tradeoffs between the country’s economic and security interests. Until corruption allegations first surfaced in 2007, China was generally seen in a positive rather than threatening light; lingering suspicions over the SCS had evaporated. A poll in January 2006 indicated that 54 percent of Filipinos had a favorable view of China while 63 percent felt it would be positive if China were to become “significantly more powerful economically than it is today”.

Economic ties even created the space for the two governments to begin modest efforts on defense cooperation. Agreements were signed in September 2004 to begin regular high-level defense talks, increase military exchange visits and swap intelligence on transnational threats.

It is in this context of lavish economic diplomacy, benign threat perception and nascent defense cooperation that the major SCS event of this period must be considered. In March 2005 the Tripartite Agreement for a Joint Marine Seismic Undertaking (JMSU) was concluded between the national oil companies of the Philippines, China and Vietnam, to explore opportunities for joint development of disputed areas of the SCS without prejudicing the positions of each government on sovereignty issues. The agreement—described by Arroyo as a “diplomatic breakthrough”—was significant because it departed from the ASEAN strategy of pursuing a joint negotiating stance on sovereignty disputes vis-à-vis China on SCS issues, a strategy the Philippines had pushed hard for the previous decade following the Mischief Reef incidents.

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419 Medeiros et al 2008, 100.
421 Wain 2008.
Adding to speculation was the fact that the JMSU—the details of which were shrouded in secrecy—was signed just prior to the announcement of a new round of lucrative Chinese investment and loan projects, inviting questions on whether the deals were related.

The issue came to a head in 2008 when it emerged that undisputed areas of the Philippines’ continental shelf were included for joint development in the JMSU. Described as “breathtaking concessions” in an article by Barry Wain breaking the story, the revelations sparked uproar in the Philippines. Public calls to release details of the agreement were coupled with allegations that the Philippine government had effectively ceded sovereign territory in return for developmental packages and, possibly, the personal gain of officials. The constitutionality of the agreement was challenged by opposition and nationalist groups and, under pressure, the Arroyo administration allowed it to lapse in a few months later.

It may never be known for certain whether the JMSU was believed in good faith to be in the best interests of the Philippines, was a classic “sellout” by corrupt officials, or simply proved the notion that generous economic diplomacy by China was able to realize—at least for a time—significant accommodation in security policy. Evidence presented by Baviera (2012) indicates that the Ministry of Foreign Affairs and the National Security Council were largely excluded from the negotiations, which were instead conducted only by President Arroyo and a few individuals close to her with strong ties to China. Baviera argues that greater involvement from the agencies normally responsible would have influenced calculations of the merits of the deal. At a minimum, there is no doubt that the JMSU (while it lasted) was a major security policy accommodation of Chinese interests.

422 Ibid.
5.5.4 Conclusion

Throughout most of her time in office, Arroyo suffered low approval ratings, popular protests calling for her resignation, four unsuccessful impeachment bids and at least three mutinies led by mid-ranking military officers.\(^{425}\) The highs and lows of Sino-Philippine relations during the Arroyo years accordingly appear to fit neatly into the standard narrative concerning the Philippines as a state hobbled by underdevelopment, fundamentally weak institutions, internal divisions and unstable, personality-driven domestic politics. At a time when China was not perceived as a security threat, the offer of economic riches to help grow a struggling economy was wholly embraced, bringing with it accommodating policy over a territorial dispute and allegedly lining the pockets of officials.\(^{426}\) Had these economic boons not been offered, it is strongly arguable based on 1990s events that the Philippines would not have adopted such accommodating security policy.

Yet this period is not a narrative about a factory economy dealing with direct conflicts between its economic and security interests; it concerns a poor economy allowing its longer term strategic goals to be eroded for immediate economic gain. It thus offers less leverage as case study to test the theory of asymmetry. Nevertheless, two causal process observations documenting the public outrage and political backlash against China are of inferential value. The first is the defeat of the JMSU following the realization that Philippine sovereignty was under threat. The second is the ultimate failure of various Chinese-financed infrastructure projects which were perceived to have fostered the threat of corruption. The backlash in response to these threats extinguished

\(^{425}\) Lum 2012, 6.
\(^{426}\) This point is also made by Medeiros et al 2008, ch. 5.
cooperative projects between the two governments, demonstrating the conditionality of power and influence from economic interdependence; as issue salience rises, the degree of accommodation of security policy falls.

Benigno Aquino III was elected President of the Philippines in May 2010 with a central policy platform of combating corruption. In late 2010, the Philippines joined a 19-state coalition organized by China that declined to send a representative to the Nobel Peace Prize award ceremony for Chinese dissident Lio Xiaobo. At the time, Aquino justified the decision as necessary to aid the chances of convicted Filipino drug traffickers sitting on death row in China. While the welfare of the imprisoned foreign workers was clearly a factor, this accommodation of Chinese interests was still surprising given the Aquino family’s legacy of promoting human rights.

In February 2011, Albert del Rosario was appointed Secretary of Foreign Affairs. Del Rosario had attended high school and college in the United States, later serving as Ambassador, and was perceived to be pro-American. The following month, China executed the convicted traffickers. That month was also a turning point for maritime confrontations in the SCS, and the Philippines entered a new period of more hostile political relations where the heightened perception of a China threat coupled with Beijing’s use of economic levers would create sharper tradeoffs between the country’s security and economic interests.

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427 As De Castro (2009, 414) writes, alarmed by the backlash to the NBN and other deals, the Chinese Embassy in Manila expressed its concern over “recently emerging tendencies in the Philippines which may impose negative influence on the two countries’ relations and mutual cooperation”.
430 Del Rosario replaced Alberto Romulo who had held the post for over six years, mostly under President Arroyo.
5.6 Economic interdependence in Sino-Philippine political relations: Part II

Second period (2011-2013): Territorial tensions in the South China Sea

5.6.1 Nature of dispute and Scarborough Shoal standoff

The South China Sea occupies one of the most important geostrategic locations in the world. A large proportion of the energy and commodity shipments passing through the Straits of Malacca continue through the SCS on to Northeast Asia. The SCS accounts for about a tenth of the annual global fisheries catch, and is believed to contain a wealth of hydrocarbons beneath its seabed. Six states have made overlapping territorial claims: China, Vietnam, Taiwan, Malaysia, Brunei and the Philippines. Of all the disputes, China-Philippines and China-Vietnam have seen the greatest level of bilateral tensions.\(^{431}\) For the Philippines, access to traditional fishing grounds is a particularly sensitive issue as fishing is the lifeblood of many coastal communities.

The collapse of the JMSU in 2007 revived the debate between the Philippines and China over perceived encroachments on the other’s sovereignty in the SCS and the rights to natural resources. Manila subsequently decided to grant a prospecting license unilaterally;\(^{432}\) Beijing, unhappy that the Philippines was conducting affairs in an area formerly covered by the JMSU,\(^{433}\) increased its surveillance and began to hassle Philippine vessels in locations where they had previously operated freely.\(^{434}\) The turning point came in March 2011, when the Philippines filed a diplomatic protest claiming that Chinese patrol boats had harassed a government-contracted oil exploration vessel in the Reed Bank, about 80 miles from Palawan and well within what the

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433 International Crisis Group 2012b, 7. The report states that China also perceived such moves as a violation of the “self-restraint” principle in the 2002 ASEAN Declaration of Conduct: ibid.
Philippines considers to be its exclusive economic zone (EEZ). The Philippine Air Force quickly deployed two small planes in response, but the vessels had already left the area. This incident was one of at least five reported in the first five months of 2011, occasioning a war of words between the two governments. While tensions subsided in the second half of that year, an announcement in late February 2012 by Manila reaffirming its intention to unilaterally explore Reed Bank drew harsh criticism from Chinese officials. This was likely the opening act of an escalation in tensions which culminated in a maritime standoff beginning six weeks later.

**Scarborough Shoal standoff**

The Scarborough Shoal, claimed by both countries (and Taiwan), is situated between the Macclesfield Bank—a submerged feature claimed by China—and the Philippine island of Luzon, 119nm away. It is roughly 44nm² in size and valued for its fishing resources. The standoff began on April 8, 2012 when Filipino sailors attempted to arrest Chinese fisherman for poaching protected marine species at the shoal. The Philippines deployed a naval frigate—the Hamilton-class cutter Gregorio del Pilar acquired from the United States in 2011—which found protected species on board one of the boats. Two unarmed China Marine Surveillance (CMS) vessels...
appeared and interposed themselves between the fishing boats and the frigate to prevent arrest or confiscation. The Philippines replaced the frigate with a coast guard vessel two days later in a bid to ease tensions, while China deployed an armed Fisheries Law Enforcement Command (FLEC) ship, beginning a standoff that would last over two months.

Both countries lodged diplomatic protests with the other, claiming the Scarborough Shoal to be part of their territory. By the second week of May, the original fishing boats had left but CMS and FLEC vessels remained, as well as more fishing boats, including a 20,000-tonne oil tanker and a 32,000-tonne fish-processing ship. On June 16, an approaching typhoon gave Aquino cover to withdraw the coast guard ships from the shoal; on June 18, the Chinese Foreign Ministry announced the withdrawal of its civilian ships. However, on June 19 the China Maritime Search and Rescue Center announced it was deploying rescue ships to provide assistance to fishing boats. The upshot was that China never completely withdrew its ships from the Shoal area while the Philippines did. The entrance to the shoal’s lagoon was roped off and Chinese vessels maintained a continuous presence throughout 2012 and 2013 with no sign of withdrawal.

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440 Thayer 2012a.
441 China even ordered the Philippine frigate to leave its waters: Thayer 2012a.
5.6.2 Chinese interests

China’s claim of “indisputable sovereignty over the South China Sea and adjacent waters” is associated with a controversial map showing a nine-dashed line enclosing the main features of the SCS, including the Spratly and Paracel Islands, and the Scarborough Shoal. China has maintained troops and structures on a number of the islands for many years and more recently enacted laws placing the islands under prefectural-level administration. China’s long-term interests in the SCS relate both to security and economics. From a security standpoint, the SCS lies within the waters of the ‘first island chain’, the naval dominance of which is a key objective of Chinese strategists. Economically, the SCS is a major artery of global shipping, carrying natural resources and commercial wares to Chinese shores. Moreover, the prospect of rich hydrocarbons beneath the seabed only increases the region’s strategic and economic significance. And, like most foreign policy issues, the SCS has a domestic dimension, in that the legitimacy of the Chinese Communist Party is tied to nationalism and the belief that China must be resolute in its international disputes, rejecting negative outcomes from a “western-dominated system.”

With respect to the Philippines, these broad interests translate first and foremost into the objective of China acquiring and maintaining de facto control over disputed areas. Where this is not yet feasible, the goal is to undermine Philippine control and send strong signals of resolve, both to placate domestic audiences and deter Manila from acting to reinforce its claims. Beijing consistently demands that territorial disputes be dealt with bilaterally (where its negotiating...
leverage is greatest), and rejects multilateralism or any type of dispute settlement mechanism, fearing its claims might be rejected. Economically, China would be willing to engage in joint development provided other claimants recognized Chinese sovereignty. In pursuit of these objectives, China has adopted different strategies over time, the economic diplomacy of the 2000s giving way at times to more forceful maritime and political measures from 2011 to 2013, interspersed with attempts at conciliation and reassurance.

5.6.3 Chinese non-economic measures

The gaping disparity in naval and maritime law enforcement capabilities between China and the Philippines meant that Beijing could achieve its immediate objective of taking de facto control over the Scarborough Shoal with relative ease; Manila simply did not have the resources to outlast Chinese hard power. Importantly, Beijing was able to expand its control of the SCS without firing a shot or initiating a confrontation, thereby minimizing the perception of Chinese aggression. It did so through the use of “salami slicing” or “cabbage” tactics, defined as small encroachments that leave the other party with the invidious decision either to escalate the incident (and risk a military conflict), or acquiesce and permit China to expand its territorial control.

Beijing supplemented its salami slicing tactics with strong statements and diplomatic pressure. During the 2012 standoff Foreign Minister Fu Ying stated that Beijing was ready for “any escalation” while the Global Times, a government-controlled newspaper, warned of a “small-

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448 While the approach of inclement weather on June 16 gave the Aquino administration both a face-saving way of withdrawing as well as the moral high ground when China did not, there is no reason to believe that the Philippines could have maintained their presence indefinitely as the Chinese have done.
449 Choong, William. “China Rules the Waves with ‘Salami Slicing’ Tactics”. Straits Times, April 28, 2012. In an author interview, a Philippine foreign policy official described the tactics as “creeping assertiveness” (location and time withheld to protect confidentiality).
scale war” between Beijing and Manila.\textsuperscript{450} Beijing also succeeded in preventing Manila from building a consensus among its ASEAN partners. For the first time in its 45-year history, ASEAN could not agree on a joint communique at its July 2012 meeting because of internal divisions regarding the SCS disputes.\textsuperscript{451} During an ASEAN meeting in 2013, the new Chinese Foreign Minister Wang Yi labeled the Philippines a provocateur for stirring tensions in the SCS.\textsuperscript{452} China was attempting to convince other ASEAN states that Manila’s conduct was the more detrimental to regional stability.\textsuperscript{453}

5.6.4 Chinese economic measures

Economic relations between China and the Philippines were clearly affected in 2012 and 2013 at the same as the SCS dispute was flaring. The following analysis has two objectives: first, to determine whether the economic disruption was a consequence of the political dispute; and second, to inquire why some economic links and not others were affected.

Most affected industry: Bananas.\textsuperscript{454}

According to information provided to the author by Philippine government officials, the first sign of problems came on March 5, 2012 when the Philippine government received a letter from Chinese quarantine officials stating that the importation of bananas from the company Sumifru had been suspended. The Chinese claimed that a certain pest—\textit{Aonidiella comperei} McKenzie—
had been detected at the Shenzhen port of entry. They demanded a list of all banana export orchards and packing facilities.

Caught by surprise, Philippine officials conducted their own investigation which identified the existence of different pest—*Aspidiotus destructor Signout*—an insect common in Philippine bananas, but also in bananas grown in China. The Philippines had been exporting bananas to China for at least a decade (some of which must have contained this common pest) and had never had any issues with Chinese customs. In response, the Philippine government issued new guidelines intended to improve cleaning, packing and inspection. Chinese customs rejected the Philippines’ evidence that the more common pest was responsible, insisting that the infestation was *Aonidiella comperei* McKenzie. In a letter on May 4, a third pest—*Dysmicoccus neobrevipes*—was alleged now to be present in both bananas and pineapples. Despite the best efforts of Philippine officials, the Chinese side could not be placated.

Prior to these phytosanitary issues arising, China was the second largest destination for banana exports, around 16 percent of total, and over half the exports of the Cavendish variety. The effect on exports was initially only marginal. In January and February 2012 exports averaged over one million boxes per week, falling to 890,000 and 785,000 in the first two weeks of March when the customs issues were initially cited, before recovering to previous levels from March 18 to April 14. By the following week (April 15-21) the Scarborough Shoal story had broken, and exports more than halved from 1.5 million boxes to 710,000. After recovering for a few weeks, numbers began falling again in May, from 777,000 boxes to 149,000 to 92,000 boxes. The week

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455 See also “Banana Exports to be Hit by Scarborough Dispute-Industry Insider”. *Philippine Daily Inquirer*, May 3, 2012; Ravindran 2012, 117.
of June 3-9 exports hit their low of 72,000 boxes, just five percent of what they had been two
months earlier.

**Figure 5.3: Philippines banana exports to China, Boxes Jan 28 - Aug 19, 2012**

![Graph showing banana exports from January 28 to August 19, 2012]

By this time, media were reporting stories that bananas were being left to rot at several Chinese
ports due to the tighter quarantine standards, causing financial losses in the tens of millions.\(^{456}\)

Exports never stopped completely, and anecdotal evidence from officials suggests that whether a
shipment was accepted depended on the individual quarantine officer and trader involved.

However, the Philippine government cannot say why some shipments and not others were
allowed. After the Scarborough Shoal standoff ended mid-June, shipments began to be accepted
at a greater rate, but nowhere near their former levels.\(^ {457}\) Banana exports never recovered fully in
2012, and nor at any time in 2013 did they match their previous highs. By one industry
calculation, the total number of boxes exported to China in 2012 (37 million boxes) was 50

\(^{456}\) “PH bananas rotting in Chinese ports”. *Philippine Daily Inquirer*, May 12, 2012; “China Dispute Threatens

\(^{457}\) See also “China Accepts Phil Bananas Again, But…”. *Philippine Star*, June 22, 2012.
percent less than what would have been exported without the quarantine issues (75 million boxes) given the trend from previous years. Figure 5.3 details the initial drop-off in March and then the sharp decline in May.

The key question is whether these phytosanitary issues were connected to the SCS dispute notwithstanding that the bananas were likely infested with some type of pest. The Chinese government denied any connection and, even as late as May 28, the official line in Manila was that the banana issues were purely phytosanitary and unconnected with politics. Yet the evidence for a connection is powerful. There had never been a problem exporting to China previously, and Philippine officials could find no evidence substantiating the specific pest infestations claimed by China. The banana industry itself is convinced that political tensions were the cause. In interviews occurring over a year later, Philippine foreign policy officials and technical specialists with knowledge of the banana industry were almost unanimous in acknowledging that the evidence was hard to explain other than through politics. The question of why quarantine concerns were raised in March, more than a month before the standoff began, may be explained by the fact that just a few days prior to the first holdups, the Chinese government had strongly criticized Manila’s Reed Bank exploration announcement. The government-controlled People’s Daily even called for economic sanctions.

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460 “China Objects Anew to Exploration in West Philippine Sea”. BusinessWorld, March 2, 2012. A final interesting coincidence is that Sumifru, the company which first experienced problems, and which was hardest hit by export difficulties throughout 2012, is a joint venture of the Japanese conglomerate Sumitomo Group. One wonders whether, of all the exporters to target, it was singled out because of ongoing Sino-Japanese tensions. There is no way to know for sure.
Tourism and other minor difficulties

Similar to Japan’s experience, tourism suffered as tensions persisted. On May 11, a month after the standoff began, reports emerged that Chinese travel agencies had suspended tourist packages to the Philippines and had promised refunds. No official ban was ever issued but arrivals declined between May and July, and a Philippine airline was forced to suspend its twice-weekly charter flights from Shanghai at the request of the Chinese-based charterer.\(^\text{461}\) In first quarter of 2012, China had sent 8.4 percent of total arrivals—only the 4\(^{\text{th}}\) largest market—leading an industry group to downplay the impact.\(^\text{462}\) Normal tour operations resumed six months later in October 2012.

The Philippines also experienced some difficulties in government to government economic cooperation. Media reported that trade missions from China became less frequent, especially from state-run companies, though no systemic boycott was identified.\(^\text{463}\) The most specific problem came in August 2013 and concerned a trade fair in Nanning. According to the Philippine government, President Aquino was invited to attend with a host of Philippine businesses, but was forced to cancel his visit when Beijing attached the condition that Manila first withdraw an arbitration case concerning the SCS dispute (discussed below).\(^\text{464}\) This effective ‘uninviting’ of Aquino was compounded by problems experienced by Philippine

\(^{464}\) “China Snubs Philippine President Over Visit to Nanning Expo”. South China Morning Post, August 30, 2013.
exporters in obtaining customs clearance for their products to be displayed at the trade fair.\footnote{465} By the time clearance was granted, the trade fair was ending.

5.6.5 Observations of symmetric interdependence

The largest export categories—semiconductors, other electronics, and natural resources—were unaffected during the Scarborough Shoal standoff. The reason why was stated simply by the Chairman of the Philippine Exporters Confederation, Sergio Ortiz-Luiz: “Most of the exporters of electronics parts and components here are multinationals who also operate in China and will thus not risk disrupting the supply chain”; the Vice-President for Communications of the Chamber of Mines of the Philippines, Rocky G. Dimaculangan, noted: “As mineral exports are prime and essential components to the industrialization program of China, we remain optimistic that [they] will not be covered by restrictions”.\footnote{466} The major concern of the semiconductor industry was simply that maritime tensions might reduce the overall attractiveness of the Philippines as an investment destination (from the perspective of any foreign investor), rather than any specific disruption by China.\footnote{467}

Philippine investments in China were also unaffected; indeed in May 2012 major property investor SM Prime Holdings announced plans to expand.\footnote{468} Part of the reason is likely that Filipino FDI into China is overwhelmingly controlled by ethnic Chinese Filipinos, who have been the biggest supporters of rapprochement between the two countries. Targeting the very Filipinos who are China’s biggest advocates in Manila would probably undermine China’s

The one business that did suffer was Beatrice Supermarkets—ironically, a wholly owned Chinese company. Loida Nicolas Lewis, a Philippine-born US businesswoman, had organized worldwide protests over the Scarborough Shoal incident in early May which received widespread attention inside China. Lewis had been Chairman of Beatrice from 2005-2009 but had since sold all of her interests to Chinese partners in 2010. Nonetheless Chinese consumers, ostensibly believing the company to be Filipino, organized a boycott, losing the company almost 10 percent of revenues.

Meanwhile, Chinese investors and finance officials continued to be interested in the Philippines. China Railway Construction Corp—China’s second biggest state-owned construction company—expressed interest in bidding for a light rail extension project. According to one Philippine finance official, throughout the tensions their Chinese technical counterparts continued to collaborate and express a willingness to finance new projects. Surprisingly, officials from the Chinese embassy in Manila worked to renegotiate an existing loan with the China Export-Import Bank to terms more favorable to the Philippines. In the private sector, new contracts signed by Chinese firms grew by 63 percent to over $1 billion.

While this argument sits outside the scope of the theory of asymmetry, it suggests that the mechanism through which economic interdependence translates into domestic influence—by empowering a certain constituency to lobby on your behalf—may also inhibit it from becoming coercive power if the would-be coercing state is reluctant to hurt its clients’ interests. Kastner (2009) makes a similar argument with respect to cross-strait economic interdependence.

471 Author interview with Philippine official with knowledge of public financing, Manila, November 2012.
Summary

Overall exports to China declined slightly in 2012.\textsuperscript{474} However, a close examination of export data posted by the Philippine Department of Trade and Industry suggests that political tensions were unlikely to have been a factor in stagnant exports, because the largest category of decline was a special type of electronics which is prone to fluctuation, and also saw significant falls in exports to Japan and South Korea.\textsuperscript{475} In the other electronics sectors as well as minerals (which can also fluctuate significantly) there was modest growth in exports to China. A steadily improving economy saw Moody’s upgrade the Philippines’ credit rating to a notch below investment grade in October 2012. The country exceeded its GDP growth target for the year, recording 6.6 percent.\textsuperscript{476}

Why were bananas and tourism affected? This economic disruption is consistent with the overall prediction of the theory of asymmetry and well as expected industry-level variation because it was concentrated in such a narrow segment of the country’s economy. Political tensions affected industries selling final goods (bananas and tourism) where the cost of substitutes was lowest for China. Meanwhile, for the larger electronics industry operating further upstream in the production network, switching to alternative inputs would have been more costly for Chinese interests. The higher degree of symmetry in these economic links meant they were unaffected.\textsuperscript{477}

\textsuperscript{474} Though a larger surge in imports meant two-way trade increased by over 12 percent.
\textsuperscript{475} The category is “special transactions” which are exports of products manufactured from imported materials on a consignment basis (i.e. the sender retains ownership). While the types of industries using special transactions vary across countries, in the Philippines this category is mostly electronics, though historically it also included garments: Alburo 1987, 508. This is exactly the kind of transaction one would expect to see in intra-firm transnational production processes where inputs cross several borders. This category accounted for 13.95 percent of exports to China in 2011 and only 3.94 percent in 2012, while for Japan it was 11.71 percent (2011) and 5.47 percent (2012).
\textsuperscript{476} “Growth Target Exceeded (Gov’t Reports 6.6% Expansion for 2012)”. BusinessWorld, February 1, 2013.
\textsuperscript{477} The same is true for resources. An additional reason cited by a foreign policy official is that bananas and tourism are ‘high profile’ industries that resonate both within China and internationally, while electronics is ‘low profile’: Author interview with Philippine foreign policy official, 2013 (location and time withheld to protect anonymity).
5.6.6 Philippine interests

The Philippines’ interests in the SCS were shaped by three factors operating at the time tensions arose. The first was a heightened insecurity toward China among Filipino policymakers, renewed by the JMSU controversy and fed by the maritime confrontations in early 2011. The standoff seemed to unite normally fractious power blocs; even regular critics of the Aquino administration came out in support of a resolute stance. The administration itself had entered office in 2010 determined to reverse the harmful effects of the JMSU, which Aquino believed had encouraged the Chinese to be more forceful in asserting their claims.

Second, public opinion complemented concern within the government. Table 5.4 records the growth in coverage of China in two of the largest Philippine newspapers between 2005 and 2013. The rise in coverage from 2008 likely came from negative stories relating to corruption scandals, the arrest and execution of the Filipino drug traffickers, the Nobel Peace Prize boycott and the SCS dispute (causing a huge spike in 2012). When surveyed in May 2012, 48 percent of respondents said they “followed closely” news of the Scarborough Shoal standoff. That year, net distrust of China reached a high not seen since the Mischief Reef incident in 1995, as

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478 The basic claim to Scarborough Shoal is based on principles of discovery, proximity and effective occupation. Since the 1950s, the Philippines has used the shoal as an impact range for defense operations and performed oceanographic surveys with the U.S. Navy: Bautista and Schofield 2012.

479 “Filipinos United in Shoal Row”. South China Morning Post, May 16, 2012. Even the Communist Party of the Philippines, whose military arm continued to fight a war against the government, as asserted Filipino sovereignty and territorial integrity.

480 International Crisis Group 2012b, 6. Author interviews with a number of Philippine policymakers, businesspeople and other observers also indicated that Aquino and especially his Secretary of Foreign Affairs Albert Del Rosario were personally more inclined view cooperation with the United States favorably while being more skeptical of China (Manila, November 2013). See also: “Aquino Says JMSU with China Worsened Spratly Dispute”. Philippine Star, July 6, 2011.

481 The word ‘Olympics’ only occurred with ‘China’ 58 times in the two newspapers in 2008.


China was perceived as engaging in bullying propaganda to intimidate the Philippines and undermine its international credibility.484

**Table 5.4: Articles containing ‘China’, Philippine Daily Inquirer and Philippine Star, 2005-2013**

<table>
<thead>
<tr>
<th>Year</th>
<th>2005</th>
<th>2006</th>
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<tbody>
<tr>
<td>Articles</td>
<td>534</td>
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<td>1,208</td>
<td>3,000</td>
<td>2,527</td>
<td>2,590</td>
<td>2,610</td>
<td>4,509</td>
<td>2,340</td>
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Source: Factiva

The combination of these two factors engendered within the Philippines an atmosphere of defiance towards China that was strikingly similar to that prevailing in Japan from late 2010 onward. Moreover in a third similarity with Japan, the major voice one would expect to be seeking accommodating policy for economic reasons—the business community—was fairly muted.

Commerce in the Philippines, in particular economic ties to China, is disproportionately controlled by Filipinos of Chinese ethnicity. While Chinese-Filipinos comprise only about five percent of the country’s population, they hold a large percentage of the country’s wealth in established industries like breweries, cigarettes, malls and manufacturing. As the largest investors in and traders with China, Chinese-Filipinos would be the primary losers if bilateral economic links were disrupted. Yet as a community their voices were virtually silent throughout the 2012 tensions, torn between loyalties to their ethnic and cultural heritage on one hand, and

484 Gallardo and Baviera 2012, 3. A Pew poll released in July 2013 found 39 percent of population viewed China as an “enemy”, 35 percent “partner” and 22 percent “neither: “Global Survey: 2 in 5 Filipinos See China as an ‘Enemy’”. Philippine Star, July 19, 2013. Yet the influence of public opinion should not be overstated, and is better considered an enabler of Manila’s robust security response rather than a core driver. Foreign policy is not a high priority issue for ordinary Filipino people or a significant fount of nationalism, and the Muslim insurgency is perceived to be a greater threat to territorial integrity than China: International Crisis Group 2012b, 21.
their adopted country on the other—a situation likened to being “caught in a family quarrel”.\footnote{Filipino Business Chiefs Urge Peaceful Solution Industry Leaders in Manila Say the Scarborough Shoal Row Could Jeopardise Exports to China”. \textit{South China Morning Post}, May 15, 2012, 3. Another barrier to becoming a well-organized interest group is the division between immigrants hailing from southern China who have been in the Philippines for generations and who are culturally assimilated into Filipino society, and newer immigrants from elsewhere in China who have much stronger ties to the mainland. The division is compounded by the fact that the two groups often compete against each other in the domestic economy.\footnote{China-Philippine Territorial Dispute Cools, Thanks to Chinese Filipinos”. \textit{Nikkei Weekly}, November 26, 2012.}

Appear too nationalist and risk damaging Chinese economic networks; appear too pro-Chinese and pay reputational costs in the Philippines. Their solution was to avoid discussing the issue as much as possible and never criticize the Philippine government or openly sympathize with China.\footnote{In the words of one tourist operator, Chinese cancellations “will mean less revenue for us, but we cannot blame our government. We just have to work harder to attract tourists from other countries”: “China Dispute Threatens Philippine Industries”. \textit{Wall Street Journal Online}, May 16, 2012; Gallardo and Baviera 2012, 16-17. Gallardo and Baviera (2012, 17) note that a strategy adopted by Chinese-Filipinos was to criticize the United States for stoking tensions, since this was an indirect critique of the pro-American Secretary of Foreign Affairs, Albert del Rosario.\footnote{“Noy Tax Speech a Gentle Reminder”. \textit{Philippine Star}, March 24, 2013.}

Where an opportunity arose, they would willingly play mediators,\footnote{A final parallel with the Japanese business lobby is the existence of a contemporaneous but unrelated issue which further inhibited the relevant business lobby from publicly advocating foreign policy positions. In the case of Chinese-Filipinos, it was a failure to pay taxes. With a reputation for not paying their due, it may be hard for the Chinese-Filipino community to say publically what they think the government should do: “’Noy Tax Speech a Gentle Reminder’”. \textit{Philippine Star}, March 24, 2013.\footnote{On May 15, 2012 during the standoff, opposition lawmakers issued a statement warning the government not to risk economic relations with China, pointing in particular to bananas, Filipino workers in China and equity and loan investments from China: “DFA Chief Calls for Patriotism”. \textit{Philippine Star}, May 17, 2012. Yet there appears to have been no fallout from this statement and the criticisms were not regularly repeated.}

but as an economic lobby with an interest accommodating policy towards China, their influence on the Aquino administration appeared to be minimal.\footnote{China-Philippine Territorial Dispute Cools, Thanks to Chinese Filipinos”. \textit{Nikkei Weekly}, November 26, 2012.}

These three contextual factors—heightened government sensitivity toward China, increasing concern among the public, and a constrained (Chinese-Filipino) business lobby—created the conditions for a prolonged dispute. Despite a severe lack of capabilities, the government adopted surprisingly assertive and potentially risky security policies. There is very little evidence to suggest that the economic component of China’s statecraft meaningfully constrained the Philippines’ choices in the security policy realm.\footnote{“Filipino Business Chiefs Urge Peaceful Solution Industry Leaders in Manila Say the Scarborough Shoal Row Could Jeopardise Exports to China”. \textit{South China Morning Post}, May 15, 2012, 3. Another barrier to becoming a well-organized interest group is the division between immigrants hailing from southern China who have been in the Philippines for generations and who are culturally assimilated into Filipino society, and newer immigrants from elsewhere in China who have much stronger ties to the mainland. The division is compounded by the fact that the two groups often compete against each other in the domestic economy.\footnote{In the words of one tourist operator, Chinese cancellations “will mean less revenue for us, but we cannot blame our government. We just have to work harder to attract tourists from other countries”: “China Dispute Threatens Philippine Industries”. \textit{Wall Street Journal Online}, May 16, 2012; Gallardo and Baviera 2012, 16-17. Gallardo and Baviera (2012, 17) note that a strategy adopted by Chinese-Filipinos was to criticize the United States for stoking tensions, since this was an indirect critique of the pro-American Secretary of Foreign Affairs, Albert del Rosario.\footnote{A final parallel with the Japanese business lobby is the existence of a contemporaneous but unrelated issue which further inhibited the relevant business lobby from publicly advocating foreign policy positions. In the case of Chinese-Filipinos, it was a failure to pay taxes. With a reputation for not paying their due, it may be hard for the Chinese-Filipino community to say publically what they think the government should do: “’Noy Tax Speech a Gentle Reminder’”. \textit{Philippine Star}, March 24, 2013.\footnote{On May 15, 2012 during the standoff, opposition lawmakers issued a statement warning the government not to risk economic relations with China, pointing in particular to bananas, Filipino workers in China and equity and loan investments from China: “DFA Chief Calls for Patriotism”. \textit{Philippine Star}, May 17, 2012. Yet there appears to have been no fallout from this statement and the criticisms were not regularly repeated.}}
5.6.7 Security policy responses to the Scarborough Shoal standoff

Until the Scarborough Shoal standoff, Manila had tended to follow two strategies to assert its maritime claims in the SCS: leverage its relationships to regionalize the dispute through ASEAN and push for a binding code of conduct; and increase defense cooperation with the United States. The standoff marked a new approach to dealing with the dispute.

Crisis management: Escalation and withdrawal

The Philippines had no chance of outlasting China in a maritime standoff. Having historically relied on the presence of the United States for its security, the government had developed few military options to deal with incursions into its territorial waters or EEZ. Military confrontation would be unthinkable—in the words of a former defense secretary, the Philippines “would not last 24 hours”. It was thus surprising that the early part of the standoff was defined by the government’s decision on April 10 to task a naval vessel—the Gregorio del Pilar—with fishery law enforcement. It is argued that because this should have been the coast guard’s responsibility, Manila made a tactical error by militarizing the dispute and allowing Beijing to respond with superior capabilities. The government’s position was that the decision was a matter of expediency for a nation with few maritime resources, and that its subsequent decision to withdraw the vessel two days later on April 12 and replace it with a coast guard vessel was a gesture intended to deescalate tensions.

490 Medeiros et al 2008, 121.
491 Buszynski 2002, 489. This quote is from 1993 but the gap in military capability has only increased since then. An editorial in the Philippine Daily Inquirer in April 2012 said as much: “PH in No-win Situations vs World’s Third Military Power”. Philippine Daily Inquirer, April 21, 2012.
492 “Scarborough Fail: How Aquino Blew It”. Philippine Daily Inquirer, May 3, 2012. All the Chinese vessels involved were civilian.
493 Lohman 2012.
It is possible that Manila simply failed to anticipate Beijing’s response, and once this was realized attempts were made to reduce tensions in the hope that the status quo could be restored. But it was too late, and on the pretext of protecting their fisherman China was able to establish and subsequently maintain effective control of the shoal. Nevertheless, it is still viewed by many as surprising (and arguably foolhardy) that the Philippine government was initially willing to take such emphatic action, and refuse to back down, despite vastly inferior capabilities. Beijing may have won tactical control of the shoal in the end, but only because they took it; it was not ceded by Manila.

Private and public diplomacy

To compensate for its lack of military capabilities the Philippine government emphasized both private and public diplomacy. Yet efforts inside ASEAN to push for a united negotiating front and joint code of conduct were neutralized by China, with the organization failing to issue a joint communique at its annual meeting the month after the standoff ended. Public diplomacy was thus Manila’s best option; in the words of Aquino, “our weapon really here is for the world to know what we are doing”. Aquino and del Rosario severely criticized Chinese tactics and rallied domestic support. In 2011, del Rosario argued that a failure to stand up and oppose

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494 On Nov 30, 2012 China told that Philippines that its presence at the Scarborough Shoal was now permanent, a move described as ‘dictatorial’ by Foreign Secretary Albert del Rosario: “China the ‘Dictator’ in Shoal Dispute”. *South China Morning Post*, November 30, 2012, 1.
496 Thayer 2012b.
China’s claims in the present would be even more costly in the future, and during the ASEAN Foreign Ministers’ Meeting in July 2013, he described China’s “massive presence” in the SCS as a “threat to the peace”. Yet throughout the dispute Manila kept bilateral channels open and expressed a willingness to talk with Beijing. Aquino approved unofficial envoys from the Senate to travel to China to negotiate, while taking the unusual step himself of receiving a call from a more junior Chinese official—Vice-Foreign Minister Fu Ying.

*Internal balancing: Military upgrades*

The aftermath of the standoff saw the administration move to upgrade the Philippines’ military capabilities. In December 2012, Aquino signed an armed forces modernization law which provided a budget of PHP75 billion ($1.7 billion) over five years, more than three times what had been spent on defense between 1995 and 2010. In July 2013, Manila announced plans to move navy and air force camps to a former US naval base at Subic Bay to create faster access to contested waters. The government took delivery of another former US Coast Guard cutter in August 2013, and in October 2013 Aquino announced a deal to purchase a squadron of FA-50 fighter jets from a Korean aerospace firm. These policies continued a trend, which had begun

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499 “China the ‘Dictator’ in Shoal Dispute”. *South China Morning Post*, November 30, 2012, 1. Del Rosario stated in 2011 that “if we allow ourselves to be pushed around, maybe tomorrow our 7,100 islands would be down to just two digits”: “Aquino Says JMSU with China Worsened Spratly Dispute”. * Philippine Star*, July 6, 2011.
500 “Philippines Slams Military Build-up at Sea”. *Straits Times*, July 1, 2013.
504 “PH Buying SK Fighter Jets”. * Philippine Daily Inquirer*, October 19, 2013. When asked about how the jets would fare against Chinese jets in the SCS, Defense Secretary Gazmin was translated as saying “We probably can now fight them”. The contracts were signed in March 2014.
in 2011 following the Reed Bank incident, of a shift in focus by the Armed Forces of the Philippines from internal security to territorial/maritime defense.505

**External balancing: Reaffirming the U.S alliance**

As no feasible level of military spending could ever be sufficient to match Beijing, Manila also moved to reaffirm and improve its longstanding (if sometimes turbulent) alliance relationship with the United States. Philippine Secretary of Defense Voltaire Gazmin explained that his country “cannot stand alone. We need to form alliances. If we don't, bigger forces will bully us, and that is happening now.”506 The alliance had survived several low points (the closure of U.S. bases in 1992 and the Philippines withdrawal from Iraq in 2004) and by 2012 was an increasingly important component of President Barack Obama’s strategy of rebalancing towards Asia.507 Manila’s priority was to leverage this renewed interest to signal to China that the 1951 Mutual Defense Treaty required the United States to defend the Philippines should it be attacked in the SCS.508 Despite efforts by Del Rosario to draw confirmation of this obligation from the U.S., Washington preferred instead to repeat that it would “honor its commitments”.509

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505 De Castro 2012, 216.
507 Lum 2012, 1.
508 Article 4 of the Mutual Defense Treaty states that the each party “recognizes that an armed attack in the Pacific Area on either of the Parties would be dangerous to its own peace and safety and declares that it would act to meet the common dangers in accordance with its constitutional processes”. In 1999, then U.S. Ambassador Thomas Hubbard wrote to Foreign Secretary Domingo Siazon saying the United States would intervene because it considered the SCS part of the “Pacific Area” under Article 4. The letter facilitated the passage of a Visiting Forces Agreement (VFA): Buszynski 2002, 498. The increased involvement of the United States following the conclusion of the VFA appeared to moderate Chinese behavior over the SCS in the subsequent two years.
In 2013, the Philippines began to open up its territory to friendly foreign forces, a significant step given the constitutional ban on foreign power establishing permanent bases. In July, Aquino announced that both the US and Japan would be given access to former U.S. bases to be able to forge a “credible alliance”.\(^5\) Talks with the United States began in August 2013 to increase rotational presence of American troops to enhance the country’s deterrent capability and boost maritime defense and security, according to del Rosario, “even before we have ships and aircraft that we need.”\(^6\) In the first six months of 2013, 72 U.S. warships and submarines visited Subic Bay, compared 88 naval vessel visits in the whole of 2012, 54 in 2011 and 51 in 2010.\(^7\)

**International Law: Seeking arbitration on the nine-dashed line**

On January 22, 2013, the government of the Philippines informed China that it would unilaterally submit its jurisdictional claims to an arbitral panel under the United Nations Convention of the Law of the Sea. The claim sought to force China to clarify its broad but ambiguous “nine-dashed line” claim to the SCS. The move—made without China’s consent—was described as unusual and highly technical by international lawyers.\(^8\) Del Rosario characterized the legal action as a “last resort” pointing out that China was still occupying the shoal.\(^9\) Reports suggested that during a diplomatic visit to Manila in October 2012, China’s Vice Foreign Minister Fu Ying explicitly told del Rosario not to appeal to the United Nations.\(^10\) China formerly rejected arbitration on February 19.

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9. The panel cannot rule on the actual maritime boundary in the disputed waters.
The legal action required a significant amount of political capital without any guarantee of a favorable legal outcome.\textsuperscript{516} It is significant because it demonstrated a continued willingness by Manila to internationalize the dispute through multilateral mechanisms such as the United Nations, directly contravening China’s strong wishes to deal with the dispute bilaterally. A Chinese Foreign Ministry Official visiting Manila in April 2013 warned of negative implications for trade, tourism and other interests if the arbitral process continued.\textsuperscript{517}

\textit{Media criticism}

The Aquino government does not lack for critics in the Philippines’ famously open press, but a comprehensive review of domestic print and TV media coverage by Galladro and Baviera (2013) during the 2011 and 2012 Sino-Philippine tensions revealed mixed views. If anything, the dominant criticism was that Manila’s foreign policy lacked a unified strategic vision, rather than being too dovish or too hawkish. While it was recognized that economic ties could be affected, the tone was less a criticism that Aquino’s policy was too accommodating or too aggressive, and more a hope that politics and economics could be separated.\textsuperscript{518}

\textit{Summary}

From the initial deployment of a naval vessel to the Scarborough Shoal to the United Nations legal claim, the Philippines consistently demonstrated a plucky forcefulness in the pursuit of its maritime sovereignty claims. It is therefore difficult to identify a counterfactual where, in the absence of economic vulnerability, the Philippines would have acted with a \textit{greater} level of assertiveness. Doing so would have risked escalating the tensions in the political/security sphere.

\textsuperscript{516} “Philippines South China Sea Legal Case against China Gathers Pace”. \textit{Reuters}, September 27, 2013.
\textsuperscript{517} Sutter and Huang 2013.
There is practically no evidence that any economic vulnerability prevented Manila from acting directly contrary to Chinese interests to the best of its capabilities.

5.6.8 The Philippines’ economic response

The impact of the maritime tensions on Sino-Philippine economic relations was neither broad nor deep—as predicted by the theory of asymmetry—meaning there is less available evidence in Manila’s economic policy response to Beijing’s minimal use of economic leverage. Without doubt, the vulnerability of the banana industry was real, and forced the government to respond with both short- and long-term measures. In the short term, Aquino ordered officials to find alternative export destinations, and trade missions were duly sent to the Middle East and Europe. The following year saw the first ever export of Philippine bananas to the United States, a goal which had long existed but which was pursued with extra vigor following the standoff. These policy responses were designed to lower the cost of diverting exports away from China when necessary, and helped reduce the degree of future asymmetry in this particular industry.

Yet China remained a very important market for bananas that could not be ignored. Accordingly, the long-term strategy developed by officials working in agriculture and quarantine was to improve the quality of production, packing and inspection of bananas, as well increasing rates of enforcement for rule violations. Increasing quality was intended to reduce the possibility that phytosanitary issues could be used as a reason to refuse exports in the future, thereby giving greater scope for international law to constrain Chinese economic statecraft and protect the

banana industry.\textsuperscript{521} In particular it was smaller producers—those most affected by Chinese customs difficulties—who received special assistance through the improvement of packing facilities and other production infrastructure in the Mindanao province (where banana producers are concentrated).

Both the short- and long-term policy responses of the Philippine government were designed to reduce the degree of asymmetry with China in the banana industry, and are thus auxiliary causal process observations which are consistent with the logic and expectations of the theory of asymmetry. Importantly, evidence of other specific economic policy responses is mostly absent. According to the theory, this is simply because the Philippines did not experience significant vulnerability that mandated a policy response in any other industry.\textsuperscript{522}

Nevertheless, the economic potential of trade and investment links with China remained vast, and during author interviews in November 2013 representatives of the business community consistently expressed the opinion that long-term Philippine development would undoubtedly need Chinese trade and capital. Government officials were more sanguine in their interviews, stating explicitly that the Chinese infrastructure financing model from the Arroyo years was not needed (nor, given its tied nature, particularly attractive) and that, other than in bananas, trade with China was healthy.\textsuperscript{523} The one area where economic cooperation remains possible is natural

\begin{flushleft}
\textsuperscript{521} One significant problem was that a significant number of bananas were being exported to China informally without any knowledge of the government, which were much less likely to conform to quality control standards. The customs difficulties with China gave impetus for the government to begin to address this widespread problem. One curious consequence of the crackdown was that, despite the sharp decline in banana exports to China, overall banana exports more than doubled in 2012. The reason was a lot of previously undocumented exports were now accounted for by the government: Author interview with Philippine officials with knowledge of banana exports, Manila, November 2013.
\textsuperscript{522} Tourism might be the sole exception as additional efforts were made to market the Philippines as a destination. As tourism is a fully substitutable consumer good this would also be consistent with the theory of asymmetry.
\textsuperscript{523} One Philippine foreign policy official described Chinese ‘Build, Operate, Transfer’ financing as a “glorified loan” and not an investment which the Philippines did not get much benefit from: Author interview, Manila, November 2013.
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resource development. In October 2013, the Filipino-British company Forum Energy reportedly began talks with China National Offshore Oil Cooperation about joint development of Reed Bank.\textsuperscript{524} It is doubtful, however, whether negotiations could ever be concluded in the absence of political agreement on administrative if not sovereign control over the relevant maritime territory.

5.7 Conclusion

Sino-Philippine relations saw both warm highs and acrimonious lows in the early 21\textsuperscript{st} century and with these fluctuations the Philippines experienced economic interdependence of contrasting varieties. During the Arroyo years, China’s lavish economic diplomacy and profuse political goodwill saw the Philippines enjoy what appeared to be significant benefits not just from trade but investment and ODA. Yet as time passed, allegations of corruption tainted the economic merit of these cooperative ventures. More seriously, it came to light that while receiving China’s economic largesse with one hand, Manila was giving away Philippine maritime territory with the other. This was not a story of an economically vulnerable state being coerced into submission, but a poor economy allowing its longer term strategic goals to be eroded for short-term economic gain. When awareness finally emerged of the salient interests being sacrificed, the political backlash was quickly followed by a policy reversal, demonstrating the power of political salience to neutralize economic influence, as was acknowledged in the positing of Hypothesis 2.

The dilemma faced by the Aquino administration during the Scarborough Shoal standoff was more complex. Philippine foreign policy has always been more reactive than deliberate, and

\[\text{\textsuperscript{524} “Philippines, China Oil Firms Eye Deal in Disputed Sea”. Japan Times, October 23, 2013.}\]
Manila sought a security policy which sought both to avoid armed escalation but also to signal resolve over what was now unquestionably a highly salient sovereignty dispute. Despite its fundamental lack of capabilities, Manila was able to act surprisingly boldly in pursuit of its interests in ways that explicitly rebuffed Chinese interests. This was anything but accommodating policy; indeed, it is almost impossible to imagine a more assertive policy that would not also have significantly increased the risk of armed conflict. Accordingly, as with the Japan case, a null result is recorded for Hypothesis 2.

Despite the obvious seriousness of the standoff, this chapter argues that there is compelling evidence that throughout the crisis the Philippines’ economic relationship with China was never really at risk. It was too costly for China to disrupt the linkages which formed the core of Sino-Philippine economic interdependence. The semiconductors and other electronic inputs produced in the Philippines as part of vertically fragmented production networks were insulated from political tension. It was only the more symbolic industry of bananas which bore the brunt of China’s wrath, but which had little impact on the broader economy. This evidence supports the theory of asymmetry and confirms Hypothesis 1.

Yet Philippine policymakers would acknowledge that the absence of direct costs does not also imply the absence of opportunity costs. The Philippines recently opened new casinos to attract regional gamblers, in particular from the lucrative Chinese market. This is the kind of consumer industry whose growth will suffer amid ongoing political tensions. The more the Chinese consumer market becomes a source of economic potential, the more vulnerable the Philippine economy will become, as the experience of the banana industry, and the (now Chinese-owned) Beatrice Supermarkets illustrates. While it has robustly defended its

525 “Manila Steps Up to Asia's Gaming Table”. Financial Times, July 12, 2012.
fundamental security interests, the Philippine government prefers to keep the economic and political relationships separate or “compartmentalized”, and wherever possible Manila deals with Beijing on this basis.\footnote{Author interviews with Philippine foreign policy officials and researchers, Manila, November 2013.}
6. SINGAPORE: Carefully Managing Economic Interdependence

6.1 Introduction

Singapore is a small city-state located in an important geostrategic position abutting the Straits of Malacca, the major sea line of communication connecting the Indian Ocean to the South China Sea and East Asia. Despite its status as a global trading and financial center, Singapore is dwarfed by China in terms of military capability, economic size and global influence. Nevertheless, Singapore is well-known for conducting its foreign affairs with strategic sophistication, rigid discipline, and a profound sense of its own strengths and limitations in a dangerous and uncertain world.\textsuperscript{527}

Singapore’s tiny size and lack of indigenous resources contribute to an inherent feeling of vulnerability which drives the nation’s policymaking. Fully aware that it cannot defend itself alone, foreign relations are an essential component Singapore’s security and foreign policies. China’s rise has therefore loomed large in Singapore’s strategic outlook, with the attractive economic opportunities on the mainland counterweighed by uncertainty regarding the future stability of regional order. Overall, bilateral relations have been predominantly positive since formal diplomatic ties began in 1990; like Australia, when differences have surfaced the stakes have been lower. Disagreeing with China has not involved \textit{as much} of a tradeoff between Singapore’s economic and security interests. This analysis therefore seeks to understand how a state with more conventional and largely positive bilateral relations has experienced economic interdependence with China and responded to the tradeoffs that do exist.

\textsuperscript{527} Leifer 2000; Archaya 2008.
Politically, Singapore’s governance exhibits unique stability and coherence, while its strategy and foreign policymaking reflect the pursuit of well-defined and consistent interests that are relatively untouched by domestic politics. Economically, the theory of asymmetry classifies Singapore as a hybrid of the “factory” and “headquarter” ideal-types; its trade with China is dominated by electronic components, but Singaporean government-linked companies (GLCs) are significant investors in China. The theory of asymmetry predicts the former economic linkage should be relatively more immune from disruption compared to the latter. Complicating the picture is Singapore’s status as a global shipping hub and entrepôt economy, importing and re-exporting large quantities of goods with little or no value-added. Overall, the theory predicts that Singapore should be relatively more vulnerable than Australia by virtue of its position in the transnational production network. Yet the unique features of Singapore’s polity and economy add complexity to the inquiry driven by Hypothesis 2 regarding whether actual or potential vulnerabilities from economic interdependence have affected the city-state’s security policy.

In light of these complexities, the major contribution of this chapter is to unpack the microfoundations of Sino-Singaporean economic interdependence. Singapore’s multifaceted economic ties with China have taught political and business leaders important lessons on the nature of vulnerability vis-à-vis China, and these experiences offer valuable inferential leverage for understanding how interdependence varies with the type of economic activity. Second, analyzing the unique nature of Singaporean policymaking enables an inquiry into how economic vulnerabilities feed into the strategic calculus of Singapore’s government, in conjunction with an evaluation of the facts regarding whether interdependence actually affected security policies.
6.2 Unpacking interdependence between Singapore and China

The level of interdependence between Singapore and China in the early 21st century according to traditional measures is represented in Table 6.1. At face value, these statistics confirm the disparity in economic size; China is a much larger trading partner for Singapore than the reverse. What distinguishes these numbers is the very high percentage of Singapore’s GDP that is comprised of two-way trade with China—much higher than the other three economies in this study, suggesting a high degree of reliance on China. But these figures are misleading; they include re-exports and re-imports pursuant to Singapore’s role as an entrepôt economy. Thus, even though two-way trade with China was almost two-fifths of Singapore’s GDP in 2006, China has never been Singapore’s largest trading partner, a distinction that continues to go to the much smaller Malaysia.528 Singapore’s trade with the world is close to three times its GDP (for most countries the percentage is far less), again illustrating why aggregate trade statistics can mislead as an indicator of interdependence. It is the breadth, depth and nature of trade and investment links which define interdependence and its connection to power and vulnerability.

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528 This remained true at least until the end of 2012, though given growth trends it is possible China overtook Malaysia in 2013.
Table 6.1: Merchandise Trade between Singapore and China

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<thead>
<tr>
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<th>Singapore</th>
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<th>China</th>
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<tr>
<td></td>
<td>2001 (rank)</td>
<td>2006 (rank)</td>
<td>2011 (rank)</td>
<td>2001 (rank)</td>
<td>2006 (rank)</td>
<td>2011 (rank)</td>
</tr>
<tr>
<td>Exports to China as a % of all Singapore exports</td>
<td>4.37 (5)</td>
<td>9.75 (4)</td>
<td>10.43 (4)</td>
<td>2.17 (7)</td>
<td>2.39 (7)</td>
<td>1.86 (9)</td>
</tr>
<tr>
<td>Imports from China as a % of all Singapore imports</td>
<td>6.2 (4)</td>
<td>11.41 (3)</td>
<td>10.39 (3)</td>
<td>2.11 (8)</td>
<td>2.23 (9)</td>
<td>1.59 (14)</td>
</tr>
<tr>
<td>Trade with China (EX + IM) as a % of Singapore GDP</td>
<td>13.74</td>
<td>38.67</td>
<td>32.7</td>
<td>0.83</td>
<td>1.51</td>
<td>0.86</td>
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<td>Exports to Singapore as a % of all Chinese exports</td>
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<td>Imports from Singapore as a % of all Chinese imports</td>
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<td>Trade with Singapore (EX + IM) as a % of Chinese GDP</td>
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<td>0.83</td>
<td>1.51</td>
<td>0.86</td>
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Sources: Author calculations based on: IMF, *Direction of Trade Statistics* and World Bank, *World Development Indicators*. China excludes Hong Kong.

6.3 Singapore as a hybrid economy: Combining factory, headquarter and *entrepôt* features

Singapore was one of the earliest beneficiaries of vertically fragmented production strategies. Technical advances in electronics in the United States from the late 1960s created the need for cheap labor to produce semiconductors, and newly independent Singapore was a viable early source. National Semiconductor and Texas Instruments arrived in 1968, and within seven years an ‘electronics revolution’ had absorbed all of Singapore’s unemployed labor as more and more American and European MNEs established production affiliates. As Singapore’s labor and property prices rose throughout the 1970s and 1980s, MNEs relocated the lowest value-added processes away from Singapore, while upgrading and automating their Singaporean

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operations to produce increasingly more advanced components such as hard disk drives. By the 2000s, Singapore had become a regional center for the design and fabrication of highly specialized electronic components such as integrated chips, which then fed into production networks across the region. By this time, Singapore was also host to a number of MNE regional headquarters, from where production facilities in nearby countries could be managed.\textsuperscript{531}

Throughout this evolution, two trends held. First, MNEs continued their dominance of Singaporean industry—between 2000 and 2004, the MNE share of exports was an astonishing 89 percent.\textsuperscript{532} Unsurprisingly, inward FDI constituted a very high percentage of Singapore’s GDP—consistently around 15 percent from 1990 to 2005, \textit{multiples} larger as a proportion than any other country in the region.\textsuperscript{533} In 2007, FDI was 60 percent of gross domestic capital formation, easily the highest in Asia (the average for Southeast Asia was 19.6 percent),\textsuperscript{534} and inward FDI stock more than tripled between 2001 and 2011.\textsuperscript{535} Throughout, components remained a very high

\textsuperscript{531} McKendrick et al 2000; Wu and Loy 2003; McKay 2006, 39; Athukorala 2008, 483; Athukorala 2009b, 400. More than 60 percent of the value-added in electronics manufacturing in 2011 was in semiconductors (broadly categorized): Wan 2013, 9. However, electronics have recently been on the decline, dropping from roughly 50 percent of total exports in 2005 to only 30 percent in 2012, in part because of Singapore’s relative lack of involvement in smart phone and tablet markets: Wan 2013, 2.

\textsuperscript{532} Athukorala 2008.

\textsuperscript{533} WTO and IDE-JETRO 2011, 53. By comparison, in 2009 China’s FDI inflows were 1.9 percent of GDP, Thailand’s 2.3 percent and Malaysia’s 0.7 percent. FDI as a percentage of Singapore’s GDP dropped in 2009 to nine percent during the global financial crisis: ibid. However, it recovered in 2010 and was back around 20 percent of GDP by 2012: World Bank, \textit{World Development Indicators}.

\textsuperscript{534} Athukorala 2009b, 379. Most of this capital, however, came from outside of Asia. As of 2011, over 70 percent of the stock of FDI came from Europe and the Americas: Author calculation based on data from Singapore Department of Statistics, \textit{Foreign Direct Investment in Singapore By Country/Region, 2008-2012}; see also Ying and Tan 2013. Note that over 20 percent of inward FDI originated from tax haven economies in Central America such as the British Virgin Islands, likely explaining why such as low percentage (11 percent) came directly from the United States. Moreover, in recent years much of the inward FDI has been held by financial holding companies (36 percent in 2011) because of Singapore’s attractive corporate governance and tax regimes: UNCTAD 2012, 7; Ying and Tan 2013.

\textsuperscript{535} Ying and Tan 2013. The trend was away from electronics and manufacturing more broadly (decreasing from 37.5 percent of total stock in 2001 to 20.4 percent in 2011): Ibid.
percentage of Singapore’s exports and imports of manufactured goods (57 and 54 percent respectively in 2007) with electronics consistently Singapore’s largest domestic export.\footnote{Kimura and Obashi, 2011, 4. In 2011, only one other economy had an imported content share of its exports of over 40 percent (Taiwan at 47 percent); WTO and JETRO 2011, 98. In 2011, electronics and machinery combined (HS84 and 85) constituted about 45 percent of Singapore’s total exports, down from around 60 percent in 2003: see data from Singapore Department of Statistics: <http://www.singstat.gov.sg/statistics/browse_by_theme/trade.html>. Accessed, January 11, 2013; see also: Lim 2013.}

These two trends ought to qualify Singapore as a “factory” economy.\footnote{Calculations of revealed comparative advantage within electronics product categories indicate that Singapore is very similar to the factory economies of the Philippines and Malaysia: Abe 2009, 9.} But electronics have been far from the city-state’s only business. During the 1990s Singapore’s government recognized that the economy was overexposed to electronics and encouraged the development of niche areas such as the biotechnology and pharmaceuticals industry. Industry output quadrupled in size between 2000 and 2010 by which time it accounted for about five percent of GDP.\footnote{Finegold et al 2004; Singapore Economic Development Board 2013.} In a similar vein, Singapore built significant hydrocarbon storage and refining facilities, and became a transit point for energy as well as a key trading and pricing center. In 2012, domestic oil exports—essentially refined petroleum—constituted almost a third of GDP, two-fifths of domestic exports and over a fifth of total exports, despite Singapore having no almost zero indigenous hydrocarbon reserves.\footnote{Singapore Department of Statistics; U.S. Energy Information Administration. Singapore Analysis. Updated March 12, 2013. Available at: <http://www.eia.gov/countries/country-data.cfm?fips=SN>. Accessed January 10, 2014. In 2012, the major destinations for Singapore’s refined petroleum exports were Malaysia (26 percent), Australia (13 percent), and China and Hong Kong (11 percent each): Ibid.} As investment in these developing industries rose, investment in electronics manufacturing steadily (if slowly) declined.\footnote{Ying and Tan 2013. On petrochemicals, see: Hing and Lee 2009.}

Yet the defining feature of Singapore’s economy is its strategic trading location and comparative advantage as an \textit{entrepôt} economy, where goods produced in other countries are routed through Singapore and officially recorded as Singaporean re-exports. To illustrate, in 2012 the size of
Singapore’s combined exports and imports was almost *three times* the value of overall output.\(^{541}\)

Numerous regional trade agreements\(^{542}\) further encouraged the flow of goods, and by 2011 Singapore hosted the second largest volume of container traffic (by country) in the region after China.\(^{543}\) *Entrepôt* trade has also made Singapore into a critical distribution and logistics hub, spurring the growth of specialized re-export services (such as quality control, sorting and packaging), increasing the share of Singapore’s re-exports from 34 percent of total exports in 1990 to 44 percent in 2012.\(^{544}\) This unique function is consistent with a “factory” economy designation since it renders Singapore even more dependent on external demand and imported inputs.\(^{545}\)

This discussion suggests that Singapore’s production and trade profile is defined (a) historically and concurrently by its position in the transnational production network as a component manufacturer and host to MNEs affiliates; (b) more recently by its refined petroleum and pharmaceuticals industries, and (c) always by its role as an *entrepôt* economy. Yet Singapore’s economy, and in particular its foreign economic strategy, are distinguished by an additional characteristic which makes Singapore look more like a “headquarter” economy: the prominence of its GLCs, principally Temasek Holdings.

Temasek Holdings was founded in June 1974 to hold and manage equity investments in a large number of SOEs that had been created during Singapore’s early years.\(^{546}\) During the 1980s and

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\(^{541}\) According to the Singapore Department of Statistics, total trade in 2012 was S$984.8 million (S$474.5 million imports, S$178.3 non-oil domestic exports, S$106.8 million domestic oil exports, and S$225.2 million re-exports), while GDP was $345.5 million.

\(^{542}\) Eighteen as of 2011, by far the largest in the region: WTO and IDE-JETRO 2011, 42

\(^{543}\) WTO and IDE-JETRO 2011, 31.

\(^{544}\) WTO and IDE-JETRO 2011, 24 and Singapore Department of Statistics. The combined re-exports of Hong Kong and Singapore constituted 11 percent of Asia’s total merchandise trade in 2009 and Singapore was ranked first in 2010 by the World Bank in ease of doing business: WTO and IDE-JETRO 2011, 24, 33.

\(^{545}\) Choy 2009.

\(^{546}\) Temasek is fully owned by Singapore’s Ministry on Finance which it holds in trust for the people of Singapore.
1990s, many of these companies were publically listed while Temasek chose to retain a controlling share of the best performers and in strategic industries. These companies became known as GLCs because the state preserved meaningful influence in their management control. By the late 1990s, the public sector and GLCs comprised around 60 percent of Singapore’s GDP. The market capitalization of first-tier GLCs controlled by Temasek encompassed 25 percent of the entire Singapore Stock Exchange. Each was a market leader in its respective industry.\textsuperscript{547}

During the 1990s, the Singaporean government made two judgments that were immensely consequential for GLCs and Singapore’s future foreign economic relations. The first was that achieving sustainable economic growth and maximizing state wealth in the long term necessitated a “regionalization program”. Singaporean commercial interests should branch out into the region and make new investments to exploit opportunities in regional markets. In doing so, they would acquire new skills and technology and improve their competitiveness. The second judgment was that the “historical underdevelopment of indigenous entrepreneurship in the private sector” meant that regionalization demanded government leadership.\textsuperscript{548} Accordingly, Temasek and other GLCs became central instruments of Singapore’s foreign economic policies by making and supporting strategic equity investments in foreign companies, forming joint ventures and leading large infrastructure projects.\textsuperscript{549} In concert, the government engaged in political entrepreneurship, using diplomacy to create business opportunities and institutional

\textsuperscript{547} Leung 2000; Leung 2004. By 31 March 2007, Temasek Holdings accounted for over a third of the capitalization of the Singapore Stock Exchange: Leung 2011, 642. Temasek is structured as an investment holding company and owns the assets it manages.\textsuperscript{548} Yeung 2004, 48.\textsuperscript{549} Temasek is run in a similar way to a private equity fund, operating as an active investor, seeking a share of at least 20 percent ownership and board representation: Elson 2008, 87-88.
frameworks in neighboring countries which GLCs and private companies could utilize, often in partnership with local commercial interests.\textsuperscript{550}

This strategy was the foreign economic policy version of the kinds of forward-looking state interventions which have been a distinctive driver of Singapore’s developmental success since independence. They are relevant to the theory of asymmetry because they imbued Singapore with “headquarter” economy features. Many Singaporean firms (especially GLCs) acquired and continue to own significant equity investments throughout the region, including in China. Most of these links were forged by GLCs as part of Singapore’s regionalization strategy. While the impetus was not the vertical fragmentation of production, the result is similar.

\textbf{6.4 Singapore and China in the transnational production network}

The bilateral economic relationship between Singapore and China is defined equally by its trade and investment components. Many of the major actors have significant ties to the state (Singaporean GLCs and Chinese SOEs), which means that mapping government-to-government cooperation is arguably more important to understanding economic interdependence between the two countries than understanding private economic links.

Two-way trade between Singapore and China boomed in the 2000s, increasing more than six-fold between 2001 and 2011, supported by a 2005 bilateral trade promotion agreement and a comprehensive free trade agreement concluded in September 2008.\textsuperscript{551} Over this period the composition of Singapore’s exports to China remained relatively stable. As seen in Figure 6.2, \textsuperscript{550}Yeung 2004, 48-49.\textsuperscript{551} This FTA is broader in scope than the ASEAN-China FTA: “Singapore, China Sign Trade Pact as Relations Warm after Taiwan Spat”. \textit{Agence-France Presse}, May 18, 2005; “S’pore, China Reach Free Trade Accord”. \textit{Straits Times}, September 5, 2008. Trade increases from author calculations based on: IMF, \textit{Direction of Trade Statistics}.\textsuperscript{550}
electronics and machinery maintained their status as the majority export, mainly because China became the largest market for high-end semiconductors which were being severely under-supplied by domestic Chinese production.\textsuperscript{552} Therefore, while Singapore’s overall electronics industry has gradually declined in importance, it has remained dominant in exports to China. In contrast, despite comprising nearly a third of all exports, only 13 percent of Singapore’s total refined petroleum exports went to China in 2012 (and another 11 percent to Hong Kong). These figures suggest that throughout the period under study Singapore maintained a factory economy position vis-à-vis China in the transnational production network.

**Figure 6.2: Top merchandise exports by Singapore to China, 2001-2011**

![Chart showing export distribution](chart.png)

Source: United Nations, *Comtrade*. Electronics and machinery defined as HS Codes 84 and 85. Excludes Hong Kong.

It is however in the investment sphere where the interaction of economics with politics has for Singapore formed a uniquely complex form of interdependence with China. After the

\textsuperscript{552} Wu and Loy 2004.
establishment of formal diplomatic relations in 1990, Singaporean investments rose steadily, and China became the number one destination for Singaporean FDI in the late 1990s. China accounted for 11.9 percent of Singapore’s total stock of outward FDI in 2001 and 18.3 percent in 2011, during which time it increased more than fivefold.\footnote{From S$15.7 billion to S$82.1 billion: Ying and Tan 2013, 7.} From China’s perspective, Singapore has consistently accounted for between four and five percent of its inward FDI since 2002.\footnote{Author calculations based on Davies 2010 and Davies 2012. This ranks Singapore about the sixth or seventh largest behind Hong Kong, the (tax-haven) British Virgin Islands, Japan, the United States and Taiwan. See also: “S’pore-China Ties Strong: Lim Hwee Hua”, Straits Times, May 11, 2011.} In 2011, around half this investment was in manufacturing and a quarter in real estate.\footnote{With 9.3 percent in financial and insurance services and 4.1 percent in wholesale/retail: Ying and Tan 2013.}

The majority of this investment is controlled by GLCs; Temasek alone controlled upwards of 45 percent Singapore’s stock of FDI in China in 2011, with Chinese exposure between 20-25 percent of its portfolio.\footnote{In 2011 Singapore’s stock of FDI in China was roughly S$82 billion, while the China exposure in Temasek’s portfolio of S$193 billion was at least 20 percent (probably higher), which calculates to about S$39 billion in assets, or 47.5 percent of Singapore’s total. This of course does not include the assets held by the Government of Singapore Investment Corporation (GIC), which does not give specific details of its investments. See: “Challenges on Many Fronts for Temasek”. Straits Times, July 8, 2011. Author calculations are based on data in Ying and Tan 2013 and Temasek’s 2011 and 2013 annual reports and the Straits Times article.} The most high-profile of Temasek’s investments are multi-billion dollar equity stakes in two major Chinese banks acquired in 2005.\footnote{“‘Singapore PM Says Temasek Independent in China Deals”, Reuters, October 6, 2005. The amounts were $1.47 billion for 5.1 percent stake in China Construction Bank and $3.6 billion for a 10 percent stake in the Bank of China.} The heavy involvement of GLCs means that the status of Singaporean investments in China engages the Singaporean government’s interests more directly than for other foreign governments. Government-to-
government economic cooperation has shaped the nature of Singapore’s interdependence with China as much as any other factor.\footnote{Although Temasek is a wholly state-owned company, the government emphasizes that both it and its subsidiaries operate as private entities on a strictly commercial basis: “Temasek’s Links in China Reflect Strong Ties: PM Lee”. \textit{Business Times Singapore}, October 25, 2005.}

Singapore’s experience with the China-Singapore Suzhou Industrial Park (SIP) was almost certainly the most influential factor shaping Singapore’s approach to investing in China over the period under study.\footnote{In author interviews with current and former Singaporean officials (Singapore, December 2013), SIP was always the first or second thing mentioned in discussing economic relations between the two countries. SIP and the Tianjin Eco-City (discussed below) were also the two flagship projects cited as examples of the strength of the long-term relationship when a free trade agreement was signed in 2008: “S’pore, China Reach Free Trade Accord”. \textit{Straits Times}, September 5, 2008. They were also cited by Prime Minister Lee in his 2012 speech to the Chinese Community Party’s Central Party School in Beijing: Lee, HL 2012.} Inaugurated in 1994, the vision of SIP was to build a township which blended Singaporean capital and administrative and business expertise with abundant Chinese labor and land resources. As the flagship project of government-to-government economic cooperation, SIP fulfilled economic and strategic objectives for both sides, and thus commanded a high level of political attention. For Singapore, industrial parks were a key element of the government’s regionalization program, and SIP was also an opportunity to improve political relations with Beijing. For China, SIP would be a key lure for foreign investors, as well as offering valuable insight into Singaporean administrative techniques that could be replicated in other parts of the country.\footnote{Perry and Yeoh 2000; Pereira 2004; Zhao and Farole 2011.}

The project was led by a Singaporean consortium comprised of GLCs, statutory boards and private companies, taking 65 percent of a joint venture, while a consortium of local Chinese SOEs held the remainder. The SIP started positively but by 1997 problems appeared, in particular competition from a rival industrial park in Suzhou that, to the chagrin of the Singaporeans, was receiving the support of local Suzhou authorities in violation of a directive...
Frustrated, embarrassed, and losing tens of millions of dollars, the Singaporean government renounced its leadership of the project in 1999 and reduced its shareholding to a minority position in 2001.\textsuperscript{562}

The underlying cause of these difficulties was, ironically, Singapore’s focus on developing the project and building goodwill with China’s central government, at the expense of cultivating relations at the local level. Singapore’s leadership held the mistaken belief that positive relations with their counterparts in Beijing would be sufficient to ensure the success of the project. In fact, China’s economic reform in the 1980s had reduced the central government’s power at the local level, giving greater autonomy to local authorities and economic elites to pursue their own development strategies.\textsuperscript{563} This meant that for foreign investors, the degree of political commitment and patronage of local officials and cadre/business elites became critical to an investment’s success.\textsuperscript{564} The Singaporean government and its GLCs had not yet realized this, and in their focus on dealing with Beijing alienated Suzhou authorities, who opted instead to divert resources and efforts to the rival industrial park which could undercut SIP’s prices.\textsuperscript{565}

While SIP was the most high-profile and embarrassing experience for Singapore, it is one of many challenges that have been faced by both GLCs and private companies. According to Singaporean financial professionals, “Singapore has lost a lot of money in China over the years”

\textsuperscript{562} Yeung 2000; Pereira 2004; Zhao and Farole 2011.
\textsuperscript{563} Yeung 2000; Yeung 2004; Pereira 2004; Gu and Chan 2009.
\textsuperscript{564} Yeung 2000; Yeung 2004. Another way of describing this reality is the necessity of developing good \textit{guanxi} (informal networks) with local authorities: Gu and Chan 2009.
\textsuperscript{565} Yeung 2000. In the words of (then) Deputy Prime Minister Lee Hsien Loong in 1999: “I think we underestimated the length of the chain of command between the center and the locals, and the extent to which the locals have latitude”. If Singapore had known that the local perspectives often prevailed over those of the center in Beijing, “we might have made a different calculation”: “Suzhou Project ‘more ambitious than thought’”. \textit{Straits Times}, July 10, 1999. Yeung (2000, 827-829) describes another, smaller industrial park founded around the same time as Suzhou as a joint venture between Singaporean GLCs and local interests in Wuxi that was immediately successful. The difference was from the beginning the Singaporean government played a reduced role, giving managers on the ground the flexibility to operate on a purely commercial basis in partnership with the local Wuxi government.
engaging in the “wild west” of the Chinese market; “everyone knows someone [who has had a negative experience and lost money]”. Moreover, SIP illustrates that disrupting a Singaporean investment could occur at minimal cost to China, indicating a high degree of asymmetry in this type of relationship.

**Theoretical predictions:** The theory of asymmetry predicts that the “factory” component of Singapore’s economy—its electronics industry—should enjoy a greater degree of symmetry in links with China than the “headquarter” component, because the costs to China of disrupting Singaporean trade are greater than disrupting Singaporean investments. Accordingly, the investment relationship should be more vulnerable to disruption and use as leverage. Overall, with factory and headquarter economy features, the theory of asymmetry predicts that compared to the “resource” economy Australia, the Singapore should face higher relative disruption losses and been more vulnerable. Hypothesis 2 tests whether this increased vulnerability is associated with greater accommodation in security policy.

### 6.5 Economic interdependence in Sino-Singaporean political relations

#### 6.5.1 Singaporean interests and strategies

Under the continuous rule of the People’s Action Party since the city-state achieved self-governance in 1959, Singapore’s government is distinguished by its unitary character. Policymaking is “highly centralized, top-down and seamlessly integrated across the

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566 Author interviews with Singaporeans working in private banking and finance with experience in the Chinese market, Singapore, December 2013.
567 Further symmetry is added by Singapore’s entrepôt status and high concentration of foreign industry, since it would be relatively more difficult to identify trade flows as being certifiably Singaporean when a significant proportion will be owned by, designated for, or originate from a third country.
government’s political and bureaucratic strata”. Relative to the other countries in this study, foreign and defense policy is immune from domestic politics and supported by a highly effective bureaucracy. This enables Singapore’s leaders (there have been only three Prime Ministers since independence) to pursue Singapore’s national interests with a precision and clarity of purpose that is almost unique in world politics.

The principles motivating Singaporean foreign policy are regularly outlined by senior leaders in public speeches. Above all, according to former President S.R. Nathan, Singapore is motivated by its “inherent vulnerability”, which stems both from its history—the difficult circumstances of Singapore’s independence and post-independence tensions with its neighbors—and from its small size and lack natural resources, which limit the state’s development potential. This vulnerability manifests in the pursuit of three core interests: “independence, survival and growth”. These interests interlock and mutually reinforce each other, and are pursued with an intense pragmatism which is the hallmark of Singaporean strategy and policy. Understanding these interests, and the strategies and policies Singapore has deployed to achieve them, is necessary to identify the areas of discord in Sino-Singaporean relations, the impact of economic interdependence, and a baseline security policy against which policy choices can be evaluated.

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568 Medeiros et al 2008, 161. The authors observe that while there are policy and bureaucratic differences, they are rarely aired in public and bureaucratic actors rarely pursue overtly conflicting agendas. As a result, there has been no public debate about China policy: ibid, 162. The sole recent exception is controversy over the role and status of Chinese nationals working in Singapore and broader questions about how Singapore maintains its delicate ethnic balance amid declining birth rates. This is approached, however, as a domestic policy issue: “Ferrari Crash Foments Antiforeigner Feelings in Singapore”. Wall Street Journal Online, May 25, 2012; “In Singapore, Vitriol against Chinese Newcomers”. New York Times, July 27, 2012.

569 Nathan 2008; On Singapore’s independence see Leifer 2000, 27-32.

570 Tan 2012.
Survival: Fostering a regional balance of power by engaging the United States

Singapore has never felt a direct threat from China but recognizes China’s rise will fundamentally reshape the existing regional order. Acknowledging that its own capabilities will never be sufficient to ensure its survival, Singapore has sought to influence the regional power transition to promote continued stability. Singaporean leaders worry China’s volatile nationalist-driven domestic politics may result in bullying or aggressive behavior. These concerns render the continued presence of the United States a vital counterweight to prevent China from imposing its will over smaller countries in the region. In the words of Singapore’s second Prime Minister Goh Chok Tong: “many in the region would feel more assured if East Asia remains in balance as China grows. In fact, maintaining balance is the over-arching strategic objective in East Asia currently, and only with the help of the U.S. can East Asia achieve this”.

The security policy manifestation of this strategy has been to deepen both military and economic cooperation with the U.S. and openly encourage its regional engagement. During Lee Hsien Loong’s first visit to the United States as Prime Minister in July 2005, the two countries signed a Strategic Framework Agreement (SFA) which formalized the ‘special relationship’ (Singapore was denoted a ‘major security cooperation partner’), and created an umbrella platform combining existing and planned security and defense cooperation. Lee said the SFA would “help to anchor the U.S. presence in Asia, and enhance the region's stability”.

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571 Archaya 2008, 100.
572 Storey 2011, 236.
573 Goh 2003.
574 Symbolic of the importance the U.S. placed on the relationship, this was the first agreement of its kind with a non-ally since the end of the Cold War. Defense Minister Teo Chee Hean described the relationship as “more than
Singapore has hosted U.S. military forces to promote American engagement; in 2010, Singapore hosted 146 U.S. Navy ships. Singapore does not operate any aircraft carriers, yet built a port deep enough at Changi Naval Base to accommodate U.S. carriers. In 2012, the Singaporean government approved a request from the U.S. Navy to deploy up to four littoral combat ships, a decision which is speculated to have been driven by increasing concern about China’s naval reach and the potential for maritime conflict. When Prime Minister Lee Hsien Loong visited the United States in 2013, U.S. President Barack Obama highlighted the “extraordinary relationship” between the two countries.

*Independence: Between China and the United States*

Beijing disapproves of Singapore’s close relationship with the United States, believing that bilateral military cooperation with Singapore may allow the U.S. to block or restrain China’s military influence. Yet Singapore refrains from positioning itself too closely to either major power. *Independence* is the second of Singapore’s interlocking core interests and is vitally important for four distinct reasons. First, Singapore never wants to become too close to or dependent on a major power, for fear of being compelled (by its own weakness) into overly accommodating policies. Second, the benefits of an alliance with either the United States or China would be outweighed by the costs from the damage to Singapore’s relationship with the

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575 Lee, HL 2005; The SFA also provided Singapore with access to advanced technology and weapons to allow it to maintain a qualitative advantage over its neighbors and project a credible military deterrent: Storey 2011, 239.
577 “Sino-S’pore Bond is Special, Says Ng Eng Hen”. *Straits Times*, June 22, 2012.
578 Tan 2012, 258.
other power.\textsuperscript{581} Third, as a predominantly ethnic Chinese country surrounded by neighbors who are majority non-Chinese,\textsuperscript{582} it is critical for Singapore to be seen to be acting on its own behalf.\textsuperscript{583} Finally, Singapore’s independence gives its voice credibility in the international community, allowing Singapore to act as an impartial and influential interlocutor between Asian and western styles of diplomacy.\textsuperscript{584}

Singapore’s desire for independence and autonomy thus restrains it from entering into a formal alliance with the United States; the SFA deliberately stopped short of this. Singapore has also sought to enhance its security cooperation with China, signing a bilateral Agreement on Defense Exchanges and Security Cooperation in January 2008, which formalized existing defense activities and created a framework for enhanced cooperation. The inaugural bilateral training exercise was conducted in China in June 2009.\textsuperscript{585} Yet defense cooperation with China is constrained by Singapore’s continued desire for access to advanced U.S. military technology, which would be jeopardized by working too close with the Chinese military.\textsuperscript{586}

\textit{Economic prosperity: The strategic pursuit of growth}

As with survival, all states seek to grow their economies, but economic prosperity takes on added strategic significance in Singapore as a means of overcoming its inherent vulnerabilities, feeding into its pursuit of survival and independence.\textsuperscript{587} At a basic level, economic prosperity is

\textsuperscript{581} Given it is impossible to predict whether China or the United States will prevail in a hypothetical power struggle, Singapore does not want to have to choose in the interim: Acharya 2008; Lim and Cooper 2014.\textsuperscript{}

\textsuperscript{582} But which are home to minority Chinese populations in delicate situations within the domestic political space.\textsuperscript{}

\textsuperscript{583} Lee 2012.\textsuperscript{}

\textsuperscript{584} Goh 2004.\textsuperscript{}

\textsuperscript{585} “Sino-Singaporean Joint Exercise Boosts Military Ties: Defense Ministry”. \textit{Xinhua News Agency}, June 24, 2009.\textsuperscript{}

\textsuperscript{586} Interview with former Singaporean foreign policy official, location and date withheld to ensure anonymity. In April 2012, Defense Minister Ng Eng Hen described growing security cooperation with China as “qualitatively different” from that with the U.S.: “US Closest Defence Partner with S’pore”. \textit{Straits Times}, April 7, 2012.\textsuperscript{}

\textsuperscript{587} Goh 2004 terms this “the economic imperative” which defines Singaporean national interest.
a necessary long-term condition for military capabilities, while building trade, investment and financial links with other states nurtures interdependence, raising the cost of attacking Singapore. In the words of Singapore’s first Foreign Minister S. Rajaratnam: “An independent Singapore survives and will survive because it has established a relationship of interdependence in the rapidly expanding global economic system”.

At a secondary level, pursuing economic growth through mutually-beneficial international economic links increases Singapore’s relevance and diplomatic clout in the international arena. Greater relevance feeds back into Singapore’s other core interests. According to Senior Minister S. Jayakumar in 2010, the “challenge for small states like Singapore is to continually search for, and create, our political, economic and diplomatic relevance which will ensure our continued well-being and survival”. Economic growth and prosperity is also a key element of the domestic legitimacy of the ruling People’s Action Party.

Economic growth also allows Singapore to save resources as insurance against an uncertain future. Singapore’s two sovereign wealth funds—Temasek and the Government of Singapore Investment Corporation (GIC)—are the key strategic instruments for this task. GIC was formed in 1981 to manage surplus funds generated by the government and central bank. It is run like an asset management company and, unlike Temasek, invests passively and only in overseas markets. The Singaporean government strategically utilizes GIC to insure against uncertainty in the international system. In its 2006 annual report, GIC wrote that “with no natural resources

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588 Matthews and Yan 2007.
590 Jayakumar 2010. This statement built on a quote from Lee Kuan Yew in 2009: “We must make ourselves relevant so that other countries have an interest in our continued survival and prosperity as a sovereign and independent nation”: Lee KY 2009.
591 Kuik 2008.
592 GIC is a low-profile passive investor, rejecting management roles in the companies in which it invests: Wu 2008.
to keep the country going in times of crisis or severe economic dislocation, these (foreign) reserves are a nest egg, a safeguard against unforeseen circumstances, and the means to mitigate shocks that might hit Singapore’s small and open economy.”

Conceptualizing economic growth and prosperity as a fundamental national interest has important implications for Singapore’s China strategy. With Singapore’s close ties with the U.S. limiting its security cooperation with China, economics has been the primary instrument of Singapore’s engagement with the rising power. Lee Hsien Loong described it simply as “In Asia, trade is strategy”. Trade and investment relationships tap China’s vast potential to expand Singapore’s economic opportunities. They make Singapore relevant and influential. Furthermore, building mutually beneficial economic links demonstrates to Beijing that cooperation within the existing international order is the optimal means through which China can achieve its interests. This aims to reduce the likelihood of conflict both by socializing China into existing norms of state behavior, and improving China’s internal stability via economic growth.

Summary: A familiar dilemma

The interests of survival, independence and prosperity are fundamental to Singapore and of high political salience. They create a complex calculus for Singapore’s leadership as every decision must be analyzed through the prism of multiple and sometimes competing strategic imperatives. The relationship with China is the greatest challenge. Economic cooperation and engagement with China have important strategic implications for Singapore’s interests in survival and

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593 Clark and Monk 2010, 439. Yeung describes how initially Temasek and GIC served the domestic purpose of securing Singapore’s economic future. However, as Singapore’s goals expanded and became more outward oriented, the two giants have engaged in economic diplomacy, leading activities to improve interstate economic relations in addition to achieving commercial success. Yeung describes it as a “double bottom line”—maximizing profits and supporting national interests: Yeung 2011, 644.

594 The quote comes from a speech Lee Hsien Loong gave in 2013 urging the U.S. to adopt a more active trade agenda in the region: Lee, HL 2013.

independence, not just economic growth. Conversely, if political discord with China harmed economic ties, Singapore’s overall capacity to pursue its objectives would also be compromised. Conflicts between economics and security are therefore a familiar dilemma to Singaporean strategists because they are inherent in Singapore’s fundamental interests, and do not just arise on an issue-by-issue basis.

6.5.2. Economic vulnerability and Singaporean security policy

To analyze how Singapore has managed the conflict between economic and security interests, the analysis of Singaporean security policy begins with a one-off crisis in Sino-Singaporean ties over Taiwan before shifting to broader patterns over time.

*Singapore, Taiwan and China: Responding to a crisis*

There is no issue more sensitive to China than the status of Taiwan, and Beijing has long disapproved of Singapore’s cooperative relationship with Taipei. Lacking the space for large-scale military maneuvers, Singapore began operating three training camps in Taiwan in 1975 under a program called “Operation Hsing Kuang” (Starlight). At the peak of the operation in the 1980s, 15,000 troops were sent to Taiwan each year. From the 1990s, the program began gradually to be scaled back as the Singaporean government established relationships with other countries to host its training activities. In 2006, approximately 7,000 troops made the journey to Taiwan.⁵⁹⁶

Fully appreciating how seriously China approached the issue, Singaporean leaders always ensured that relations with Taipei were low profile, even though senior leaders, from founding

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⁵⁹⁶ “Singapore Military Juggles Ties with Taiwan, China”. *Reuters*, August 24, 2006. Whether the reduction was in response to Chinese pressure is not known but the subject of speculation: Storey 2011, 248.
Prime Minister Lee Kuan Yew downward, would make regular trips. Visits followed a set ritual: the Singapore minister planning to visit would take official leave from his job so that the visit could be described as private; Singapore would inform Beijing, which would ask that the visit not take place (and threaten unspecified consequences), and the visit would proceed anyway. With neither side wanting to jeopardize flourishing economic and political ties, China tolerated the relationship and Singaporean leaders were careful to respect Chinese sensitivities.\(^597\) This pattern signified Singapore’s consistent pursuit of its security interests while displaying courtesy and respect towards China.

This ritual was followed in July 2004 when Deputy Prime Minister Lee Hsien Loong (son of founding Prime Minister Lee Kuan Yew) visited Taipei. The timing was carefully planned—long enough after the Taiwanese Presidential election (March), after Lee had first visited Beijing (May), but before he officially replaced the retiring Goh Chok Tong as Prime Minister (which happened the following month).\(^598\) From Singapore’s perspective, its stance had not shifted on the Taiwan issue—the visit was status quo.\(^599\)

Beijing’s reaction was not. A foreign ministry spokesperson immediately described the visit as “a serious violation of Singapore Government’s commitment to the ‘one China’ policy and will harm the political foundation of Sino-Singaporean relations”, warning that Singapore must “take all responsibilities for the consequences arising”.\(^600\) China’s Ambassador to Singapore Zhang Yun said the visit had “hurt the core interests of China and the feelings of 1.3 billion Chinese

people”, accusing Lee of helping Taiwan’s independence forces and therefore undermining regional stability.\(^{601}\)

Beijing cancelled a series of bilateral visits and exchange programs at all levels. More significantly, Beijing postponed the start of FTA negotiations that had been announced when Lee visited a few months earlier; talks would not restart until late 2006.\(^{602}\) After earlier granting approval, Shanghai authorities cancelled a trade fair organized by a Singaporean company dubbed the ‘Singapore Carnival’, just two weeks before the event was due to open.\(^{603}\) Over 100 Chinese officials delayed plans to attend two lucrative master’s degree programs at Nanyang Technological University specifically designed for Chinese civil servants to learn about Singapore’s economy.\(^{604}\) In the summation of Lee Kuan Yew, China “just froze all economic ties at the official level”.\(^{605}\)

At least three factors explain Beijing’s severe reaction. First, cross-strait relations had recently worsened following the re-election of pro-independence President Chen Shui-bian in Taiwan, likely reducing China’s tolerance of Singapore-Taiwan relations. Second, as Lee was about to become Prime Minister, China’s fury was viewed in Singapore as a test of Lee’s mettle.\(^{606}\) The incident was not reported by national daily newspapers in China, suggesting the intended

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\(^{603}\) “Shanghai Scraps Fair Organised by Singapore Firm”. \textit{Straits Times}, July 17, 2004. The report did not mention Lee Hsien Loong’s Taiwan trip and authorities claimed the issues were unrelated. However, the last-minute timing of the cancellation suggests otherwise: “Politics Suspected in Cancelled Singapore Festival in Shanghai”. \textit{Kyodo}, July 18, 2004.

\(^{604}\) “Chinese Officials Put Off Study Plans Here”. \textit{Straits Times}, July 18, 2004. There were no non-Chinese students in the programs.

\(^{605}\) Lee, KY 2005. Lee continued: “We are a very small part of their economy, but they are a significant part of ours – and they are fully aware of this. It’s a lever they will use from time to time”.

Third, there is some sense that the response reflected a broader displeasure at a perceived “American tilt” by Singapore. Singapore had commenced an FTA with the U.S. in January 2004, and recent reports suggested that Singapore had proposed that the U.S. deploy marines to the Malacca Straits to combat terrorism, a location a Chinese diplomat described as a “choke point” for China.

Lee’s initial response to the spat was to affirm Singapore’s independence, explaining that “to call off the trip at China’s request would have undermined our right to make independent decisions, and damaged our international standing. As a small country, this is a vital consideration in our dealings with all countries”. The following month at his first National Rally Day speech just ten days after becoming Prime Minister, Lee explained that the cross-strait situation was potentially the most dangerous in the region and he personally needed to understand the thinking on the Taiwanese side. Singapore needed to be informed so its opinion would stay relevant, and Lee did not see the visit as a change in status quo from Singapore’s clear support of a ‘one China’ policy.

Had Lee stopped there, the incident would have remained a clear-cut case of Singapore asserting its core interest in independence despite major diplomatic and minor economic pressure from Beijing. However, the Prime Minister continued on in his speech, rebuking Taiwan and accusing the Taiwanese people of not appreciating “the international strategic environment”, warning that Singapore would not support Taiwan if it “provoked” a conflict with China, and asserting that

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608 Cheow 2005.
609 Cheow 2005.
“many Taiwanese believe China will not use force on Taiwan, even if it moves towards independence. They are wrong”.\textsuperscript{612}

Beijing, seemingly satisfied with this strong language, signaled its tacit approval by “noting” Singapore’s commitment to the one China policy and opposition to Taiwanese independence.\textsuperscript{613} But Singaporean leaders went further; in a speech at the United Nations the following month, Foreign Minister George Yeo criticized pro-independence groups inside Taiwan for risking a war with China, inciting a furious response from the Taiwanese foreign minister and even the burning of a Singaporean flag in Taipei by pro-independence activists.\textsuperscript{614} In November, following a meeting with Chinese President Hu Jintao, Lee Hsien Loong described Taiwan as the region’s “most dangerous” flashpoint.\textsuperscript{615} Four months later in March 2005, Singapore refused a planned port call by two Taiwanese naval vessels; a last-minute decision which Taiwan claimed was because of pressure from China.\textsuperscript{616}

These strong statements appear to have been an attempt by Singapore’s leaders to repair the damage done by Lee’s Taiwan visit. They were not without justification—a cross-strait conflict would cost Singapore and, worse, possibly require the choosing of sides, inevitably destroying relations with either the United States or China.\textsuperscript{617} Nevertheless, Lee “spared no effort”\textsuperscript{618} and

\footnotesize
\begin{itemize}
  \item \textsuperscript{613} “Beijing Notes S’pore’s One-China Policy”. \textit{Straits Times}, August 26, 2004.
  \item \textsuperscript{615} “Taiwan is Our Most Dangerous Flashpoint, Says Singapore's PM”. \textit{South China Morning Post}, November 21, 2004, 7.
  \item \textsuperscript{616} “Taiwanese Navy Ships Denied Entry to Singapore”. \textit{South China Morning Post}, March 23, 2005. However that same day Singapore had been forced to deny Taiwanese reports it was planning to conduct war games inside Taiwan with local forces, suggesting Singapore’s refusal was more about signaling its displeasure with Taipei than accommodating Beijing. Two Singaporean naval vessels visited Taiwan the following month.
  \item \textsuperscript{617} Storey 2011, 246-47.
  \item \textsuperscript{618} Rodan 2005.
\end{itemize}
was criticized for sending a “muddled message” that risked encouraging China’s hawks to be more aggressive.619

Identifying a pattern: ‘Tit-for-tat’ in Singapore’s China policies

The narrative of the 2004 Taiwan episode is potentially an element of a larger “tit-for-tat” pattern whereby Singapore’s foreign and security policies oscillate within a range, never settling at an equilibrium which is too accommodating of or too conflicting with Chinese interests.620 Other cases appear to fit this pattern. In 2009, in the months immediately before and after a visit by President Hu to Singapore for a multilateral summit, Lee Kuan Yew made controversial statements about the need for the U.S. to stay engaged in the region and the need for Singapore to ensure it never became a ‘satellite’ of any nation.621 In August 2010, Singapore and Taiwan announced the launch of FTA negotiations.622 Lee Hsien Loong visited China the following month to celebrate the 20th anniversary of diplomatic relations and, the day after he departed, Foreign Minister Yeo visited the Panchen Lama, a controversial Beijing-sponsored successor to the Dalai Lama—the first foreign leader to do so.623

In June 2011, the Chinese marine patrol ship Haixun 31 made a planned voyage to Singapore, but took an unexpected route through disputed areas in the South China Sea. The route was interpreted as a show of resolve to defend China’s sovereignty claims.624 Caught by surprise and receiving a high number of media inquiries, the Ministry of Foreign Affairs released a statement

620 The same could be said with respect to the interests of the United States.
623 “George Yeo Meets Tibet’s Panchen Lama”. Straits Times, September 15, 2010. The visit was covered on China’s state broadcaster’s prime news bulletin. Yeo had asked to meet the Panchen Lama when he visited Tibet in August 2009.
calling on China to clarify “with more precision” the extent of its claims in the SCS, saying its “ambiguity” had only heightened concerns in the region.\textsuperscript{625} Singapore did not wish the vessel’s route to implicate it in China’s claims.\textsuperscript{626}

During a visit to the United States in February 2012, (new) Foreign Minister Shanmugam warned the U.S. not to try to contain China,\textsuperscript{627} but in June of that year Singapore agreed to host U.S. littoral combat ships on a rotating basis. A few months later in September, Lee Hsien Loong made a successful visit to China where he had the rare honor to meet five members of the Politburo Standing Committee.\textsuperscript{628} Yet he also delivered a widely-reported speech to the Central Party School arguing that the Chinese should not view the U.S. as a declining power, and calling for a regional solution to SCS disputes.\textsuperscript{629} In September 2013, less than two weeks after another successful Lee Hsien Loong visit to China during which a Politburo Standing Committee member was appointed to a Joint Council for Bilateral Cooperation (JCBC) with Singapore,\textsuperscript{630} Singapore and Vietnam upgraded relations to a strategic partnership.\textsuperscript{631}

These observations are of events closely proximate in time, and there is no direct evidence linking an event to any other. Nevertheless, Singapore is known for its deliberate and disciplined strategic approach to its international affairs and for the absence of mistakes. Together, these

\textsuperscript{626} Wain, Barry. “Tossed in a Stormy Sea of Subterfuge”. \textit{Straits Times}, June 23, 2011. Wain reported that media statements sent from the Haixun 31 en route to Singapore stated that “the purpose of the journey is to protect China's maritime rights and sovereignty”.
\textsuperscript{629} Lee, HL 2012.
\textsuperscript{630} New Chinese President Xi declared ties with Singapore to be in “in excellent shape”, and appointed a member from the politburo standing committee to the Joint Council for Bilateral Cooperation (JCBC) with Singapore, which was the highest rank appointment ever: “Singapore/China Politics: Deeper Ties”. \textit{Economist Intelligence Unit}, September 16, 2013.
events form a pattern consistent with a ‘tit-for-tat’ strategy that emphasizes independence and never aligning Singapore too closely to a major power.\textsuperscript{632}

\textbf{Table 6.3: Security and foreign policy under Lee Hsien Loong—‘tit-for-tat’?}

<table>
<thead>
<tr>
<th>Date</th>
<th>Towards Chinese interests</th>
<th>Away from Chinese interests</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>Aug-Nov: PM Lee &amp; FM Yeo criticize Taiwan’s independence movement.</td>
<td>July: PM Lee visits Taiwan just prior to becoming Prime Minister.</td>
</tr>
<tr>
<td>2009</td>
<td>November: President Hu visits Singapore for the APEC summit. Meets with PM Lee, offers assistance to ‘ensure the safety of the Strait of Malacca’.</td>
<td>October: Lee Kuan Yew (LKY) makes controversial remarks on China’s naval modernization and the need for U.S. to stay in the region. December: LKY says that Singapore must never descend to becoming a ‘satellite’ of Beijing or any other power.</td>
</tr>
<tr>
<td>2010</td>
<td>September 6-14: PM Lee visits China to mark 20\textsuperscript{th} anniversary of diplomatic relations. September 15: After PM Lee departs Beijing, FM Yeo visits Beijing-sponsored Panchen Lama</td>
<td>August: Announcement of negotiations for Singapore-Taiwan FTA.</td>
</tr>
<tr>
<td>2011</td>
<td>June: Chinese marine patrol ship takes unexpected route through disputed South China Sea prior to planned visit to Singapore.</td>
<td>June: Following patrol ship’s visit, Singaporean Ministry of Foreign Affairs releases statement calling on China to clarify its South China Sea claims.</td>
</tr>
<tr>
<td>2013</td>
<td>August: PM Lee visits China. Politburo member appointed to Joint Council for Bilateral Cooperation.</td>
<td>September: Singapore upgrades relations with Vietnam to a strategic partnership.</td>
</tr>
</tbody>
</table>

\textsuperscript{632} An alternative view is that they reflect a sophisticated evaluation of regional politics and the need for Singapore to stay a step ahead: Author interview with former Singaporean foreign policy official, Singapore, December 2013.
Conclusion: Has Singaporean security policy accommodated China?

The foregoing discussion yields at least one firm conclusion, which is that Singaporean strategy and policy has always been sensitive to economic vulnerability, but in a macro-strategic sense; policymakers are sensitive to how any vulnerability, economic or otherwise, may compromise the pursuit of Singapore’s fundamental interests in survival, independence and prosperity. Yet the mechanism through which economic vulnerability has an impact in Singapore is different to other states. Policymakers’ concern comes not from bottom-up political pressure applied by private economic actors, but because Singapore’s unique political structure allows for the weighing of competing political interests within a long-term strategic calculus. To test Hypothesis 2 one must look for evidence of a specific vulnerability arising from economic interdependence with China causing Singapore to adopt security policies relatively more accommodating of Chinese interests. Unfortunately, the evidence—primarily arising from the Taiwan episode—is inconclusive.

On one hand, the economic disruption experienced by Singapore in the aftermath of Lee Hsien Loong’s visit was minor. Trade flows were never disrupted and Singaporean investments in China were not broadly or routinely harassed. The economic effects were limited to a temporary suspension of government-to-government cooperation—an important part of the overall relationship, but not a very costly disruption of an asymmetric economic link. China’s angry response might more accurately be described as a diplomatic freeze with minor economic ramifications. In the absence of significant economic disruption, the inferential leverage that can be drawn from the episode on the impact of interdependence is low.
On the other hand, Singapore may still have overcorrected following Lee’s Taiwan visit, and in doing so temporarily compromised the perception of independence it initially sought to protect. Singapore began the episode believing it was maintaining the status quo but by the end its leaders were making public statements much closer to Chinese interests. Singaporean policymakers acknowledge in interviews that Singapore felt strong pressure at the time, and it seems clear that Beijing was at least able to convince the leadership that Singapore had drifted too far from Chinese interests on the Taiwan issue, when arguably Singapore had done nothing to depart from its longstanding policy. Faced with this pressure, Singapore opted to repair relations even if this came at the cost of a minor departure from the status quo in China’s favor. Singapore’s leaders make no secret of the fact that vulnerability motivates their country’s strategy and policy. In this single episode, Singapore arguably aligned itself more closely with China than expected. Nevertheless, there is insufficient evidence to link this decision to specific economic vulnerabilities, and a null funding on Hypothesis 2 must thus be recorded. Moreover compared to its close neighbors, Singapore’s record of security cooperation with the United States is far more extensive. For example, both Indonesia and Malaysia have rejected a significant military presence from Washington in the Malacca Strait on the grounds it would violate their sovereignty. Accordingly Singapore cannot be said to have been accommodating China in any significant way, and it seems likely that the city-state would be willing to incur economic costs to protect its independence. According to one former senior foreign policy official, “you must pay the economic cost to assert your sovereignty”.

6.5.3 Singapore’s economic response to interdependence: Learning the lessons of Suzhou

633 Author interviews with Singaporean foreign policy officials and a Singaporean international relations academic, Singapore, December 2013.
634 Casey and Sussex 2012.
635 Author interview with former senior Singaporean foreign policy official, Singapore, December 2013.
While the available data on Singaporean security policy suggests a null finding for Hypothesis 2, better evidence is available to test the theory of asymmetry’s hypothesis that specific features of Singapore’s economy generated predicted variation in vulnerability. In particular, auxiliary causal process observations can be drawn from the lessons Singapore learned from the difficulties suffered with its investments in the Suzhou Industrial Park and other ventures in China, and the resulting policy response.

Following Singapore’s disengagement from Suzhou, the new majority-Chinese leaders slashed rents, scaled back burdensome oversight and, within a decade, the park was a huge success. Despite their now minority stake, Singapore’s leaders once again began to tout Suzhou as the signature cooperative venture between the two governments. This turnaround confirmed the lesson that the failure to properly engage with local interests created commercial vulnerability which resulted in economic losses. Singapore needed to align itself with local interests and, moreover, relax its rigid rule-based attitudes to collaborative investments in favor of a more flexible approach to doing business in China. Importantly, this lesson shaped the government’s policy response in new high-profile government-to-government cooperative projects such as the Tianjin Eco-City (launched in 2007) and two more industrial parks launched in 2010.

Singapore scaled back its focus on profits and exclusive “high-level” leadership by government, taking a backseat role that focused on supplying China with technical and management experience in support of business ventures. Importantly, senior leadership no longer neglected

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638 The parks launched were the Singapore-Sichuan Hi-tech Innovation Park and the Guangzhou Knowledge City. These parks, along with Suzhou and Tianjin, were all cited by Prime Minister Lee in his 2012 speech to the Central Party School of the Chinese Communist Party in 2012 as examples of Sino-Singaporean economic cooperation: Lee 2012.
local authorities; during his visit to China in 2013 Lee Hsien Loong visited the remote province of Xinjiang in western China (for three days) and the city of Shenyang in Liaoning province, demonstrating that ‘getting out of Beijing’ was now a key element of Singapore’s economic strategy to reduce the commercial vulnerability of its investments.\footnote{Xi: 3 Ways to Take Ties with S’pore to New Level”. \textit{Straits Times}, August 27, 2013.}

In these and other projects, GLCs have been able to successfully promote the Singapore ‘brand’ by providing technical skills and experience in partnership with local Chinese governments and businesses in areas such as infrastructure, urban planning, logistics, public works management and environmental management.\footnote{Gu and Chan 2009, 120; “S’pore Brand Name in Demand in China”. \textit{Straits Times}, September 3, 2012.} This new role has allowed the city-state’s best aspects to be emphasized inside China—its political and economic models and common cultural ties—which in the long-term build the image of Singapore as ‘China’s friend’, potentially immunizing Singaporean business interests if conflict ever arises.\footnote{Author interview with Chinese-Singaporean academic, Singapore, December 2013.}

In turn, these projects laid the ground for profit-driven investments and projects by Singaporean companies. In 2010 the two countries marked the 20\textsuperscript{th} anniversary of the establishment of diplomatic relations. By June of that year, 18,000 Singaporean companies had invested in China. Importantly, private companies, including investment banks and other financiers, have learned similar lessons. They too lost money by ignoring local interests, and have responded by structuring newer deals to give local partners a greater (if not the majority) share of profits.\footnote{Author interviews with Singaporeans working in private banking and finance with experience in the Chinese market, Singapore, December 2013.}

The other major economic policy response to this identification of commercial vulnerability is diversification. Difficult experiences in the 1990s proved the commercial risks of investing in China. Therefore, while Singapore’s leadership has recognized that China is a primary avenue
for expanding economic opportunities, it can never be more than one element of a diversified portfolio of trading and investment relationships. The Suzhou experience demonstrated that China is “difficult to penetrate, lacks transparency and lacks a reliable legal regime” which Singapore, despite shared linguistic and cultural ties, has not been able to solve consistently.\(^{644}\) Diversification is thus the optimal economic response to spread risks and avoid catastrophic losses.\(^{645}\) Accordingly while exports (the “factory” element of Singapore) have maintained a healthy upward trend over time, Singaporean investment (the “headquarter” element) has matured since the 1990s in response to commercial vulnerabilities, and is now lower in profile, more engaging of local actors and more sensitive to risk.

### 6.6 Conclusion

The foregoing analysis of Sino-Singaporean relations suggests three relevant conclusions. First, Singapore’s stable political system has allowed its leaders to manage relations with China pursuant to a well-defined and interconnected strategic calculus drawn from its fundamental interests in survival, independence and prosperity. Economic interdependence enters into this calculus both as a vital strategy for engaging China, exploiting its economic opportunity and developing influence and relevance, but also as a potential vulnerability to be carefully monitored. Singapore’s security requires the maintenance of a stable balance of power, the continued assertion of a robust independence, but also the minimization of confrontation.

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\(^{644}\) Medeiros et al 2008, 173.

\(^{645}\) However, even as recently as 2013 there is debate within Singapore’s economic ministries between officials who prefer to entrench ties with China further, and those who see merit in further diversification into Southeast Asia: Author interview with Singaporean economic official, Singapore, December 2013.
Second, there is little evidence consistent with Hypothesis 2 that Singapore’s security policy has been relatively accommodating of China because of economic vulnerability. However, evidence of a tit-for-tat policy mix over time appears to demonstrate how China’s undeniable importance has mandated a strategy which positions Singapore neither too close to nor too far from China’s interests. Such a strategy risks occasional overcorrection, such as (arguably) occurred following Lee Hsien Loong’s Taiwan visit in 2004. Economic vulnerability is likely one of the key variables driving this policy discipline, but isolating its independent effect is not possible on the available evidence.

Finally, while Singapore’s security policy has been relatively invariant over the period studied, Singapore’s experience of economic interdependence and policy responses offer perhaps the most important insights for this project. Singaporean investors, both government-linked and private, have lost a lot of money in China. These experiences helped identify commercial vulnerabilities that triggered a policy response which, over time, changed the way Singapore did business with China in ways consistent with Hypothesis 1. This leads to this chapter’s most important conclusion: policies to reduce the risk of commercial losses had the effect of reducing Singapore’s broader economic vulnerability. What Singapore learned doing business with China may be useful to other states, industries and firms which are facing economic vulnerabilities from political tensions.
7. AUSTRALIA: Successfully Separating Economics from Politics

7.1 Introduction

Australians enjoy a fortunate geopolitical inheritance. Their country’s size, wealth of resources, inherited institutions, sheltered strategic location and powerful friends have created a relatively benign regional environment with few strategic challenges. This inheritance has long dominated Australian strategic thought and anchored the country’s foreign and defense policies. Without question the most important component of Australian strategy has always been a tight security alliance with a major-power situated far from the country’s shores but with which it shared deep linguistic, cultural and institutional bonds. Initially this meant the United Kingdom, though Australia’s colonial founder was replaced after the Second World War by the ascendant United States. Yet in recent decades, the economic rise of Australia’s neighbors has challenged this inheritance by creating a new set of interests derived from the country’s geographic location in Asia and the lucrative trade and investment relationships that formed as East Asian nations grew. These emerging economic interests generated the strategic imperative to engage the region with unprecedented vigor, and placed increasing pressure on Australian policymakers to examine whether and how these new interests mandated a rethink of the principles which had long anchored the foreign and defense policies of their “lucky country”.

This strategic dilemma is most acute vis-à-vis China despite the fact that Sino-Australian relations have a long history of goodwill and mutual benefit. No other country has more openly and self-consciously engaged in an internal debate, sparked by China’s rise, on the correct balance between its competing security and economic interests. Australia’s political leaders unfailingly insist that Australia need not ‘choose’ between the two priorities. Indeed, no overt
choice has needed to be made; like Singapore, Australia’s disagreements with China have been relatively low-level. At the margins however, the Australian government has faced policy decisions which were perceived to involve tradeoffs between economics and security. The logic of these decisions, and the debate surrounding them, provide a fruitful opportunity to consider the extent to which economic interdependence with China has generated vulnerability and any consequential impact on security behavior.

Traditional measures of interdependence would emphasize that following a steady rise throughout the 2000s, by 2010 Australia exported the highest percentage of its merchandise to China of any country in the region. Yet according to the theory of asymmetry, Australia’s raw materials exports from the periphery of the transnational production network designate it as a “resource” economy. The theory predicts that these economic linkages should face the most symmetric disruption losses, thus generating the lowest vulnerability. Australia is the clearest case study in this research where the theory of asymmetry makes opposite predictions regarding vulnerability compared to traditional thinking on interdependence. Ultimately, interdependence is hypothesized to have the smallest effect on Australia’s security policy, relative to other states in this study.

The unique feature of Sino-Australian economic interdependence between 2002 and 2013 is that it came to be highly concentrated in a single commodity—iron ore. The major contribution of this chapter is thus to present a detailed description of the microfoundations of the iron ore market, China and Australia’s respective roles as customer and supplier, and how these roles in this one commodity shaped the nature of economic interdependence between the two states. The other politically controversial component of the interdependent relationship, Chinese FDI into

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646 Bisley 2012.
Australia, is also explored. The analytical challenge Australia presents is the fact that its open, pluralistic society has generated probably the largest and most polarized volume of debate globally regarding the rise of China and Australia’s optimal strategic response. Accordingly, the second contribution of this chapter is to attempt to separate the ‘noise’ generated by this vigorous and often sophisticated discourse of competing interests and perspectives—which has comparatively less evidential value—from the ‘signal’ of underlying policy decisions which constitute the key inferential leverage in testing the theory’s hypotheses.

7.2 Unpacking interdependence between Australia and China

The level of interdependence between the Australia and China in the early 21st century according to traditional measures is represented in Table 7.1. These simple statistics confirm an apparent asymmetry; China became increasingly important to Australian trade, becoming Australia’s largest trading partner in 2009. By 2011, China was a long way ahead of second-ranked Japan, taking over 27 percent of Australia’s exports.
Table 7.1: Merchandise Trade between Australia and China, 2001-2011

<table>
<thead>
<tr>
<th></th>
<th>Australia</th>
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<td></td>
<td></td>
<td>2001 (rank)</td>
<td>2006 (rank)</td>
<td>2011 (rank)</td>
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<tr>
<td>Exports to China as</td>
<td>6.16</td>
<td>12.3</td>
<td>27.38</td>
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<tr>
<td>a % of all Australian</td>
<td>(4)</td>
<td>(2)</td>
<td>(1)</td>
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<tr>
<td>Imports from China as</td>
<td>8.77</td>
<td>14.41</td>
<td>18.54</td>
<td></td>
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<tr>
<td>a % of all Australian</td>
<td>(3)</td>
<td>(1)</td>
<td>(1)</td>
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<tr>
<td>Trade with China (EX</td>
<td>2.58</td>
<td>4.84</td>
<td>8.81</td>
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<tr>
<td>+ IM) as a % of</td>
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<td>Australian GDP</td>
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<td>China</td>
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<td></td>
<td></td>
<td>2001 (rank)</td>
<td>2006 (rank)</td>
<td>2011 (rank)</td>
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<tr>
<td>Exports to Australia</td>
<td>1.34</td>
<td>1.41</td>
<td>1.79</td>
<td></td>
</tr>
<tr>
<td>as a % of all Chinese</td>
<td>(10)</td>
<td>(13)</td>
<td>(10)</td>
<td></td>
</tr>
<tr>
<td>Imports from Australia</td>
<td>2.23</td>
<td>2.42</td>
<td>4.65</td>
<td></td>
</tr>
<tr>
<td>as a % of all Chinese</td>
<td>(7)</td>
<td>(6)</td>
<td>(5)</td>
<td></td>
</tr>
<tr>
<td>Trade with Australia</td>
<td>0.68</td>
<td>1.21</td>
<td>1.57</td>
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<tr>
<td>(EX + IM) as a % of</td>
<td></td>
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<td></td>
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<tr>
<td>Chinese GDP</td>
<td></td>
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</tbody>
</table>

Sources: Author calculations based on: IMF, Direction of Trade Statistics; World Bank, World Development Indicators. China excludes Hong Kong.

Figure 7.2 illustrates how Australia’s economy could be considered the most dependent on China in the region, as from 2010 the highest percentage of its exports went to China following a rapid ascension over the previous decade. Australia’s total trade with China was also over eight percent of GDP, much higher than both the Philippines and Japan. The implication is clear—Australia should have been the most dependent on China.

647 With Singapore’s entropōt economy being the exception as discussed in Chapter 6.
7.3 Australia as a resource economy: The commodities boom and its consequences

Blessed with abundant land and high-grade natural resources, agriculture and mining loom large in the history of Australian exports. Yet one factor above all distinguished Australia’s economy over the 2002-2013 period: a surge in the demand for minerals beginning in 2003 which caused the biggest and most sustained boom in Australia’s export prices in its history, elevating the country’s terms of trade in 2011 to their highest level in 140 years. In 2011, Australia made

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648 Government of Australia 2012. Terms of trade are the ratio of a country’s export prices to import prices. Conceptually this means the amount of imports the country can purchase per unit of exports. An increase in the terms of trade therefore allows the purchase of more imports for a constant level of exports. The raw figures are
almost half the world’s exports of metallurgical coal (used for producing steel), and was the second largest exporter of thermal coal (used to produce electricity). But the main story was iron ore, for which Australia was also the world’s largest exporter in 2012, but whose share of all Australian exports (including services) increased from 3.3 percent in 2001 to 20.5 percent in 2011. Whereas the value of coal exports increased almost 300 percent between 2001 and 2011, iron ore exports increased more than tenfold in value, averaging almost 32 percent growth annually.  

The mining boom helped sustain consistent economic growth; GDP grew over two percent on average each year, and the economy avoided recession during the global financial crisis and economic downturn in 2008-09. The boom also generated positive externalities for mining-related industries including construction, transport, manufacturing and services. Mining and mining-related sectors comprised around 20 percent of the economy in 2011, contributed over two-thirds of real GDP growth, though less than 10 percent of employment. The boom in iron ore and (to some extent) coal was partially offset by weaker performance in other commodities, especially oil, the production of which peaked in 2000 and declined by 45 percent in 2012. Overall, this meant that the volume of Australia’s total resource exports rose only at a rate of 3.5 percent over the course of the boom, a rate below its average increase the decade prior. This emphasizes how higher commodity prices were the decisive factor in driving the boom. Figure

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staggering: Between 2003 and the peak in the second half of 2011, Australia’s terms of trade increased by 85 percent: Plumb, Kent and Bishop 2012.

649 Department of Foreign Affairs and Trade 2012a. Between 2003 and 2011, coal production increased by 25 percent and iron ore production doubled: Gruen 2011. The rise in production reflected both increased utilization of existing capacity and the building of new capacity: Plumb, Kent and Bishop 2012. The expansion in coal was broadly at a similar pace to its pre-boom average.


651 Plumb, Kent and Bishop 2012.
7.3 shows how iron ore (and to a certain extent coal) constituted an increasingly larger share of Australian exports over the period.

**Figure 7.3: Coal and Iron ore exports as a percentage of total Australian merchandise exports to the world, 2001-2011**

Source: United Nations, *Comtrade*. Note: Harmonized System (HS) codes in parentheses; coal (HS2701) includes both thermal and metallurgical coal.

The other major consequence of the resources boom was a wave of capital investment in Australia’s mining sector. The sustained nature of the boom allowed mining companies time to take advantage of higher prices by expanding capacity. Investment spending rose from less than two percent of GDP in 2002/03 to seven percent of GDP in 2011/12, and played an important role in Australia’s economic growth during this period.\(^{652}\) Australian companies accounted for 54 percent of this total and investment was overwhelmingly concentrated in four commodities, iron ore, coal, oil and gas, which took 84 percent of the total.\(^{653}\) Between 2008 and 2012, the mining industry averaged roughly 33 percent of the stock of FDI in Australia, though given the lengthy timeframe for mining investment, much of the new capacity did not come online during the

\(^{652}\) Arsov et al 2013, 51.

\(^{653}\) Listed Australian companies are part-owned by foreign entities and often seek financing in foreign debt markets (especially the U.S. bond market). Most estimates thus find that effective foreign ownership of mining operations in Australia has been around 80 percent: Reserve Bank of Australia 2011, 42-44; Arsov et al 2013, 51-52, 58.
Yet the shift towards the mining industry did not drastically alter Australia’s overall FDI profile; Australia’s stock of inward and outward FDI remained on par with global averages, and ownership of inward FDI remained dominated by the United States and United Kingdom, which together compromise over half of the total stock of FDI held.655

7.4 Australia and China in the transnational production network

Australia and China possess a long history of mutually beneficial economic linkages, headlined by Australia’s sale of wheat to China during its famine in 1960 in defiance of a U.S. trade embargo. The two economies enjoy a high degree of complementarity; Australia’s abundance in land and natural resources matches China’s surplus of labor. Accordingly, while China’s economic relationship with most other Asian states evolved with the rise of transnational production networks, Australia’s exports to China—long dominated by agricultural products such wool and wheat—remained focused on primary commodities, situating Australia at the periphery of the network. Beginning in the early 2000s, China’s rapid urbanization and industrialization fueled demand for vast quantities of minerals, and it is the supply of these commodities which has been the most important aspect of Sino-Australian economic interdependence and defines Australia as a “resource” economy.

Two-way trade between Australia and China grew swiftly in the 2000s, increasing in volume and, as discussed above, even faster in value as Australia’s terms of trade soared. Exports grew at an annual rate of over 25 percent and China rose from Australia’s 6th largest customer in 2001 to its largest in 2009. Yet as shown in Figure 7.4, during this period the diversity of exports

654 Australian Bureau of Statistics 2013. This average grew, peaking at 37.6 percent at the end of 2012.
655 Sanyal 2011, Table A2.
declined and iron ore became ascendant. In 2001, Australia’s top five categories of goods and services exports to China (iron ore, wool, aluminum, education and barley) comprised 51 percent of the total, with no category topping 16 percent. In 2011, iron ore alone constituted 57 percent of total exports of goods and services to China, and added with the remaining top five (coal, education, petroleum and wool) comprised almost 75 percent of the total. In 2011, 68.6 percent of Australia’s iron ore exports went to China; meaning that over 16 percent of Australia’s total merchandise exports to the world (excluding services) were iron ore sales to China.656

Figure 7.4: Top merchandise exports by Australia to China, 2001-2011

The rapid growth of China’s steel industry (and thus the country’s ravenous demand for iron ore) resulted from a sustained period of urbanization and industrialization that necessitated significant investments in infrastructure, buildings and machinery. China’s need for resources has thus been

656 Department of Foreign Affairs and Trade 2012b. China was also Australia’s largest services market and strongest source of growth of trade in services, though the category has declined in importance from over 14.3 percent of total exports of goods and services in 2001 to 7.3 percent in 2011. Services are dominated by education (72 percent), with 150,000 Chinese students studying in Australian universities and schools in 2011. However, the services market remained smaller than agriculture and in 2011 was barely 11 percent of the size of the minerals sector.
driven by both construction and manufacturing. In 2010, the iron and steel industries occupied third and second place respectively among 39 industrial categories in China, together accounting for over 15 percent of China’s industrial output, 7.81 percent of its revenue and ranking eighth largest in exports. China actually possesses the largest quantity of iron ore reserves in the world, but average ore quality is lower and reserves are located in China’s north and west—expensive to transport to the steel mills in the southern coastal provinces. China produced over 45 percent of world steel output in 2011, up from 15 percent in 2000. Figures 7.5 and 7.6 depict the importance of bilateral iron ore trade to both countries; Australian imports constituted around a fifth of China’s total domestic consumption over the 2000s during which time Australia was China’s largest supplier.

**Figure 7.5: Sino-Australian iron ore trade (as % of total)**

![Graph showing Sino-Australian iron ore trade](image)


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657 Roberts and Rush 2012. The authors present evidence that manufacturing has been at least as important as construction as a driver of China’s demand for resource-intensive metal products.

658 Zhang 2012.

659 Dyster and Meredith 2012, 361.
Coming a distant second to iron ore is coal, of which China took a relatively small fraction of Australia’s exports but exhibited strong growth towards the end of the 2000s. China’s share of Australia’s thermal coal exports rose from 1.5 percent in 2007 to 12.7 percent in 2011 and from 0.7 percent of metallurgical coal exports in 2008 to 8.1 percent in 2011.\textsuperscript{660} Thus while in absolute terms China was not Australia’s most important coal customer, in the late 2000s it emerged as the largest growth opportunity.

The historic surge in mineral exports in the mid-2000s was soon accompanied by the efforts of Chinese firms—beginning in 2006 and taking off in 2007—to invest in the Australian mining industry. In 2006 China was just the 17\textsuperscript{th} largest holder of Australian FDI at 0.25 percent of the total,\textsuperscript{661} but quickly became Australia’s second largest source of FDI flows (around 16 percent of total flows in 2008-09). Ninety-nine percent of this investment came in the mineral exploration

\textsuperscript{660}Department of Foreign Affairs and Trade 2012a.
\textsuperscript{661}Laurenceson 2008. While many Australian companies have invested in China, the total stock of FDI held by Australian interests in China is a fraction of China’s holdings in Australia.
and development sector; one project alone constituting 74 percent of flows in FY2008-09.\textsuperscript{662} Between 2006 and 2012, the mining industry received 73 percent of Chinese FDI in Australia, with natural gas a distant second at 18 percent.\textsuperscript{663}

As these investments were the first large flows into Australia, by 2012 Chinese FDI was still only three percent of the total stock of inward FDI. Yet for China, Australia was its largest destination for outbound FDI, accounting for 13.2 percent of the total between 2006 and 2013.\textsuperscript{664} Outward FDI by China to any destination was essentially non-existent prior to the mid-2000s; once Chinese companies—largely state-owned enterprises—began their investment drive, Australia started at the top of their desired destinations.\textsuperscript{665} Yet flows were more volatile than consistent, reflecting the nature of the resource market where one or two big projects can define investment flows in a given year. Many proposed deals fail, either for commercial or regulatory reasons—a fact that has been the source of the political tensions discussed in the next section. In the 2010s, Chinese investment shifted slowly away from iron ore into the natural gas sector; in 2012, 48 percent of new investment flows went to iron ore, while 42 percent went to gas.\textsuperscript{666}

Figure 7.7 charts the growth in Chinese investment in Australia over the period under study. The large increases began in 2007, turned down during the financial crisis in 2010, and had recovered somewhat by 2012.\textsuperscript{667}

\textsuperscript{662} Foreign Investment Review Board 2009. The following year, China was the third-largest investor with 75 percent of its proposed investment coming in the mining sector: Foreign Investment Review Board 2010.
\textsuperscript{663} Ferguson and Hendrischke 2013, 7.
\textsuperscript{665} “Resources Investment ‘Rose Tenfold’”. Australian, March 9, 2013, 24. China’s preferred method of investing has been the purchasing of stock at the corporate level, rather than acquiring interests in particular projects or assets.
\textsuperscript{666} Ferguson and Hendrischke 2013.
\textsuperscript{667} By this time, however, China was beginning to diversify its investment destinations, and Australia’s share of total annual flows began to fall: Larum and Qian 2012. The authors argue that part of the reason for the relative decline is a sense of “mistrust and discrimination” felt by Chinese investors (discussed below), though they present no decisive evidence for this claim.
The theoretical predictions: As a “resource” economy, the theory of asymmetry predicts that the Sino-Australian economic relationship is one of symmetric interdependence. The Australian economy reaped immense economic benefits from selling iron ore and other natural resources to China. It is equally true that Australian resources were critical inputs into China’s urbanization and industrialization, the engines of its development model. For both sides, while the global market for iron more meant that feasible alternatives did technically exist, disrupting the relationship would still have been highly costly, reducing the credibility of any threat to do so. The posited symmetry in the relationship generates the prediction that (compared to Singapore) the Australian economy should have faced lower relative disruption losses and been less vulnerable. Hypothesis 2 tests whether this reduced vulnerability precluded strong connections between economics and accommodating security policy. This does not mean Australian policy could never accommodate China, but that economic imperatives had relatively little impact on security policy choices.
7.5 Economic interdependence in Sino-Australian political relations

While a heated debate raged around them among business and opinion leaders, academics, and the media, the Australian government—both its political leaders and senior bureaucrats—has been remarkably clear and consistent in expressing how it perceives, and resolves, the dilemma caused by the fact that the country’s largest trading partner holds conflicting security interests. The resolution was first enunciated by John Howard during his first overseas trip as Prime Minister in 1996 when he said that Australia did not have to “choose between its history and its geography”.668 Howard’s formula was that Australia should engage with neighbors like China on the basis of shared economic interests and mutual respect, and not insist that any differences in core values be at the center of the relationship.669 Such an approach could help insulate growing economic ties from Australia’s security alliance with the United States, a partnership that had formed the stable core of the country’s grand strategy and security policy for over 50 years.670 Howard saw no need for Australia’s economic and security relationships to interfere with each other, and conducted Australia’s foreign relations on this basis, successfully maintaining positive relations with both the United States and China.

Yet China’s rapid economic development throughout the 2000s expanded Beijing’s interests and the clean distinction enjoyed by Australia between economics and security began to corrode. What for Howard was mostly a successful strategy appeared like it would recede to an increasingly harder-to-maintain ideal for his successors, as China sought an increasing influence over Australian security policy, and was willing to use the economic relationship strategically to achieve it.

668 Wesley 2007, 10.
670 Tow 2012, 89.
7.5.1 Conflicts between Australian and Chinese security interests

The U.S. alliance: Domestically untouchable

The core of Australian security policy is its alliance with the United States, and this is the first area in which China sought to chip away at the status quo. There is some evidence to suggest that, following a successful visit to Australia in 2003, President Hu Jintao ordered Chinese officials to strengthen business and political ties to try to dilute American strategic influence. The goal was to turn Australia into a “second France; that dared say ‘no’ to the United States”. If China were able to achieve some policy separation between Australia and the U.S. it would send a powerful signal of China’s rise and America’s decline in the region.

Foreign Minister Alexander Downer’s visit to Beijing in August 2004 hinted that Hu’s strategy was yielding payoffs. Speaking with journalists, Downer lauded the growing bilateral strategic and economic relationship between the two nations. A reporter inquired how the relationship could flourish given Australia would be required by its treaty commitments to side with the United States in any conflict over Taiwan. Downer responded by stating that the treaty was “symbolic” of the alliance and did not necessarily require Australia to get involved in such a conflict. This comment immediately cast a shadow of doubt on Australia’s commitment to the alliance which had until that point had been wholly unquestioned.

672 Uren 2012, ch. 2; Author interview with senior Australian foreign policy official, Canberra, March 2013.
673 “Downer Flags China Shift”. The Age, August 18, 2004, 1. Downer’s comments are worth reproducing in full: “Well, the ANZUS treaty is a treaty which, of course, is symbolic of the Australian alliance with the US, but the ANZUS alliance is invoked in the event of one of our two countries, Australia or the US, being attacked. So some other military activity elsewhere in the world, be it in Iraq or anywhere else for that matter, does not automatically invoke the ANZUS treaty. It is important to remember that we only invoked the ANZUS treaty once, that is after the events of 9/11, because there was an attack on the territory of the US.”
The repercussions were immediate. The Chinese were delighted, and called for Australia to increase pressure on Taiwan. Washington, both astonished and incredulous, responded vigorously, pressuring Canberra to clarify the remarks. John Howard quickly intervened by publicly reassuring Washington that Australia’s treaty obligations were clear and that it would remain a loyal ally, though he refused to be drawn on a Taiwan Strait hypothetical. In subsequent interviews, Downer emphatically denied that his comments in any way represented the charting of new strategy of separation from the United States. When, in the wake of passing an anti-secession law in 2005, at least one Chinese official recommended that Australia consider exempting Taiwan from its ANZUS commitments, Australian officials “politely and firmly refused”, appearing to put an end to the matter.

Much has been written since on whether the incident signified the beginnings of a strategic shift by Australia, a simple mistake by Downer, or something else. Media commentary at the time concluded that Downer’s comments at least represented the recognition of China’s increasing economic importance to Australia. Whether or not this is true, what matters from an evidentiary standpoint is that this minor event would ultimately represent the maximum drift in Australian security policy away from the alliance during the entire 2002-2013 period, and it was a single comment that was quickly walked back before it could signal a policy shift. There is, simply, no other evidence of Australia’s security policy scaling back its alliance commitment,

As Sheridan (2006, 191) points out, Downer was wrong on the text of the security treaty, as Article V provides that an “armed attack on any of the parties is deemed to include an armed attack on … armed forces, public vessels or aircraft in the Pacific”.

675 Uren 2012, ch. 7; Sheridan 2006, 192-193.
677 Sheridan 2006, 192.
678 Scobell 2007, 87.
679 Sheridan (2006, 192) theorizes that Downer was actually trying help the United States reinforce the message to Taiwan not to alter the status quo by declaring independence.
either to accommodate China or for any other reason. Rather, all available evidence indicates that Canberra actually increased the depth of its alliance commitments and cooperation, most prominently by agreeing in November 2011 to the rotational deployment to the north of Australia of U.S. Marines and increased visits by the U.S. Air Force.681

The absence of evidence of drift is unsurprising both because of the alliance’s benefits and its high political salience. In addition to American assistance if Australia were attacked, the alliance offers privileged access to U.S. military technology and training, integration with U.S. intelligence networks and political connections in Washington.682 Giving up these benefits would be prohibitively costly.683 Political salience comes from strong domestic support for the alliance and the prestige of associating with American leaders. A poll conducted in 2005 found that 84 percent of those surveyed viewed the alliance as either very important or fairly important,684 while a 2012 poll found 74 percent saw the United States as Australia’s most important security partner. This last result came despite over 90 percent of respondents in the same survey accepting that China’s resource demand helped Australia avoid economic recession during the global financial crisis.685 Accordingly, Chinese economic ties have proven insufficiently compelling to sway the public away from the United States, and no Australian politician could question the alliance without greatly damaging their reputation.

The Marines deployment did not escape criticism, but it was muted and not sustained. The Chinese foreign ministry described the strengthening as “inappropriate”, but did nothing

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681 Dobell 2012.
682 Bisley 2013.
683 Babbage (2011) describes a possible defence policy option which would reduce dependence on the United States through heavy investments in military capabilities, but which would be highly costly, possibly requiring a 25-50 percent increase in defense spending over ten years.
684 McAllister 2005.
685 Hanson 2012. A further 13 percent ranked the United States as Australia’s second most important security partner. China was ranked the most important by 10 percent of those surveyed and second most important by 14 percent.
further. Chinese state-run media was more inflammatory, with the *Global Times* threatening economic punishment, but even Australian business leaders did not take this threat seriously. The most strident criticism came from within Australia. Former Prime Minister Paul Keating described the deployment as a “ruthless” strategy by the United States to contain China. Billionaire businessman Kerry Stokes, a staunch advocate of improving economic ties with China, said he was “physically repulsed” by the deployment of U.S. troops Australian soil not under Australian command. Yet none of these criticisms had any impact on the government; (then) Foreign Minister Kevin Rudd responded to the muted Chinese criticism by politely telling Beijing not to interfere with Australian national security policy, while the Secretary of the Department of Foreign Affairs and Trade declared—likely in response to Stokes’ criticism—that “our alliance with the United States is not up for sale”.

*Australian criticisms of Chinese security policy: Willing to speak out*

Canberra has also been willing to initiate verbal disputes with Beijing over security matters, seemingly without concern of any economic consequences. On two separate occasions Australian leaders chose to be publicly critical of China in situations where, on the available evidence, there was no imperative to do so. The first occasion came in 2009 with the release of a Defense White Paper by the Rudd government that explicitly referred to the “pace, scope and structure of China’s military modernization” as having the potential to give neighbors “cause for concern if not carefully explained” because the modernization appeared to be more than “what

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686 Less than two months later Beijing indicated to Canberra that it wanted to accelerate negotiations on a free trade agreement. Australia’s Trade Minister Craig Emerson observed that the Chinese did not appear to see the alliance strengthening as an act of aggression: “Full Steam Ahead with China despite US Military Ties”. *Australian Financial Review*, January 9, 2012, 1.


would be required for a conflict over Taiwan”. Such bold language was unnecessary, and perceived as “rather startling” given the strong economic partnership between the two countries and other contextual factors. The White Paper recommended the largest peacetime defense expenditure since the Second World War, primarily in the form of procurement upgrades for Australia’s navy, which further strengthened the perception that Australia was reacting to a China threat. While the document was attacked by a leading Chinese military strategist as “crazy” and “dangerous” and likely to incite a regional arms buildup, the Chinese government issued no official comment.

The second occasion came in November 2013, when the newly elected Abbott government took the bold step of calling in China’s ambassador and demanding an explanation for Beijing’s unilateral decision to declare an expanded “air defense identification zone” (ADIZ) over disputed maritime areas in the East China Sea. This move was also unexpected and arguably unnecessary, since it enhanced the perception within China that Australia was siding with Japan over the sensitive East China Sea territorial disputes, an issue on which Australia had previously taken no position. China responded by urging Canberra to “correct its mistakes to avoid hurting

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690 Department of Defence 2009, 34.
691 Thayer 2011.
692 The reversal of the language used to describe China in the 2013 Defence White Paper compared to the 2009 version is evidence that there was no strategic imperative to be so bold in 2009. In the 2013 document, Australia did “not approach China as an adversary”: Department of Defence 2013, 11. Commentary at the time characterized this softer done as a conscious effort to undo the overly strong language from 2009: “Defence White Paper Goes Down in Flames”. Australian, May 4, 2013, 15. Yet if anything by 2013 the regional security environment had deteriorated, making the 2009 language appear be even more of an outlier.
693 Thayer 2011.
694 Without naming China, the 2009 Defence White Paper raised “the remote but plausible potential of confrontation” with “a major power adversary”: Department of Defence 2009, 64. In a speech the previous year, Rudd had referred to the rise of China during a discussion of “strategic risks” as “driving much of the change in our region”: Rudd 2008a.
696 It was left to former Prime Ministers Bob Hawke and Paul Keating to argue that relations with China had been damaged: Tubilewicz 2010, 153.
697 The ADIZ announcement was described as “unhelpful” by Foreign Minister Julie Bishop: “Bishop Queries China over Air Rights Claim”. Australian Financial Review, November 27, 2013, 6.
the cooperative relationship between China and Australia”\textsuperscript{698} Under criticism for damaging relations with China, both Prime Minister Abbott and Foreign Minister Julie Bishop refused to back down.\textsuperscript{699}

The point of this discussion is not to analyze the merits of the White Paper or the ADIZ response, but to argue that the strength of the government’s public censure of China in these instances suggests that Australia’s leaders have felt relatively uninhibited in criticizing China where they deemed it to be in Australia’s interests to do so.

\textit{Human rights: Further willingness to speak out}

As part of the strategy to focus on shared interests rather than conflicting values, the Howard government avoided publicly criticizing China on human rights issues, instead conducting human rights diplomacy behind closed doors. Howard’s successor Kevin Rudd, a fluent mandarin speaker and former diplomat to China, felt differently. During his first overseas visit in April 2008, Rudd surprised his Chinese hosts by delivering a stern lecture (in Mandarin) at Peking University stating that, as a “true friend”, he felt it appropriate to state that human rights conditions in Tibet should be improved.\textsuperscript{700} In early July 2009 riots and a violent clash between Uighurs and Han Chinese in China’s Xinjiang province left several hundred dead and thousands injured, with Han the majority of victims. In commenting on the riots, Rudd noted “there are continuing human rights problems in China”, infuriating Beijing over what it perceived to be the murder of Han by a terrorist organization. Compounding China’s anger, the Australian government granted the leader of the World Uighur Congress—businesswoman Rebiya Kadeer,

\textsuperscript{698} “Abbott Won’t Be Bullied on Air Zone Stoush with China”. \textit{Sydney Morning Herald}, November 29, 2013, 10.
\textsuperscript{699} “No Time to be Meekly Standing By, Placating Other Lands”. \textit{Australian}, January 4, 2014, 12.
\textsuperscript{700} Rudd 2008b; “The PM Finds His Voice”. \textit{The Age}, April 12, 2008, 1. This provoked a rebuke from Hu which, unlike the rest of Rudd’s visit, was widely covered by Chinese media: “Hu Ticks Off Rudd on Tibet Issue but still Lu Kewen Fever Engulfs China”. \textit{Australian}, April 21, 2008, 36.
whom China viewed as the political leader of a terrorist movement—a visa to attend a film festival in Melbourne. Chinese officials had demanded the visa application be denied. Chinese media were furious, asserting that Canberra had sided with a terrorist and calling for trade sanctions. In response, China’s Vice Minister for Foreign Affairs cancelled an upcoming visit to Australia and a planned visit by Vice-Premier Li Keqiang was also postponed.

The Kadeer episode came at the end of a tumultuous few months for the bilateral relationship, which had included the failed (second) Chinalco deal and Stern Hu’s arrest (discussed below), as well as the release of the 2009 Defense White Paper. Relations were undoubtedly at their lowest in more than a decade, with tensions so high that Australia’s ambassador to Beijing had to rush back to Canberra for emergency meetings. Yet the Australian government held firm and issued the visa, arguing the Chinese government had produced no evidence that Kadeer was a terrorist. Moreover, no economic repercussions materialized; indeed, the same day that the Vice-Minister for Foreign Affairs cancelled his visit, Australian and Chinese officials signed a A$50 billion LNG deal in Beijing—the largest bilateral trade deal ever between the two countries. In addition, the diplomatic freeze caused by the cancelled visits ended less than two months later, largely at the initiative of Beijing.

703 “Beijing Lashes Australia on Trade”. Sydney Morning Herald, August 20, 2009, 1.
704 “Piping Hot: $50b Gas Deal with China”. Sydney Morning Herald, August 19, 2009, 1. Nor did the tensions affect ongoing negotiations with Baosteel, China’s largest steelmaker, which sought to acquire a 15 percent stage in Australian mining company Aquila, a deal that was announced a few weeks later: “Beijing Lured by Big Deals”. Australian, August 29, 2009, 27.
Chen Bingde visited Canberra in October to meet with military and defense officials, followed shortly after by the rescheduled visit of Vice-Premier Li Keqiang.

Summary: Interdependence not a factor in security policy

These high-profile cases of Canberra initiating a dispute obscure the fact that discord is the exception rather than the norm in Sino-Australian relations. Australian policy has mostly promoted positive engagement with China at the federal, state and industry levels, and the bulk of cooperation has been wholly unaffected by high-level political tensions. In interviews with the author, Australian politicians and officials stressed that interdependence incentivizes Australia to look to cooperate as much as possible. On occasion Australia has even diverged somewhat from U.S. positions. In both 2005 and 2007 the Howard government declined opportunities to join the United States and Japan in being critical of China’s military buildup. Early in Rudd’s term, Australia chose to withdraw from a quadrilateral dialogue with the United States, Japan and India. The decision, announced by Foreign Minister Stephen Smith at a joint press conference with his Chinese counterpart Yang Jiechi, was widely perceived as accommodating Chinese interests.

Yet there is little evidence connecting these individual decisions to specific economic pressures or incentives. Rather, Australia’s leaders appear to prefer cooperation with China unless the political or security tradeoff is high. Considering the entirety of Sino-Australian relations from

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707 “China Pushes Trade Pact”. Australian, October 30, 2009. Uren (2012, ch. 9) reports that the reinstating of the Li visit occurred with just one week’s notice; such visits would normally take months to arrange.
708 A former state politician who had worked closely with Chinese counterparts while in office stated that in his experience the quality of political relations between Canberra and Beijing had never affected the extensive cooperation and goodwill at the state/provincial level: Author interview, March 2013, Melbourne.
709 Author interviews with current politicians, and current and former foreign policy officials, Canberra, March 2013.
2002 to 2013, the instances of accommodation fall well short of a systematic trend of alignment towards China. Indeed, when a low point in the relationship arrived in 2009 with the Kadeer visa wrangle, and the Australian government might have been expected to have felt the most pressure to initiate attempts to repair relations, Canberra held firm and it was China who instigated reconciliation.\textsuperscript{712} This nadir may be contrasted with the low point in Sino-Singaporean relations in 2004 following Lee Hsien Loong’s visit to Taiwan discussed in Chapter 6, where Singapore’s leaders responded to Chinese pressure by making several firm statements accommodating China’s interests. At a minimum, the difference between the two outcomes offers evidence that Canberra feels less vulnerable than Singapore during times of discord with Beijing.

Australian security policy can thus be coded as firmly in alignment with the United States, with the alliance remaining the central pillar of Australia’s security.\textsuperscript{713} The clarity of Australia’s strategic posture highlights the absence of substantially accommodating policy towards China, for economic or any other reasons, yielding a null funding on Hypothesis 2. Incidences where Australia was friendlier towards Beijing’s interests come in no systematic pattern, and are more likely to be the result differences of opinion across leaders on how best to engage China. The Howard model was to focus only on shared interests while ignoring sources of discord as much as possible. Julia Gillard adopted a similar approach during her term as Prime Minister by de-emphasizing human rights and speaking of bilateral relations in terms of “a clear understanding of each other and our interests [which is] deepened by mutual respect”.\textsuperscript{714} Gillard’s government

\textsuperscript{712} Uren 2012, ch. 10.
\textsuperscript{713} Bisley (2013) arrives at the same conclusion.
\textsuperscript{714} In her keynote speech in Beijing, Gillard made passing reference to human rights disagreements but did not discuss specifics, instead describing the Sino-Australian relationship as being “grounded in a clear understanding of each other and our interests [which is] deepened by mutual respect”: Gillard 2011.
also oversaw the release of a Defence White Paper in 2013 which greatly softened the language of 2009, explicitly stating that Australia did “not approach China as an adversary”.\footnote{Department of Defense 2013, 11. Commentary at the time attributed the 2013 White Paper’s conciliatory tones as trying to undo what had been perceived as unnecessarily provocative language towards China in the 2009 White Paper: “Softer Tone, But China Wariness Remains”. \textit{Sydney Morning Herald}, May 4, 2013, 5.}

The opposing model is that engagement must include issues on which there is disagreement. This view was embodied most clearly by Kevin Rudd although early policy choices by Tony Abbott’s government since late 2013 appear to adopt a similar approach. In this view, a successful strategy of engaging China will sometimes require Canberra to publicly disagree with and (where necessary) criticize Beijing.\footnote{Rudd’s approach is typified in his Peking University speech: Rudd 2008. Abbott’s view shone through when, after Beijing rebuked Australia’s public criticism of China’s ADIZ in November 2013, he said: “Where we think Australia’s values and interests have been compromised, I think it is important to speak our mind”: “To Each Their Own No Longer Applies to China”. \textit{Australian}, January 25, 2014, 16.} Ultimately, whatever their views on engaging China, Australia’s leaders appear to have pursued their preferred strategies seemingly unconstrained by the fear of economic consequences.

7.5.2 Australia’s economic response to interdependence with China

The previous analysis is revealing for what it does not show—any systematic evidence of economic interdependence with China affecting Australian security policy. The political tensions between the two countries have however been relatively minor, and so it is possible that Beijing simply elected not to employ economic tools of statecraft in the furtherance of its security interests. Helpfully, Sino-Australian relations were distinguished equally by clashes of economic interests, primarily in the iron ore market, of such gravity as to affect the political relationship. Evidence to test Hypothesis 1 and the mechanism proposed by the theory of asymmetry can thus be drawn from the dynamics of these tensions, the experiences of Australian suppliers in price negotiations, and the policy choices of the Australian government regarding Chinese FDI. Such
evidence will speak to the question of whether Australia was even vulnerable to economic leverage.

A critical input into China’s urbanization and industrialization, the steel industry has always been a key priority for the Chinese government, so much so that as China developed its leaders elected to keep steel production under state control. The industry flourished with the aid of large subsidies, so much so that by the mid-2000s domestic raw materials production could not fully supply the needs of Chinese steel mills, which were forced to turn to imports to augment their sources of iron ore.\textsuperscript{717} The rising need for imports crystallized Beijing’s objectives in the international iron ore market\textsuperscript{718}: to control price inflation; and to develop and maintain stable and long-term sources of supply by building strong relationships with suppliers.\textsuperscript{719}

Asymmetry is the question whether the disruption costs faced by Australia and China differ in the bilateral trade of iron ore. This calculation cannot be made directly because the measure cannot be observed; iron ore trade has not been significantly disrupted. Yet examining the relative market power of Australian suppliers and Chinese steel mills—revealed in price negotiations between the two parties—offers relevant auxiliary evidence. As discussed in the next section, the consistent ability of Australian suppliers to extract favorable prices from Chinese buyers signifies that China’s need to buy has at least equaled (if not exceeded) Australia’s need to sell, reducing the credibility of any threat to disrupt the iron ore trade. Similarly, the conditional welcome given to Chinese FDI is evidence that Australia does not feel dependent on Chinese investment to develop its iron ore resources.

\textsuperscript{717} Wilson 2011a, 290-91.

\textsuperscript{718} This development was not confined to iron ore, but here the focus is on iron ore since this was by far the largest proportion of bilateral trade with Australia, as well as the most contentious; it therefore offers the most analytical leverage in studying interdependence.

\textsuperscript{719} Dou (2012, 135) highlights speeches given by Vice President Xi Jinping in 2010 and Vice Premier Li Keqiang in 2011 calling for deeper and more stable trade and investment relations with resource suppliers.
Prior to the 2000s, the Asia-Pacific iron ore market was characterized by a high-level of firm concentration in both suppliers—the “Big-3” giants Brazil’s Vale and Anglo-Australian companies Rio Tinto and BHP Billiton—and customers from Japan, South Korea and China. Unlike most other minerals, sales volumes were determined by long-term contracts and prices set to annual benchmarks negotiated between representatives from both sides. After contract obligations were met, a parallel spot-market allowed suppliers and customers to buy and sell excess inventory. But the largest volumes were sold by contract, making benchmark negotiations tactical and often tense affairs which commanded the attention of national governments.

As China’s global share of crude steel production rose from 18 to 47 percent between 2001 and 2009, its steel industry replaced Japan’s as the largest regional customer and in 2005 Chinese steel producers took over benchmark negotiations. Inexperience meant they did not inaugurate their tenure as lead negotiators successfully; the Big-3 suppliers were able to achieve an unprecedented 71.5 percent increase in the negotiated benchmark price in 2005. Shocked and outraged by the defeat, the Chinese government responded by releasing a national *Iron and Steel Industry Development Policy*. A central pillar of the Policy was to introduce a licensing system for Chinese steel producers under the coordination of the China Iron and Steel Association (CISA). The program’s initial purpose was to “stabilize” prices, but by 2008 CISA was openly aiming for “cartelization”—the effort to increase China’s monopsony power by

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720 Wilson 2012, 332-33. Wilson observes that Chinese steel producers were especially exposed to iron ore price inflation as their product mix was concentrated in lower value-added steel for which raw materials comprise a high proportion of total costs.

721 The same month, the Australian government recognized China’s ‘market economy status’ under World Trade Organization rules, only the second country to do so. This earned Australia much goodwill in China: Zha 2013.
presenting steel mills together as “unified front” in benchmark negotiations.\textsuperscript{722} The cartel achieved early successes from 2006-2008; CISA and its lead negotiator Baosteel succeeded in dividing and conquering the Big-3 and achieving more favorable prices.\textsuperscript{723}

Concerned by the cartel’s successes and frustrated with the uncertainty, politics and brinkmanship of benchmark negotiations, the Big-3 regrouped in 2009 and put forward a radical proposal to eliminate benchmark negotiations and link contract prices to the spot market.\textsuperscript{724} Realizing the change would neutralize their cartel’s power, CISA rejected the proposal and a negotiating deadlock ensued. The Chinese would blink first. The problem for CISA was that to maintain a tough negotiating stance it directed its steel mills to boycott the spot market until a benchmark price was finalized. As the deadlock dragged on, the spot price fell and smaller mills began ignoring CISA’s directive by making purchases on the (now) cheaper spot market, massively undermining CISA’s negotiating position.\textsuperscript{725} The cartel defections demonstrated the inability of CISA to control every steel producer, and gave an opening to the suppliers to press for a better price.\textsuperscript{726} But before this could happen, a larger shock would rock the negotiations.

\textsuperscript{722} Wilson 2012, 335.
\textsuperscript{723} At one point during tense 2008 negotiations, Australia’s Trade Minister Simon Crean filed a formal complaint regarding a boycott by Chinese steel mills of Australian iron ore shipments, and threatened to raise the matter with the WTO: “Crean Tackles Chinese over Iron Ore Wrangle”. \textit{Sydney Morning Herald}, April 18, 2008, 24; “Ore Boycott: Heat on Rudd”. \textit{Australian Financial Review}, May 17, 2008, 3. Later in 2008, Chinese steel manufacturers were able to organize a short-term boycott of Vale, which included emergency stockpile sharing between firms, forcing the Brazilian company to withdraw its price demands: Wilson 2011b, 257.\textsuperscript{724} The proposal was justified on the basis that it would improve transparency in price-setting and decrease the level of price uncertainty in the market.\textsuperscript{725} “Impasse Over Iron Ore Continues”. \textit{China Daily}, June 26, 2009; Wilson 2011b, 258-59. Attempts by CISA to restore discipline by reinig in the smaller producers were overruled by the Chinese Ministry of Commerce (from which CISA received its coordinating authority) on the grounds that cutting off the supplies of the smaller mills would harm the industry: Ibid. Wilson (2011b, 259) cites the “lack of Chinese political will to pay the short-term costs of a boycott war” in addition to newfound unity amongst the Big-3 as critical in destroying the Chinese cartel.\textsuperscript{726} A possible factor in the smaller mills’ decision to depart the cartel was that they had been treated poorly by the cartel arrangements, often being forced to buy the lowest quality ore at the highest prices while larger mills skimmed the highest quality materials: “China’s Iron Ore Confusion is Good News for Australia”. \textit{Sydney Morning Herald}, April 13, 2009, 19; Wilson 2012, 336.
On July 5, 2009, in the middle of these tense negotiations, four Rio Tinto employees working on the iron ore negotiating team were arrested in Shanghai for allegedly stealing “state secrets” and paying bribes to learn the Chinese negotiating position.727 One of the four was a naturalized Australian citizen named Stern Hu. The handling of the arrest caused worldwide controversy with Rio Tinto strongly defending its employees; doubts were widespread regarding the veracity of the claims and no clear evidence was ever produced proving the allegations.728 The charges were later reduced with no explanation, though Stern Hu would later admit in March 2010 to receiving bribes and receive a lengthy prison sentence. Yet the timing of the arrests and identity of the accused meant that this was far from a simple bribery case.

Various theories emerged to explain the arrests. These included that the arrests were a tactic to obtain leverage in benchmark pricing negotiations,729 that they were retribution for the failed Chinalco-Rio deal (discussed below),730 or that they were part of complex and sometimes personal political infighting within China’s steel industry.731 Whatever the reasons, there is evidence to suggest that either President Hu or the Chinese Communist Party Standing Committee (or both) were involved in the decision to arrest the Rio employees,732 indicating how seriously China’s leaders took the negotiations and the Australia relationship.733

The Rudd government, for its part, maintained a robust and consistent stance. While initially refraining from commenting on the matter, mounting domestic outrage forced Rudd to speak up on July 15 by reminding China that it had “significant economic interests at stake” and that

730 “Australia Warns China Over Rio Tinto Charges”. Vancouver Sun, July 16, 2009, B5.
733 Solberg 2013, 86.
China’s trading partners “will draw their own conclusions as to how it [the arrest] is conducted”. While the government was criticized for not asserting its right to full consular access to Hu and presence at his trial, there is certainly no evidence that the government felt specifically pressured by the arrest or the broader pricing negotiations (a benchmark price was still to be finalized) to accommodate China’s interests in any substantive way.

However, for that year’s negotiations, and indeed the entire benchmark system, the Hu arrest was pivotal. With a key member of Rio’s negotiating team in jail, agreement became impossible, and a nervous market sent spot prices soaring. Fearful of the potential damage to the steel industry of perpetuating the dispute, CISA chose to concede defeat and officially authorized spot market purchases by steel mills. But the long-term damage had been done; the Big-3 refused to send staff to China to negotiate when the next round of negotiations was scheduled to commence in early 2010, and subsequently declared they would no longer participate in price negotiations at all, jointly proposing a quarterly benchmark pricing scheme linked to the spot market. Though the Chinese government threatened tariffs in response, the miners held their nerve and won—the final agreement for the new pricing system coming a day after Stern Hu was jailed for 10

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736 The contentious negotiations and arrest were part of a sequence of negative shocks to the relationship in 2009 (with the Kadeer controversy still to come), and both governments would quickly look to move on and restore positive ties.


The outcome caused massive financial losses for China because high prevailing spot prices saw the contract price double within three months. Following the transition to spot market pricing, the Australian exporters gained an estimated $7 billion in extra revenue in the first 18 months of the new system. Evidence continued to mount throughout 2013 of Chinese frustration with the continued market power of suppliers.

Beijing was unable to convert its position as the world’s largest importer of iron ore into negotiating leverage over benchmark iron ore prices. Between 2005 and 2010, the price of Chinese steel increased by 33 percent, while the price of iron ore rose 116 percent. The Secretary General of CISA, Shan Shanghua, attributed this failure to “too many players” in the Chinese steel market. In Kevin Rudd’s words, “in quality, price and proximity, the iron ore Australia provides to China is without peer, and is not easily replaceable elsewhere on the world market”. The absence of market power in price negotiations is strong (albeit indirect) evidence that the costs of disrupting iron ore trade with Australia would have been prohibitive for China, meaning Beijing could not credibly threaten the relationship. Economic interdependence in the iron ore industry was symmetric during this period, or perhaps even favorable to Australia, a finding consistent with the expectations of the theory of asymmetry regarding resource economies.

*Chinese foreign investment in Australia: Conditionally welcome*

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744 Dou 2012, 134.
746 Rudd 2011.
The second pillar of the *Iron and Steel Industry Development Policy* of 2005 was to promulgate a financial support program to allow state-owned steel producers to invest in foreign mining projects with the aid of concessional loans from state-owned banks. The program had two central goals: first, to increase global supply and enhance resource security, including by locking up long-term supply contracts; and second, like cartelization, to dilute (in the words of the Chairman of Baosteel) the “monopolistic” bargaining power of the Big-3 and increase Chinese leverage during price negotiations.747

Australia was at the top of China’s list of preferred investment destinations because of its stability, proximity and the high quality of its iron ore and other resources. Between 2002 and August 2010, 36 of the 49 overseas investments made by Chinese firms in iron-ore and metallurgic coal projects (totaling at least A$40 billion) were in Australia.748 But from the Australian government’s perspective, Chinese FDI was only conditionally welcome. Yes, Chinese demand and the investment that accompanied it had provided jobs and generated wealth, helping insulate the Australian economy from the global financial crisis in 2008-09.749 Nevertheless, the rapid takeoff of Chinese investment sparked fierce domestic debate and widespread anxiety because of the nature of both the assets involved and their Chinese suitors. FDI was probably the single most contentious and high-profile political issue vis-à-vis China in

748 Australian projects received two-thirds of the A$40 billion: Wilson 2011a, 291-295. Many investments included ‘off-take’ agreements where the investor could purchase a large share of the production output even while owning only a minority stake in the company.
749 The Department of Treasury (2010, 2-3) wrote that: “Australia has largely avoided the business failures and large-scale employment losses that have occurred in many other countries... The positive outlook is being increasingly underpinned by an improved global outlook and by our close trade links to the rapidly growing Asian region, and in particular China”. Chinese capital was especially attractive to the many smaller mining operations that had sprung up to meet the resources boom between 2005 and 2007, but were mired in cash-flow problems during the financial crisis: Huang and Austin 2011, 54.
Australian politics during this period. This one issue captured perfectly the fact that the
Australian public only welcomed economic engagement with China on its own terms.

Foreign investment in Australia’s commodities sector is a sensitive issue no matter the source,
due to a reluctance to cede control of strategically or symbolically important firms or industries.
Such attitudes are driven less by specific cost-benefit calculations and more by innate desires to
preserve national control in the mining and agriculture industries. Despite the criticism of
appeasing nationalist sentiment, Australian leaders have vetoed several high-profile investments
over the years.\textsuperscript{750}

Chinese FDI arouses two specific concerns. First, China’s potential status as a security
competitor has seen a small number of mining investments vetoed because of their proximity to
military sites,\textsuperscript{751} while Chinese telecommunications supplier Huawei was barred from submitting
a tender to build a national broadband network due to cyber-security concerns.\textsuperscript{752} Second, the
state-controlled nature of Chinese resource companies also creates the perceived risk that, as
investors, SOEs might engage in non-commercial behavior in pursuit of China’s broader national
interests at the expense of Australia’s. To reduce this risk the Australian government has pursued
two related policy objectives: first, to minimize the instances where Chinese interests could gain
control of Australian firms or projects which gave them the power to act non-commercially; and

\textsuperscript{750} Examples include Royal Dutch/Shell’s seeking full control of petroleum producer Woodside in April 2001; a
merger between the Singapore and Australian Stock Exchanges in April 2011; and an American agribusiness
company’s bid for Australia’s largest listed agribusiness company GrainCorp in November 2013. See: “Costello
Loses Interest in Good Policy”.\textit{Australian}, April 24, 2001; “Merger Inquiry Won’t Find Anything Contrary to
National Interest”.\textit{Australian}, April 8, 2001; “Graincorp Takeover Veto Raises Foreign Investment Fears”.\textit{Wall

\textsuperscript{751} In March 2009 the Australian government blocked an initial takeover for OZ Minerals by a Chinese company
because one of the assets was situated too close to a missile range. The offending mine was cut out and the smaller
deal was later approved: “Shock as OZ Deal is Shot Down”.\textit{Australian}, March 28, 2009, 25; Uren 2012, ch. 6. Later
in 2009, a Sino-Australian joint venture was vetoed because it included an iron ore deposit which fell within a

second, to prevent any behavior which might disrupt the smooth operation of the Australian market.\footnote{Yao et al (2010) show in a simple model how the augmentation to China’s national power achieved by gaining greater control over strategic resources can outweigh the costs of entering into otherwise commercially unfavorable deals.}

Chinese FDI first became politically sensitive in early 2008 when state-owned giant Chinalco (Aluminum Corporation of China) made a one-time ‘dawn raid’ purchase of $14 billion (9 percent) worth of Rio Tinto shares, at the time by far the largest overseas investment ever made by a Chinese company.\footnote{“Alcoa and Chinese Rival Buy 12% Stake in Rio Tinto”. \textit{New York Times}, February 2, 2008, 1. Chinalco contributed $12.8 billion of the $14 billion investment giving them a nine percent stake, while American aluminum firm Alcoa contributed the remainder. The purchase was of shares listed on the London Stock Exchange and fell short of the 15 percent threshold, Chinalco thus arguing it did not require Australian government approval. Nevertheless, it voluntarily submitted an application for approval to the government which was ultimately approved with some conditions attached: “Australia Govt Stance on China Invest to Be Clarified”. \textit{Dow Jones Newswires}, September 17, 2008.} Funding for the investment came from China’s Export-Import Bank and was approved by the State Council, creating the perception in Australia that the purchase was a strategic maneuver by the Chinese government to thwart an ongoing takeover attempt by BHP Billiton of Rio Tinto.\footnote{“Chinalco’s $14bn Move Shows Political Savvy”. \textit{Financial Times}, February 2, 2008, 9; “China and Rio in a Torrid Affair”. \textit{Australian}, May 13, 2009, 31. Uren (2012, ch. 5) writes that Rudd had personally informed Chinalco’s Australian leadership that the investment would be approved, but that anything further was out of the question.} Seeking to allay the public’s concerns the Rudd government quickly announced new principles which would guide governmental decisions whether to allow foreign investments by SOEs.\footnote{“Foreign Investors Face Strict Scrutiny”. \textit{Sydney Morning Herald}, February 18, 2008, 1. Existing law required foreign companies seeking to acquire a stake in a company greater than 15 percent to make an application to the statutory Foreign Investment Review Board which would make a recommendation to the Treasurer, who had the final authority to determine whether the proposal was in Australia’s ‘national interest’. These new principles gave greater detail on how the government interpreted the question of national interest.} While denying that the new principles specifically targeted China, the timing was a clear signal to Chinese investors that investment by SOEs would be closely scrutinized and limited when not in Australia’s best interests. In a speech to the Central Party School in Beijing in June of that year, Treasurer Wayne Swan specifically raised foreign investment and Australia’s “aim of maintaining a system in which investment and sales decisions
are driven by market forces rather than external strategic or political considerations”. Between April 2008 and June 2010 four Chinese investments in the minerals industry were rejected (including the two on national security grounds discussed above), while another four were burdened with additional conditions.

A high-profile test of Australia’s resolve to reject Chinese FDI came the following year, when Chinalco followed up its initial Rio Tinto purchase with a proposal to increase its ownership to 18 percent and thereby obtain the right to appoint two Board members. From a commercial perspective, the deal was not a good one for the Chinese and had to be financed by state-owned banks at discounted rates. This fact inevitably highlighted the non-commercial benefits of the deal; Chinalco would control the marketing of a significant proportion of Rio’s production from which it could, theoretically, pressure the company into unfavorable deals with Chinese

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757 Swan 2008; Uren (2012, ch. 5) writes that the reference to foreign investment was “passed very lightly over” and that Swan otherwise was granted very generous access to China’s top leadership who wanted to discuss the Chinalco-Rio deal and other potential investments.

758 Wilson 2011a, 287-88. Wilson (2011b, 245) points out that the Australian government had only intervened on one other occasion in a foreign investment since 1992 and that was to block Royal Dutch/Shell’s takeover of Woodside in 2001.

759 Rio Tinto had endured a bad 2008 during which profits fell by 99 percent and debts rose to $34 billion. Weak and vulnerable to a takeover, the Chinalco deal would inject $20 billion in funds, the logic being to buttress the company’s finances and buy it time to rebuild: Yao et al 2010. Aside from the increased shareholding and the board positions, Chinalco gained part ownership of certain strategic mining projects.

760 The interest rate for the investment was only 90 basis points above the London Inter-Bank Offered Rate (LIBOR), some 255 basis points lower than what BHP Billiton could obtain on the open market at the same time: Huang and Austin 2011, 51. Since investing $14 billion in the February 2008 thwarting of BHP, Chinalco had suffered over $10 billion (70 percent) in paper losses due to Rio’s declining share price.
customers. The perceived concern was only heightened when the head of Chinalco departed the company just days after drafting the deal to join the Chinese government’s State Council. The Australian government was caught between the desire to maintain positive relations with Beijing and strong domestic opposition. Probably to its immense relief, Canberra was saved from making a decision after Rio Tinto pulled out at the last minute, announcing instead a new partnership with BHP Billiton and separate capital-raising to meet its needs. A furious Chinese government threatened trade sanctions for the two giants if they did not submit their partnership for approval from Chinese regulators. At least publicly, this possibility was dismissed by the Australian government, with Resources Minister Martin Ferguson describing the threat as “argy bargy” and responding: “you can expect some angst but I believe we’ll return to a normal commercial alliance”, later telling reporters that “in terms of the future, Australia needs China and China needs Australia”. Treasurer Wayne Swan echoed these sentiments: “Obviously, any

761 Yao et al 2010, 323. The conservative opposition leader Malcolm Turnbull cited the conflict of interest as grounds for his opposition to the deal: “Turnbull Against Chinalco Deal”. Australian Financial Review, May 1, 2009, 3. However, Australia’s anti-trust authority, the Australian Competition and Consumer Commission issued an opinion in March 2009 stating that it did not believe that the deal would lessen competition in any relevant market because any attempt to lower the world price would be neutralized by reductions in output by other suppliers: Australian Competition and Consumer Commission 2009; “China Caution as Rio Cleared”. Australian, March 26, 2009. The Chairman of CISA was quoted by Bloomberg saying “this will help break the duopoly of Australian iron ore supply over the long term”: Uren 2012, ch. 6.

762 “China Digs In”. Australian, February 18, 2009, 11.

763 This included an unprecedented op-ed in April by China’s Ambassador to Australia which claimed that “Chinese companies investing in Australia, state-owned or private, do not seek to control Australia’s energy or mineral resources”: Zhang, Junsai. “Chinese Firms Seek to Invest, Not Dominate”. Australian, April 2, 2009, 12.

764 The delay caused by uncertainty over government approval had allowed time for global markets to recover, reducing the attractiveness of Chinalco’s offer to Rio’s shareholders: “Rio Dumps Chinalco for Raising and BHP Deal”. Australian Financial Review, June 6, 2009, 3. There was also suggestion that the BHP Billiton deal had the support of the Rudd Government: “Chinese Puzzle over Canberra’s Reasoning”. Sydney Morning Herald, June 16, 2009, 18. However, this deal was opposed by both anti-trust authorities and steel producers around the world, and was abandoned in October 2010: “Three Times Unlucky for Rio”. Wall Street Journal Online, October 18, 2010.


766 Ferguson continued: “I don’t expect to see any trade sanctions because in the end I think China and companies such as BHP and Rio will get through what is really on the agenda at the moment and that’s the round of commodity price negotiations”: “Australia Shrugs Off China Resources ‘argy bargy’”. Agence France Presse, June 12, 2009; “Canberra Wary of Beijing, Tokyo Ire”. Australian Financial Review, June 12, 2009, 3.
such actions would not be in anyone’s interests including China and the many Chinese businesses that depend on Australian materials.”\textsuperscript{767} It is telling that both these statements emphasize China’s dependence (albeit mutual) on Australia.\textsuperscript{768}

Australia’s inward FDI policies clearly became less accommodating of Chinese interests from the moment the new guidelines were released in February 2008 after Chinalco’s dawn raid. This willingness to displease China suggests that Australia’s need for Chinese capital was limited and insufficient motivation to overcome broader interests in protecting the integrity of the resources sector. Even the business community, the constituency one would expect to have put the most pressure on the government to accommodate Chinese investors, was itself divided on the issue. On one hand, many Australian miners and associated industries welcomed Chinese capital, which during the global financial crisis brought needed financial relief (as in the Rio Tinto case) and the opportunity to undertake new, higher-cost projects that would otherwise have struggled to attract local funding. These parties expressed concern that Chinese investors felt “discriminated” against and implied that Australia might lose out;\textsuperscript{769} one prominent industry figure, Clive Palmer, went as far as describing the government’s approach as ‘racist’.\textsuperscript{770}

On the other hand, even the most vocal supporters of Chinese investment—such as Australia’s third-largest iron-ore miner Fortescue Metals and its renowned CEO Andrew Forrest—have been at pains to emphasize the Chinese investment must be passive and “respect Australian sovereignty”.\textsuperscript{771} As Fortescue’s own Head of Government Relations said at a Senate hearing:

\textsuperscript{767} “Canberra Wary of Beijing, Tokyo Ire”. \textit{Australian Financial Review}, June 12, 2009, 3.
\textsuperscript{768} Solberg 2013, 83.
\textsuperscript{769} Larum and Qian 2012.
\textsuperscript{771} “Fortescue Deal a Yardstick for Future Investment”. \textit{Australian Broadcasting Corporation News}, April 1, 2009.
“I will be quite clear about what our fear is: investment in expanding production for the sole purpose of increasing supply to drive the price down. If you are the Chinese government and you own both the company and most of the steel mills, it can be in your interest to engage in such commercial activity.”

According to this logic, Chinese SOE’s (financed by the Chinese government) could undertake investments that would never need to pass orthodox commercial tests of profitability, because if the investment succeeded in lowering the overall price of iron ore, the loss from the individual project would be offset by a net gain for the Chinese steel industry as a whole. In 2011, China imported approximately $112 billion of iron ore; reducing the global price of iron ore by even one percent would accordingly save China’s steel industry over a billion dollars. While it is far from certain that such an outcome could practically be realized given internal company constraints and the global market response, this was perceived as a salient risk amongst both the Australian policymaking and business community at the time. Moreover, Chinese FDI has proven unpopular with the Australian public. All the major non-government parties were opposed to Chinalco’s second (failed) Rio Tinto bid, and a 2009 poll found 57 percent of Australians believed in resisting Chinese investment in mining companies. Two 2010 surveys of investors further illuminated skepticism of the Chinese government.

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773 More, for example, than the A$844 million investment made by Chinese steel group Hunan Valin to acquire a 17.5 percent stake in Fortescue Metals in April 2009. The assessment of the second proposed Chinalco deal in 2009 by the Australian Competition and Consumer Commission actually stated as an assumption that such market-manipulation would be possible: Australian Competition and Consumer Commission 2009, 8.
774 Drysdale and Findlay (2011) argue that such anxiety is unfounded, citing the well-established and robust taxation and regulatory networks in Australia.
776 A majority in one survey opposed Chinese buying stakes in Australian companies, while 81 percent in the other survey believing human rights should play a role in the China relationship, with 40 percent seeing Chinese firms as typically “under government influence” (only 19 percent saw China as “just another trading partner”): “Most Wary of China’s Big Spend”. Australian Financial Review, February 22, 2010, 19; “Attitudes Towards China Start to Harden”. Sydney Morning Herald, January 29, 2010, 7. Of those who supported China’s investment in Australia, 85
The totality of this evidence—the Australian government’s policy choices, a conflicted business community and skeptical public—leads to the conclusion that the lure of Chinese investment has limited political power in Australia and has not brought about any meaningful policy accommodation. Australia welcomes Chinese investment—after all, the vast majority of applications have been approved, a mere handful with conditions attached—but only on favorable terms, and Canberra will not hesitate to undertake defensive measures to reduce the risk of non-commercial or politically strategic behavior.\footnote{These observed outcomes are consistent with the expectations of the theory of asymmetry and its conceptualization of interdependence as relative disruption costs. Australia has been able to refuse Chinese FDI, and thus disrupt investment flows, because the Australian market is not dependent on Chinese capital. With fully developed and highly liquid capital markets, commercially viable projects can attract investment. Of course, Chinese capital can expand Australia’s productive capacity, but Chinese-sponsored projects are, on average, riskier, a fact reflected by the billions Chinese investors lost in Australia after 2008. \footnote{Loss-making investments are not vital to Australia’s economy. Tony Abbott (while in opposition) told a Beijing audience in 2012: “It would rarely be in Australia's national interest to allow a foreign government or its agencies to control an Australian business”.} Abbott could not imagine percent said majority stakes should be prohibited. Huang and Austin (2011, 82) argue that public opinion may actually guide the determination of “national interest” according to the wording of the 2008 FDI guidelines where public opinion towards a proposal is overwhelmingly negative.\footnote{Wilson (2011b, 246-57) argues that Australia’s ostensibly strict foreign investment rules have been rarely used to shut down Chinese investments, but have been able to ensure that control of Australian iron ore remained with Australian-based firms which are independent of Chinese interests. As Huang and Austin (2011, 96) observe, the Chinese investments that have received unconditional approval have been smaller ‘greenfield’ projects that are still in their exploration and development stages.}}
Australia ever inviting foreign government control because no Australian businesses would ever be so starved of capital that foreign governments would be their only viable source of funds.

**China’s response to disappointment in Australia**

China’s response to its inability to gain sufficient influence over iron ore prices or a strong investment foothold in Australia is also consistent with the expectation of symmetric interdependence. In 2010 CISA announced an import diversification program which would seek to reduce China’s dependence on the Big-3 by importing iron ore from new foreign sources being brought online by Chinese investment.\(^{781}\) In the first six months of 2011 China imported iron ore from 58 countries, compared to 37 countries the previous year, and reduced the percentage of its imports from its three largest suppliers (Australia, Brazil and India) from 81.1 percent to 75.4 percent.\(^{782}\) A further plan promised to build iron ore stockpiles which could be strategically released to “guard against monopoly from global mining companies”.\(^{783}\) This new strategy is likely the result of China’s inability to gain the necessary presence or influence in the Australian market.\(^{784}\) Moreover, SOEs appear to be reforming, diversifying their ownership structure and shifting corporate management policies away from being subject to government dictates, as well as reducing their reliance on soft loans through the state-owned banking

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\(^{782}\)Dou 2012, 134.

\(^{783}\)Quoted in Wilson 2012, 337.

\(^{784}\)Yet despite this diversification program, there is no decisive evidence that Australia’s strict regulatory regime has caused a reduction in Chinese investment. Reilly (2012, 389) cites anecdotal evidence indicating that regulatory scrutiny indeed caused a reduction. An equally likely reason is a general belief in the merits of diversification in combination with some failed ventures and cost overruns in Australia. With the glut of government funding available to Chinese SOEs, they acted with undue haste and inexperience in their Australian investments, meaning latter reductions were an inevitable correction: “China Set to Shift Foreign Target”. *Australian Financial Review*, March 8, 2012, 30; Solberg 2013, 87.
system. Such reforms appear to be further concessions to countries like Australia which demand transparency and market-driven decision-making and have the ability to say no to Chinese investment.

7.6 Conclusion

Economic interdependence with China had a major impact on the structure and performance of the Australian economy in the 2000s, causing a uniquely (for OECD countries) uninterrupted period of economic prosperity. It might therefore have seemed that Australia was the most economically dependent on China. This chapter unpacked the microfoundations of bilateral interdependence by focusing its attention on iron ore price negotiations and Canberra’s treatment of Chinese FDI. The analysis showed that Australian suppliers enjoyed considerable market power in influencing prices, and that the Australian government was willing to restrict Chinese FDI it felt was not in Australia’s interests. The evidence from both these economic linkages is consistent with the expectations of the theory of asymmetry and confirms Hypothesis 1: Sino-Australian economic interdependence is relatively symmetric because China needs the relationship at least as much, if not more.

The narrative that emerges is one of China’s unsuccessful attempts to acquire influence, both for economic reasons to gain a measure of control over supply and pricing, and for political reasons,

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785 The terms of new funding are increasingly based on commercial considerations: Drysdale 2011; Drysdale and Hurst 2012; Larum and Qian 2012; Zha 2013. In addition, anecdotal evidence cited in 2013 suggested that Chinese companies’ preference for majority shareholdings in Australian projects was declining: Zha 2013.

786 Nevertheless, Chinese commentators argue for the need for hua yu quan or ‘power to influence change’ in the global natural resource trade, which continues to drive efforts to acquire control of resources: Zha 2013. Zha also argues that there is less strategy behind Chinese outward investment policies than is commonly believed, claiming that company executives, rather than regulators, initiate investment projects.

787 A similar conclusion is reached by Thompson 2012.
to potentially pry Australia away from its U.S. alliance. There is simply no evidence of Australia systematically accommodating Chinese interests in its security policy, least of all because of economic considerations: a null funding for Hypothesis 2. Rather, the strategy pursued by John Howard of keeping economics and politics separate has been maintained by his successors despite increased political tensions in 2009 creating the perception that the costs of resisting China were rising.\textsuperscript{788} The new conservative government of Prime Minister Tony Abbott, elected in September 2013, appeared to align itself even more firmly away from China and closer to the United States. In October, Abbott declared Japan to be Australia’s “best friend” in Asia,\textsuperscript{789} while in January 2014 Foreign Minister Julie Bishop described the United States as Australia’s “most important economic partner”, a judgment based on the U.S.’ status as the largest investor in Australia.\textsuperscript{790}

No country has debated the rise of China more than Australia, and a review of the voluminous commentary on the subject appears to suggest that Australians feel conflicted by the divergence in their economic and security interests. Undoubtedly, Australia does not want a regional conflict, and does not want to be forced to choose between China and the United States. In person, some policymakers express frustration with a U.S. discourse which focuses on primacy, and express worry that the United States might not fully appreciate the gravity of the strategic shifts occurring in the region. Moreover, Australia does not want to be taken for granted. But the public discourse obscures the reality that, when faced with the risks and uncertainties attached to reversing Australia’s strategic alignment, in neither economic nor security policy is there

\textsuperscript{788} An Australian business executive working on behalf of a Chinese firm, when asked about the cost of poor political relations between Australia and China, responded that they should be measured as lost economic opportunities for further Chinese FDI and Australian access to China’s market, rather than disruptions of existing economic links: Author interview, March 2013, Melbourne.


evidence indicating that an alternative to the alliance exists. In the words of Tony Abbott in November 2013 after China reacted with fury at Australia’s denunciation of their East China Sea ADIZ sparking worries of economic repercussions: “China trades with us because it is in China’s interest to trade with us”. 791

791 “Abbott Won’t Be Bullied on Air Zone Stoush with China”. Sydney Morning Herald, November 29, 2013, 10.
8. CONCLUSION

8.1 Initial motivations

China’s rapid economic development has been a welcome boon for the economies of its East Asian neighbors, especially since it joined the WTO in 2001. China’s massive reserves of labor enabled manufacturing firms to relocate production operations to the mainland to realize significant cost savings. China’s industrialization and urbanization created numerous opportunities for profitable investment and a ravenous demand for natural resources, boosting commodity prices and trade volumes. And China’s middle class has emerged as the largest source of consumer sales growth for many multinational firms. Economic interdependence with China has been a hugely beneficial phenomenon for every state in the East Asian region.

Yet accompanying its economic development has been an equally rapid modernization and growth of China’s military, particularly the expansion of its air and naval capabilities. Many predict China will eventually topple the United States from its role as the dominant military power in the region. Long-simmering territorial disputes have reemerged as a source of tension and Beijing has increasingly talked and acted tough in asserting its interests. China’s neighbors are therefore nervous regarding its long-term intentions and the potential for great-power conflict with the United States. Policymakers are worried that closer security cooperation with the U.S. may damage political and economic ties with Beijing.

The conflicts that East Asian states have faced and continue to face between their economic and security interests are the central motivation for this dissertation. They raise important theoretical questions. Under what conditions does economic interdependence render states vulnerable to influence and coercion and through what mechanism does this occur? Can interdependence ever
actually affect security policy? East Asia’s response to China’s rise is an ideal context to investigate these questions.

8.2 Main findings

The research described in the previous chapters sought to achieve two goals. First, mapping the microeconomic foundations of economic interdependence in East Asia to identify the conditions under which it generates power and vulnerability. Second, to trace the mechanisms of influence which connect economic interests to security policy decision-making and outcomes. My argument and main findings can be summarized in the following propositions.

*Existing measures of economic interdependence do a poor job of measuring economic vulnerability.* By employing aggregate trade volumes and economic size, existing measures cannot account for the bargaining power which can arise within interdependent relationships. Vulnerability and power and are a function of asymmetry in “disruption losses”—defined as the relative cost of alternatives—which aggregates do not capture.

*The vertical fragmentation of production has fundamentally shaped the character of states’ bilateral economic relations with China.* Trade has evolved from traditional bilateral movements of final goods to integrated movements of intermediate inputs within a vertically fragmented transnational production network. Within this network, economies have specialized in different production processes which shape the character of their economic relationship with China. “Resource” economies primarily export natural resources, “factory” economies primarily export intermediate inputs, and “headquarter” economies use FDI to set up subsidiaries in China to manufacture final goods, many of which are sold under national brands to Chinese consumers.
I propose a “theory of asymmetry” which hypothesizes that specialized production profiles do a good job of explaining variations in relative vulnerability. Specialized production profiles determine the specificity of economic relationships and thus the relative cost of switching to alternatives. Resource economies are the least vulnerable because disrupting economic links would be costly to both buyers and sellers, imbuing the relationship with symmetry. Moreover, resources are sold on a global market and both buyers and sellers have alternatives. Headquarter economies are the most vulnerable because their links are the most asymmetric. Headquarter economy products can be boycotted and factory operations disrupted. While such disruption is not costless to Chinese interests, it is relatively more costly for headquarter economy firms—fixed assets inside China cannot be moved and alternative consumer markets are less profitable compared to the growing wealth of China’s emerging middle class. Factory economies face an intermediate level of vulnerability; their interdependence with China is less symmetric than resource economies but more symmetric than headquarter economies. Intermediate inputs progress through delicate and sophisticated production chains the disruption of which would be costly for Chinese assembly operations. Yet the absence of alternatives to China’s assembly hub makes factory economies more sensitive than resource economies to threats to the trading network.

Case study evidence from four countries—Japan, the Philippines, Singapore and Australia—between 2002 and 2013 offers strong support for the theory of asymmetry’s hypothesis on relative vulnerability. The states (Japan) and industries (Japanese cars, Philippine bananas) which suffered the greatest losses from disruption of economic relations with China were those facing significant asymmetry—low disruption losses for the Chinese side but high for the other side. Asymmetry in disruption losses was also identified in the absence of political tensions in
purely commercial circumstances (Singaporean investment in China). States (Australia) and industries (iron ore, semiconductors) with greater degrees of symmetry in disruption losses were relatively less vulnerable to political (or commercial) tensions.

*However, there is very little evidence that economic vulnerability brought about security policy that was relatively more accommodating of Chinese interests.* There is consistent evidence across all four countries that economic interests cannot trump politically salient security concerns which relate to fundamental interests such as territory, sovereignty and autonomy. Even in Japan where economic vulnerability was clearly a significant concern to both firms and policymakers, the need to preserve economic relations with China could not overcome the political salience of the territorial and sovereignty issues in dispute. Moreover, in both Japan and the Philippines, business interests faced strong constraints preventing them from publicly advocating *rapprochement* with China for economic reasons. There was very little evidence during times of high tension that either government felt significant pressure to accommodate China for economic reasons.

*Economic interdependence matters most when it matters least.* Interdependence is not a toothless phenomenon; it enters into the strategic calculus of all states in their formation of both economic and security policy towards China. Singapore’s approach is the most overt, deliberate and sophisticated example of the balancing of strategic interests that all governments must undertake. When the stakes are low, economic benefits are relatively more valuable and governments have every incentive to improve political relations with China to foster growth in the economic relationship (such as the Philippines under Arroyo). When disputes arise, interdependence encourages leaders to act with caution and try wherever possible to seek an amicable resolution of differences; in this sense, economic interdependence at the very least
brings states to the table and makes them willing to talk. But the evidence is clear that neither economic interdependence nor the vulnerability it can generate have caused states to make significant security policy concessions when highly salient issues are at stake.

8.3 Deterring and defending against the economic weapon

The theory of asymmetry presented in this dissertation is a theory of relative vulnerability. Headquarter economies are the most vulnerable, resource economies the least, and factory economies fall in between. Yet by itself this theory at least leaves two questions unanswered. First, what is the extent of absolute vulnerability? Even if they are the most vulnerable in a relative sense, are headquarter economies especially vulnerable in an absolute sense? And vice-versa with respect to resource economies. Second, what are the dynamics of vulnerability looking into the future—will China’s economic leverage increase or decrease? The evidence presented in the case studies provides clues to answering both these questions.

8.3.1 Absolute vulnerability: Lower than anticipated

The relatively opaque nature of the Chinese political system means one cannot determine with certainty whether the instances of apparent economic coercion were ordered and coordinated by senior government leadership, or were the autonomous conduct of subordinates reacting to an overall climate or mood set by official statements and state media. Chinese authorities insist that no official policies were ever in place; Beijing denied instituting a ban on rare earths in 2010 or formal boycotts of Japanese goods in 2012; Philippine bananas were banned for ostensibly

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792 And vice-versa with respect to resource economies.
793 Drifte 2013, 32 (with respect to Japan). This uncertainty was also acknowledged by several Japanese officials working on Sino-Japanese relations in author interviews, Tokyo, June/July 2013. Reilly (2013, 8) similarly observes that China rarely openly declares sanctions.
legitimate quarantine concerns. When asked to explain the sharp drop in sales and imports from Japan in 2012, a Chinese official said “the attitude of Japan has hurt the feelings of the Chinese people”. Japanese officials and observers agreed in interviews that in many cases it was quite plausible that policy decisions were the result of individual units exercising their own initiative. Of course, the refusal of Chinese government officials to meet with their Japanese counterparts then removed a key mechanism through which public animosity could have been diffused.

If China’s economic statecraft takes the form of central authorities setting a ‘tone’ to be acted upon at the initiative of local actors—whether customs officials rejecting Philippine bananas, local governments and SOEs refusing to do business with Japanese partners, or protests and boycotts by individuals—these actors become crucial to economic statecraft. The evidence bears this out; the most important auxiliary finding from the case studies is that the conduct of local actors was decisive in determining the efficacy of attempts to disrupt economic relations.

All four case studies offer important evidence on this point. The Japanese businesses which suffered least during the 2012 crisis were those which had the best relationships with local governments and further, in the case of Dalian where there were no protests, were widely perceived to be critical to the local economy. Market-leading Japanese-branded products such as air purifiers remained free of boycotts because Chinese consumers refused to give them up. Whether a given container of Philippine bananas successfully passed port inspections appears to have depended on the relationship between the importer and individual customs official. The Singaporean government had to remold its investment strategy in China to engage more with

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795 See also Drifte 2013, 32. Note this is not the case in rare earths—no Japanese official interviewed by the author ever expressed doubts that a deliberate policy rare earth export restrictions had been implemented in 2010.
local officials after local interests undermined the commercial success of its high-profile, Beijing-sanctioned projects. Finally, during tense iron ore benchmark price negotiations, the government-backed lead negotiators from the Chinese side were unable to prevent smaller steel producers from defying a directive to boycott the iron ore spot market.

A common thread runs through each of these examples: the conduct of actors at the local level is enormously important if coercive pressure via the disruption of economic relationships is to be accomplished. This point is a reminder that interdependence means disruption costs are borne by both sides of the transaction. While they may be asymmetric, businesses, workers and consumers on the Chinese side do bear costs, and if their behavior cannot be controlled, Beijing’s bargaining leverage will be significantly weakened. While the Japanese case study demonstrated that large losses can be and were imposed on Japanese economic interests, the lack of uniformity in effects highlights the inherent instability of this tool of statecraft. Economic vulnerability exists and leverage can be extracted from it, but once the microeconomic foundations of that vulnerability are understood, the leverage is revealed to be more fragile than it initially appeared.

8.3.2 Deterrence and defense

The importance of local actors in leveraging economic interdependence points to the primary strategy available to firms and governments to help immunize economic links from being used as ‘weapons’. Policies to improve relationships at the local level, aligning the interests of authorities, workers and consumers with the interests of the firm can help it ‘defend’ itself from political tensions when they arise. As described in Chapter 4, Japanese firms learned this exact lesson in the aftermath of the 2012 crisis. For them, such practices—in combination with efforts to diversify away from China—were simply about prudent risk management. A similar lesson
was learnt by Singaporean GLCs investing in Suzhou in the 1990s, though their experience was of vulnerability to commercial rather than political risks. Governments can learn a lot from firms, since efforts by private actors to reduce commercial risks have the positive externality of reducing the overall economic vulnerability of states. Accordingly, by collaborating with and assisting firms (who will often possess much more information on these matters) governments can reduce disruption losses and the degree of asymmetry in the interdependent economic relationship.

The alternative to ‘defending’ against economic disruption through local channels is to deter China’s leaders from seeking to disrupt economic relations in the first place. Successful deterrence requires Chinese leaders to believe they will pay unacceptable costs if economic links are disrupted. Japanese government officials and business representatives were unanimous in expressing the opinion that a necessary condition for the economic measures deployed by China from 2010 onwards has been a strong belief that China enjoys an asymmetric advantage over Japan because of its rising economic power and Japan’s decline. This belief was augmented by China’s economy surpassing Japan’s in size in 2010, and further by the West’s struggles with a global financial crisis occurring at the same time. In the words of one Japanese official, by 2010 “the economic power balance was different”. The belief in asymmetry favorable to China only encouraged the use of economic leverage.

However certain Chinese commentators—such as Hu Shuli, one of China’s chief economic journalists—expressed doubts during the 2012 crisis that punishing Japan economically was realistic because of the job losses caused by boycotts of Japanese goods produced in Chinese

796 Author interviews, Tokyo, June/July 2013.
797 Author interview with senior Japanese official with knowledge of the China relationship, Tokyo, July 2013. The phrase captured a sentiment broadly expressed in almost all interviews.
factories. Nevertheless, the public appeared to disagree, believing that China could withstand losses from disruptions to business relations; parts and materials could be substituted, other brands purchased and, in any event, Japanese firms could never withdraw because of the unparalleled opportunities presented by the Chinese market. This belief was not always consistent with facts, especially in the automobile industry, which ironically was Japan’s most affected sector. While Japanese automakers suffered huge reductions in sales from boycotts, they were not operating independently in China, but partnered with state-owned Chinese firms. For these local firms, the Chinese market constituted a much larger percentage of total sales. Where 15 percent of total sales for Japanese firms came from China, the figure for Chinese firms was closer to 70 percent, meaning these local firms suffered more from boycotts by Chinese consumers.

State-owned and second-ranked Dongfeng Motor, which partnered with Nissan and Honda, and sixth-ranked Guangzhou Automobile which partnered with Toyota, posted 2012 profit decreases of 13 percent and 73 percent respectively. Japanese brands accounted for 40 percent of Dongfeng’s sales and 90 percent of Guangzhou’s. The evident vulnerability of these Chinese firms suggests an informational asymmetry between popular belief about China’s invulnerability to disruption losses and the actual reality, providing an opportunity for Japanese policies to decrease economic asymmetries by reducing the information gap.

The continued courtship by local governments of Japanese firms indicates local actors remained well aware of the losses from economic disruption. Anecdotal evidence suggests that, eventually,
the central government realized this fact too. Chinese sensors apparently blocked the phrase “Boycott Japan” from Weibo in early 2013, and during New Year celebrations that year Beijing banned sales of “Tokyo Big Bang” fireworks.\textsuperscript{803} Ultimately, these anecdotal indications of restraint cannot obscure the fact that the Chinese government appeared to value the appearance of strength and resolve against Japan more than the significant economic losses Chinese businesses and workers were suffering. Nevertheless, Japan’s multifaceted and variable experience with economic coercion offers an important lesson for other governments and firms that may face similar pressures operating in China in the future. The more Chinese economic interests can be demonstrably shown to be losing, the less likely economic disruption will endure.

\subsection*{8.4 Economic vulnerability into the future}

This dissertation’s primary argument is that economic vulnerability varies with the particular production profile of East Asian economies and what each economy does with China. Yet this final chapter has observed that the potential leverage China gains from economic interdependence is inherently fragile due to the important role played by local actors with potentially conflicting interests. How might this situation change in the future?

The evidence suggests that whether the economic vulnerability of East Asia vis-à-vis China will rise or fall will heavily depend on opposing forces created by the change in a single variable—Chinese wages. Rising wages will increase production costs and push firms to look elsewhere to base production and assembly operations, broadening and deepening transnational production

\textsuperscript{803}Katz 2013.
networks and reducing firm dependence on China as a network assembly hub. Moreover, as new production and assembly locations develop, networks will become even more complex and costly to disrupt.

Rising wages will also mean rising incomes, further increasing the opportunities presented by China’s consumer market. As more firms offer their wares to China’s middle class, competition will increase. The greater the level of competition in these markets, the greater the degree of substitutability between products and the more easily certain firms from a given country can be shut out. Perhaps in time a German, Korean or American air purifier will offer the same features as the top-of-the-line Japanese model. Under such conditions, the control the Chinese government can exercise over access to its consumer market will have powerful effects on the profitability of firms. If local interests also enjoy alternative sources of investment, employment and tax revenue, the vulnerability of foreign firms could rise substantially.

It was Keohane and Nye who described interdependence as “complex”.\textsuperscript{804} If nothing else, this project demonstrates how this descriptive term has become even truer in the 21\textsuperscript{st} century. This complexity blurs the lines of power and vulnerability that arise from interdependent relationships. Only through a careful investigation of the foundations of economic interdependence will governments, firms and scholars be able to understand how the phenomenon may shape the bigger questions of power, conflict and regional stability which are being regularly asked by those witnessing China’s rise.

\textsuperscript{804} Keohane and Nye 1977.


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