

East Asia tensions simmer

Marko Papic | BCA Research | 30 May 2016

We have written for some time about the rotation of geopolitical risk from the Middle East into the Asia Pacific.¹ We believe investors are not accounting for the structural shifts taking place in the region that raise the probability of extremely adverse developments – like military conflict – as well as lesser, but still market-negative, events, like growing state intervention, protectionism, and sanctions.

Since our last missive on this topic, several new developments have come into focus:

- The United States and China continue to see relations worsen;
- Japan continues to make progress in lifting its military profile;
- The Philippines is likely to score a "win" against China in international courts;
- China's cooperation in enforcing sanctions on North Korea is insufficient to mend US relations or stabilise the region.

These developments suggest that tensions in China's near abroad will get worse before they get better. Investors should be aware that it is not only China's domestic economy that poses risks to regional and global growth, but also China's tensions with the outside world, which are connected.

SINO-AMERICAN TENSIONS CONTINUE

The US and China always cooperate to some extent, but recent signs suggest they remain deeply at odds – particularly over the South China Sea, where China's accelerating attempts to realise its sovereignty claims have set it at loggerheads with American grand strategy.

As we have outlined before, American grand strategy has long focused on naval supremacy, free movement of commerce, and the prevention of regional hegemony.² China's efforts in the East and South China Seas conflict with all of these ends. The US is clearly seizing the opportunity to coordinate more closely with Japan, South Korea, Taiwan, Southeast Asian states, and others to prepare a full-fledged "containment policy." From China's perspective, such a policy is already in full motion.

Most recently, China has continued to install civilian and military hardware on islands it controls – including advanced HQ-9 surface-to-air missiles on Woody Island, in the Paracel Islands. Meanwhile the US insists that China promised not to "militarise" the various disputed islands and that any good faith on the issue has been broken. As a result, Secretary of

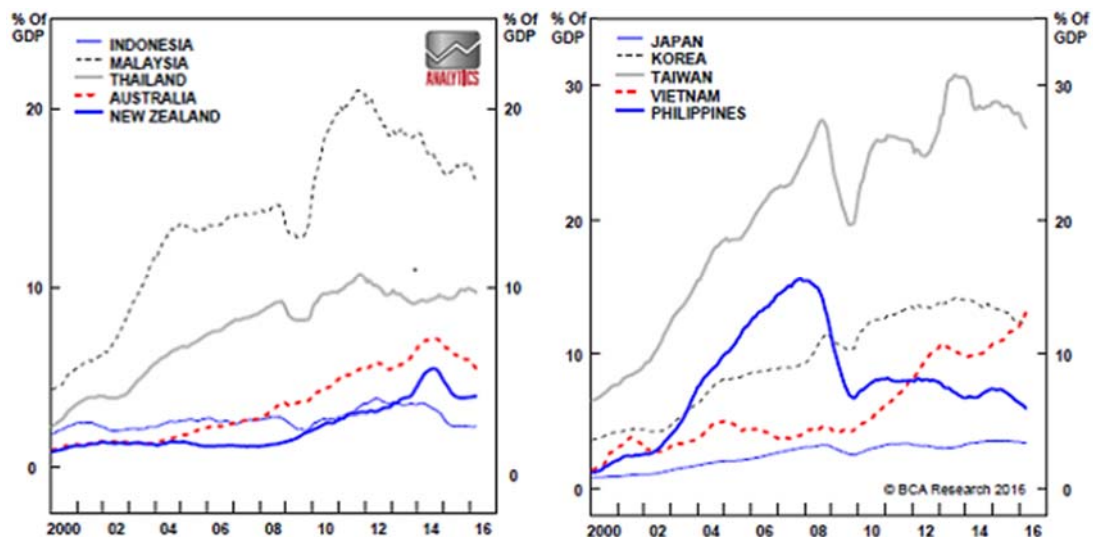
Defense Ashton Carter has canceled his trip to China, to go to India instead, raising questions about the continuity of US–China military–to–military relations. In addition, the US and Japan pushed for the latest G7 meeting to make a thinly veiled statement against China's moves.

Until Beijing and Washington come to a substantial agreement to postpone their more profound differences, Asia's reputation as a stable, business–focused region will continue to give way to rising geopolitical risks reminiscent of earlier eras. **This is a paradigm shift that the market has not even begun to price.**

Nevertheless, to really understand the negative trajectory, it is important to see what is happening within the region and how America's new engagement interacts with it.

Souring relations between China and its neighbors speak volumes. Almost all of Beijing's neighbors are distancing themselves from China. This ranges from adversaries like Vietnam and the Philippines, to friends and neutrals like South Korea, Indonesia, Malaysia, and even to Hong Kong and Taiwan. Russia and Pakistan are the major exceptions, but even Russia is hedging via relations with Vietnam and, possibly, Japan.³ China's neighbors are massively exposed to China's economy (Figure 1) and would not challenge Beijing geopolitically if they did not genuinely fear China's hawkish foreign policy.

Figure 1: Neighbours exposed to China
Exports to China

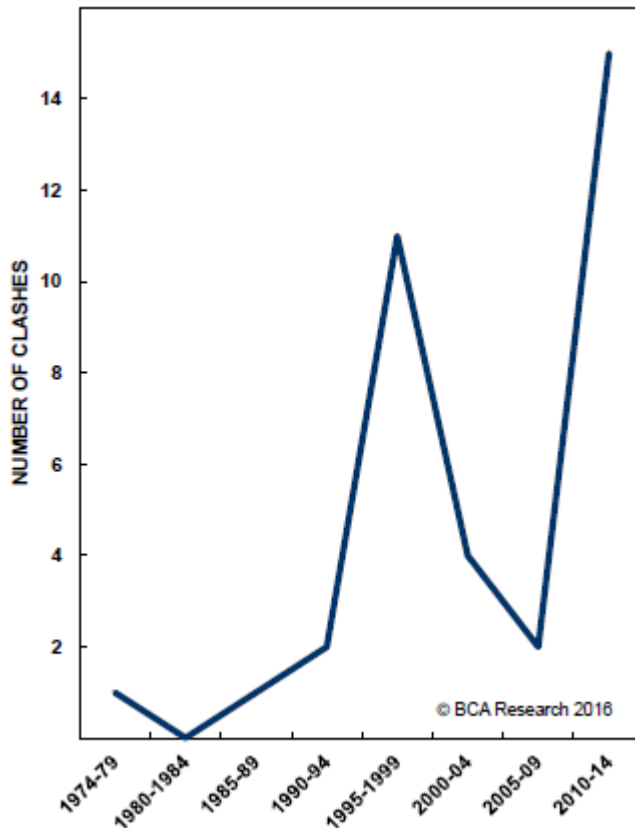


Source: BCA Research

If the maritime–territorial disputes were only about subsea oil and gas or rare earths, then tensions would have decreased with commodity prices in 2014. Instead, they continued to increase – by some measures, dramatically (Figure 2). This is because their root is

strategic. China is extending its national security cordon outward and this process obviously provokes reactions from the neighbors.

Figure 2: The heat is on
Confrontation in the South China Sea



Sources: CNAS; Brad Kaplan, “Rich region, strong states,” University of California Institute on Global Conflict and Cooperation, Policy Brief 2013-7 (April 2013); After April 2012, CSIS AMTI and BCA calculations.

JAPAN'S RE-MILITARISATION RAISES THE TEMPERATURE

Independently of the US, Japan is a major obstacle to China's attempts at regional preeminence. Tokyo's reason for not wanting China to control the South China Sea is the same as China's reason for wanting to control it – supply security. Both are highly dependent on imports of essential goods through this channel, yet Japan cannot trust China to be an impartial policeman any more than China can trust the US to do so. Japan is using its alliances and relationships to deny China the southern sea, while focusing its own forces on solidifying its surveillance and military capabilities across its southern string of islands in the East China Sea, down to Yonaguni near Taiwan (Figure 3).

Figure 3: East China Sea disputes



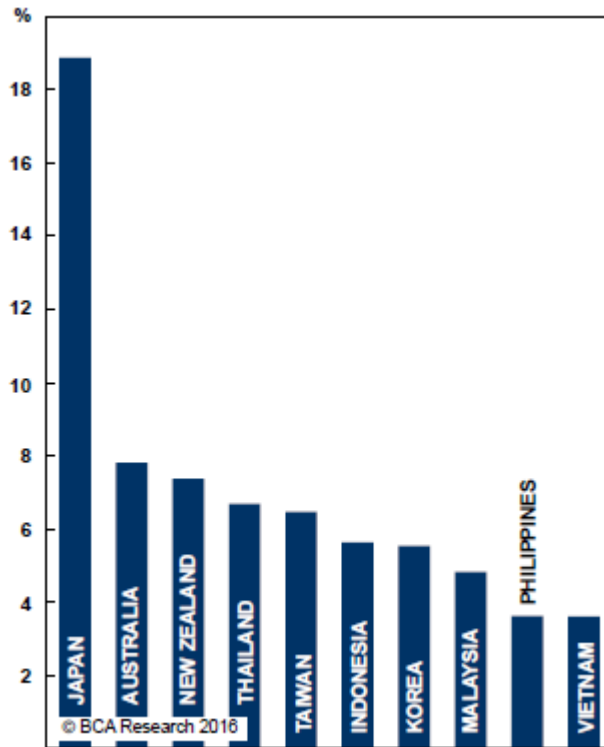
Sources: CRS, BBC.

Investors should be aware that the upper house election in Japan in July is not important primarily for its impact on the economy. Barring a catastrophic scenario, in which Prime Minister Shinzo Abe calls a general election and loses his supermajority in the lower house, monetary and fiscal policies will continue to develop along the current ultra-dovish trajectory while structural reforms will remain lackluster. Abenomics may disappoint, but it is not yet exhausted.⁴

The election is really pivoting on the issue of revising the post-World War II constitution and widening the legal and political scope for a more assertive Japanese security and defense policy. Constitutional revision will require a popular referendum that will raise a lot of noise in the region if it occurs in the next couple of years. While Japan's new posture may be beneficial, or at least tolerable, for its former World War Two adversaries (since they are now predominantly fearful of Beijing), it is anathema to China and will substantially increase geopolitical risks in the region in the long run.

The high level of Sino-Japanese economic interdependence is often cited as a constraint on conflict. While trade has declined since the China slowdown and Japanese disasters in 2011, bilateral investment remains at a very high level, even in the regional context (Figure 4).

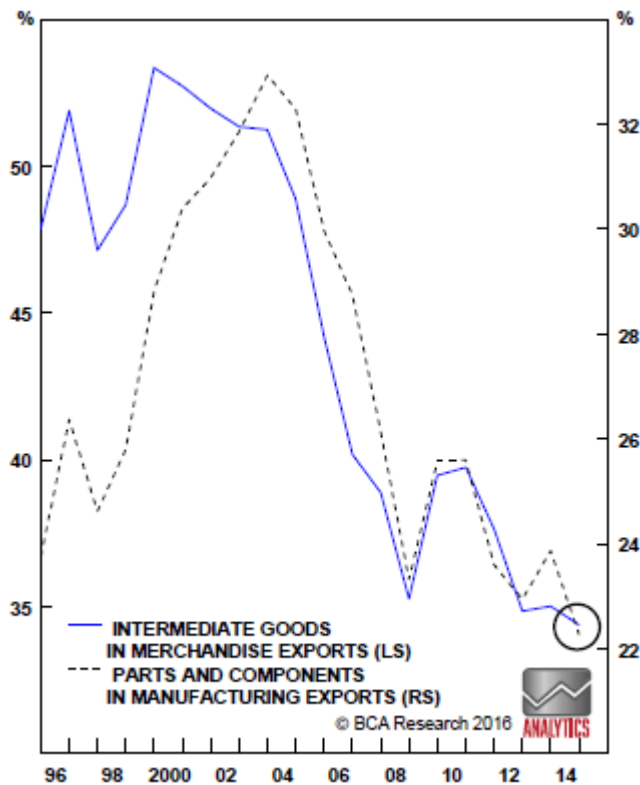
Figure 4: Sino-Japanese investment outstanding
Chinese ODI as % of country's total FDI, 2014



Source: UNCTAD

Looking forward, however, China's rise up the value chain threatens Japan's comparative advantage and removes a source of interdependence (Figure 5). So does China's shift towards more consumer-oriented economy. Beijing will want its sizeable middle class to consume Chinese-made consumer products, not Japanese.

Figure 5: Displacing foreign parts
Chinese import share



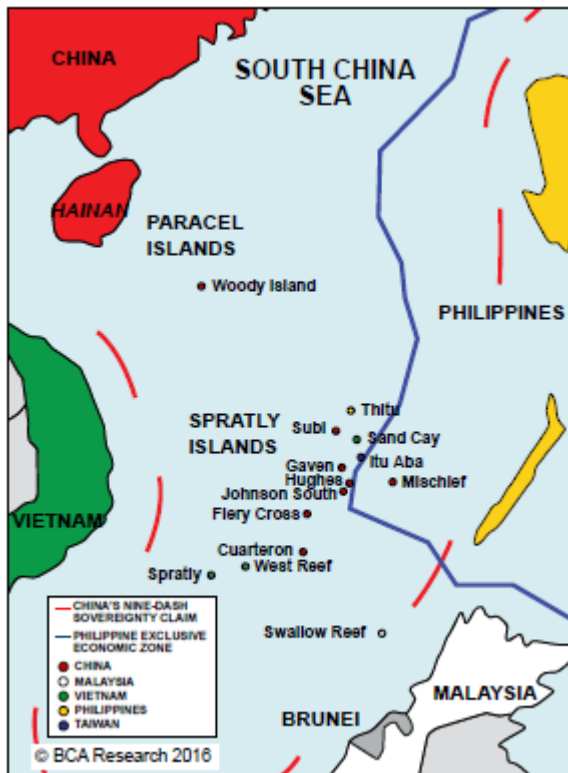
Sources: Cristina Constantinescu, Aaditya Mattoo, and Michele Ruta, "The global trade slowdown: cyclical or structural?" IMF working paper (2015). Data revised and updated in January 2016.

THE PHILIPPINES AND THE EMERGENCE OF "LAWFARE"

Another dark cloud on the horizon is the Philippines. The Permanent Court of Arbitration – a well-established international tribunal that aims to resolve disputes of various kinds between states – is set to rule on a case the Philippines has lodged against China's activities in the South China Sea that has ramifications for the whole region.

The court will not rule on sovereignty or boundaries but on the nature of the geologic features (islands, rocks, elevations) and whether they generate territorial seas and Exclusive Economic Zones (EEZs) (Figure 6). Its decision will probably favor the Philippines, especially since China has refused to participate and defend its view in the proceedings.

Figure 6: South China Sea disputes

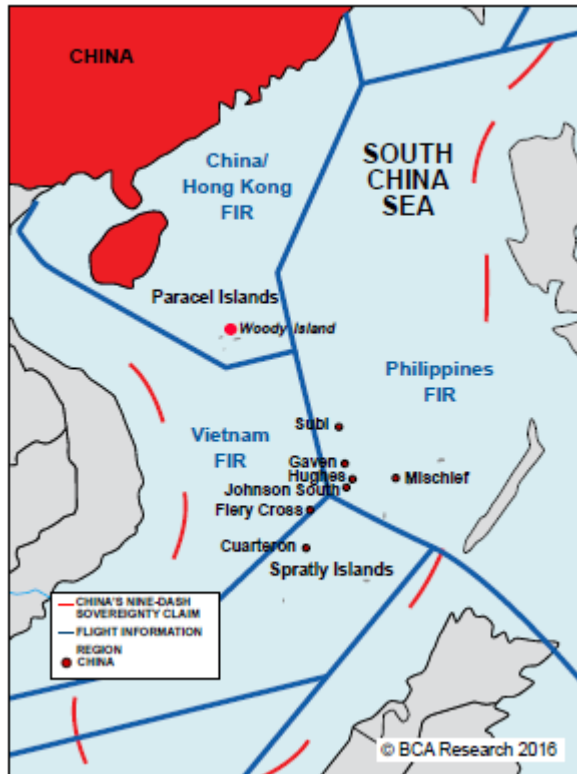


Sources: FAS; CRS.

The ruling is non-binding and unenforceable. China will continue to reclaim islands, build structures, and install hardware – it will probably accelerate the process, and it could also take another long expected step of declaring an Air Defense Identification Zone (ADIZ) that would ostensibly make Beijing the chief air traffic controller over a sea through which 23% of global trade transits (Figure 7).⁵

It has already made steps in this direction, and, thanks to the island installations, it would have better enforcement capabilities in the South China Sea than in the East China Sea, where it declared an ADIZ in 2013 (see Figure 6 above). Beijing may also impose unilateral sanctions of some kind on the Philippines. It has an incentive not to react lightly to a pro-Philippines ruling, lest it encourage more lawsuits.

Figure 7: An ADIZ In the South China Sea?



Source: ICAO.

This trend of "lawfare" in the region ultimately has to do with China's place in the global system.⁶ For decades the goal of the US, Europe, and Japan has been to ensure that China joins rather than overturns the established Western liberal-capitalist world order. The problem is that the established powers are unwilling to change that order as much as China thinks they should to accommodate its needs.

Thus, while an unfavorable court decision will not force China to adjust its maritime posture, it will help to alienate China from the international system. And a victory for the Philippines will likely encourage others to follow suit. Vietnam has supported Manila's claim (having similar disputes with China), and Japan is preparing to wage lawfare by turning to the International Court of Justice (ICJ) over its disagreements with China over resource exploitation in the East China Sea (see Figure 3 above). Investors should expect a legal morass in the coming years that encourages China to speed up its *de facto* control on the ground and in the seas.

In parallel, China will create alternate institutions to legitimise its domestic laws and project them into the international realm. The setting up of alternate legal systems is a recurring feature of the conflict between emerging, revisionist powers and status-quo powers.⁷ An

important difference in East Asia today is the fact that the South China Sea islands and rocks do not provide strategic approaches to invade the core territory of other countries. Rather, this sea is effectively a roundabout – maritime traffic enters and exits from a number of different points and the territory in the middle is inert. The various parties want to be able to police, set up barricades, observe who passes, spy on each other, and exploit whatever resources they can. These motives are apparent from reviewing the chronology of skirmishes and incidents over the past several decades (Figure 8).

Figure 8: Notable incidents in the South China Sea (2010–14)

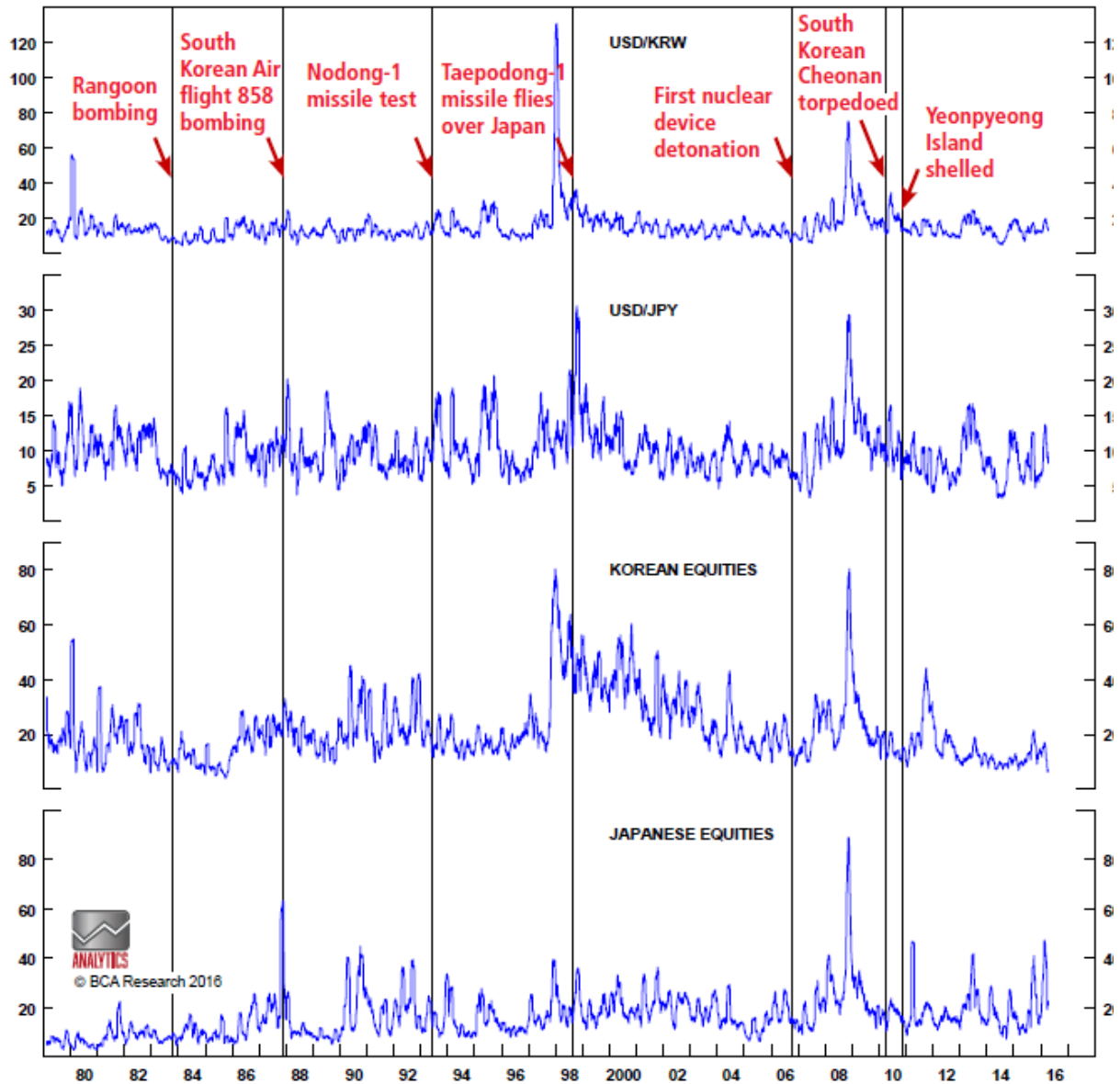
Date	Description	Purpose
Jun-10	Indonesian naval patrols encounter armed Chinese fishing ships that threaten fire.	Military; fishing
Jul-10	Chinese and Indonesian naval vessels capture each other's ships for illegal fishing.	Military; fishing
Feb-11	Chinese missile frigate fires warning shots at Philippine fishing ship ordering it to leave Quirino (Jackson Atoll).	Military; fishing
Mar-11	Two Chinese patrol boats force Philippine seismic survey ship to withdraw from Reed Bank.	Resource survey; policing; surveillance
May-11	Chinese surveillance ships cut the cables of a PetroVietnam survey ship.	Resource survey; surveillance
Jun-11	China fishing administration ships attempting to cut Vietnamese seismic survey ship cables becomes caught in the cables.	Resource survey; policing; surveillance
Jul-11	Chinese military vessels attack Vietnamese fishing crews and drive them from Paracel Islands.	Military; fishing
Jul-11	Chinese naval vessel confronts Indian amphibious assault ship making port calls in Vietnam.	Military; policing
Oct-11	Philippine naval ship rams a Chinese fishing ship.	Military; fishing

Feb-12	Chinese authorities force Vietnamese fishermen away from Paracel Islands. They were allegedly seeking shelter from a storm.	Policing; fishing
Mar-12	Chinese authorities arrest Vietnamese fishermen near the Paracels.	Policing; fishing
Apr-12	Chinese and Philippine naval ships and aircraft engage in showdown over Scarborough Shoal. U.S. holds naval exercises with the Philippines around the same time.	Military; policing; surveillance; fishing
Nov-12	Chinese fishing administration ships cut the cables of the same PetroVietnam seismic survey ship as they did in May 2011. The incident, near Hainan, is declared an accident.	Resource survey; surveillance
Dec-13	Chinese navy ship cuts off the U.S. navy's USS Cowpens while the latter observes China's newly floated aircraft carrier.	Military; surveillance
Mar-14	Chinese coast guard blocks the Philippines navy from resupplying its troops stationed on Second Thomas Shoal.	Military
May-14	Chinese and Vietnamese ships ram each other, and Chinese warplanes fly over, in a confrontation over CNPC's locating an oil rig, HD981, off the Paracel Islands.	Resource survey; military
Jul-14	Chinese ships detain Vietnamese fishermen, accusing them of illegal behavior.	Policing; fishing
Aug-14	Chinese fighter intimidates a U.S. navy reconnaissance aircraft.	Military; surveillance
Dec-14	Chinese coast guard ships harass Filipino and Vietnamese fishing crews near the Paracels.	Policing; fishing
Apr-15	Chinese naval ship warns away a Philippine warplane from Subi Reef.	Military; surveillance

Sep-15	Chinese vessels raid and sink a Vietnam fishing boat near the Paracels.	Policing; fishing
Oct-15	United States begins freedom of navigation operations that send naval ships into the immediate waters of China's artificial islands to challenge Beijing's claims that they are entitled to territorial seas.	Military
Mar-16	Indonesian patrol ships detain Chinese fishermen near Indonesia's Natuna Island; a Chinese coast guard ship rams the Indonesian vessel and takes back the Chinese ship; Indonesia keeps the crew.	Policing; fishing
Mar-16	Malaysia coast guard encounters a large fleet of Chinese fishing boats, escorted by Chinese coast guard, in the Luconia shoals.	Policing; fishing
Apr-16	Vietnamese coast guard arrests crew of fuel ship supplying Chinese fishing vessels.	Policing; fishing

Sources: CNAS; CSIS AMTI; Brad Kaplan, "Rich region, strong states" University of California Institute on Global Conflict and Cooperation, Policy brief 2013-7 (April 2013); Boston Global Forum; SCMP; Thanh Nien news; Jakarta Post.

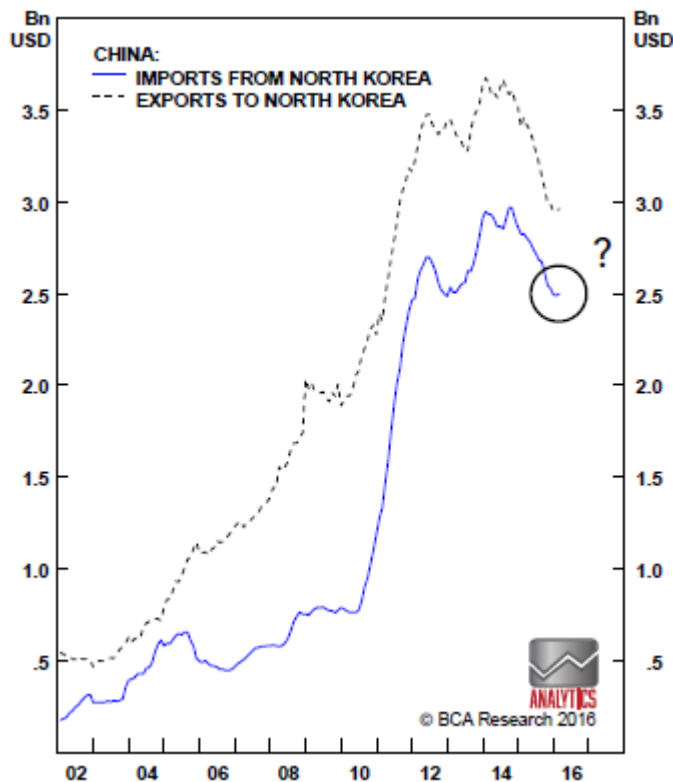
Figure 9: North Korean antics – not moving markets much
30-day volatility



Source: BCA Research 2016

However, we do not think the lack of a breakdown in North Korea is necessarily positive for markets. The country is in an unusually weak and isolated position: it has an untested leader, bad relations with Beijing, weak commodity export prices, and a darkening strategic outlook (Figure 10).

Figure 10: Growing apart

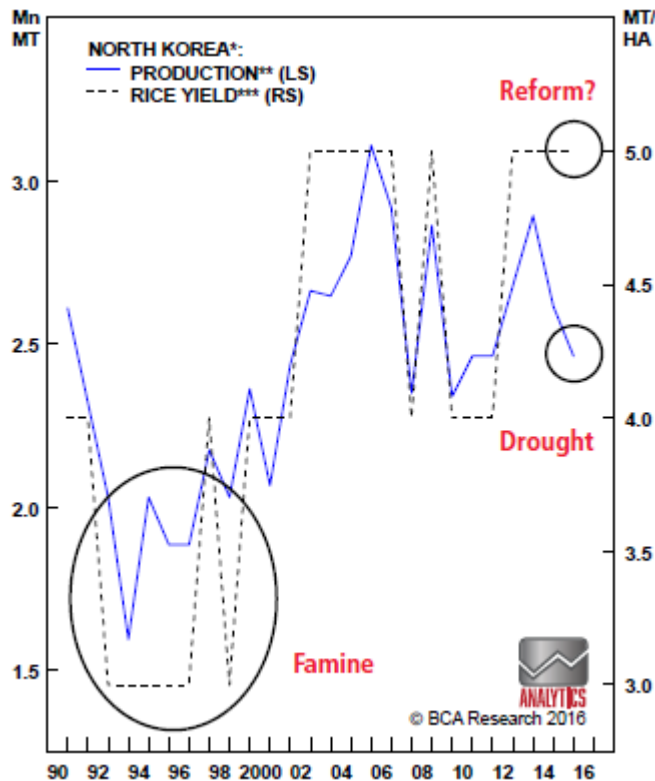


Source: CEIC.

Moreover, the latest round of North Korean provocations prompted Washington to threaten to sanction Chinese entities for skirting sanctions enforcement on the North. This should serve as a reminder that, gradually, the US and China are losing the ability to quarantine the Korean peninsula from their other disagreements. Outrages committed by the North could someday feed into a rupture in US–China ties.

Finally, we continue to think that domestic economic reforms pose as much of a risk to the regime's stability as any geopolitical issues.⁸ At the moment, agricultural reforms may be keeping up crop yields, which is obviously beneficial (Figure 11). But unlike China and Vietnam, North Korea has not yet tried and made it through the risky period of glasnost and perestroika that took down the Soviet Union. Any reforms launched in May will be modest, but history shows that such reforms can take on a life of their own.

Figure 11: Another famine on the horizon?



* Source: USDA Foreign Agricultural Service. **Shown in metric ton. ***Shown in metric ton per hectare.

BOTTOM LINE

East Asia represents a region where multipolarity is in full view. This bodes ill for regional trade and investment. It raises the prospect of more frequent violent incidents that inflame nationalist tensions and motivate strategic balancing by China's neighbors and the United States. Protectionism and punitive economic measures could proliferate, while the tail-risks of military incidents are growing. The risk is not only miscalculation but also obstinacy driven by populist pressures as different states struggle with, and seek to distract from, socio-economic problems. Meanwhile North Korea's situation means that its latent geopolitical risks may become reactivated in the short- to medium-term, given Sino-US distrust.

Regional assets do not exhibit any sign of a geopolitical risk premium, but one ought to begin creeping into markets. Asia- or EM-dedicated investors should hedge their risks by exposure to DM assets.

ENDNOTES

1. See BCA's Geopolitical Strategy Monthly Report, "[The Great Risk Rotation](#)," 11 December 2013, available at gps.bcaresearch.com.
2. See BCA's Geopolitical Strategy Special Report, "[Sino-American Conflict: More Likely Than You Think, Part II](#)," 6 November, 2015, available at gps.bcaresearch.com.
3. In the past month alone (as at April 2016), China had diplomatic incidents over maritime clashes with Vietnam, Indonesia, and Malaysia. Even allies with few other options, like Myanmar and North Korea, have distanced themselves.
4. See BCA's Global Investment Strategy Weekly Report, "[Japan: On The Road To Debt Monetization](#)," 5 February, 2016, available at gis.bcaresearch.com.
5. Air Defense Identification Zones are areas adjacent to a country's national airspace in which aircraft must identify themselves and provide their coordinates upon request by air traffic controllers. They can be intercepted if they do not comply. China is suspected of using its ADIZ to regulate air traffic not intending to go to China and extend control over disputed waters and territories, including the air above the Senkaku/Diaoyu islands it claims against Japan.
6. For the concept of legal war in this context, please see Fu-Kuo Liu and Jonathan Spangler, eds, "[South China Sea Lawfare: Legal Perspectives and International Responses to the Philippines v. China Arbitration Case](#)," Taiwan Center for Security Studies, 29 January, 2016, available at www.scstt.org.
7. The most famous example comes from Louis XIV, who established special courts, the Chambers of Reunion, to revive dormant territorial claims in the Rhineland-Palatinate and Alsace-Lorraine and thus expand on conquests achieved by force, thus prompting a Grand Alliance of European states against him.
8. See BCA's Geopolitical Strategy, "[Strategic Outlook 2016: Multipolarity & Markets](#)," 9 December, 2015, available at gps.bcaresearch.com.



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